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Senator Nellie R. Santiago

Thomas T. Holyoke

Ross D. Levi

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TURNING DAVID AND GOLIATH INTO THE ODD COUPLE: HOW THE NEW COMMUNITY REINVESTMENT ACT PROMOTES COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

Senator Nellie R. Santiago, Thomas T. Holyoke**
and Ross D. Levi****

INTRODUCTION

In 1995, a small Bronx-based community activist group filed suit against the Board of Governors of the Federal Reserve System and the New York State Banking Department in an attempt to halt the merger of two financial institutions into an entity which, to

* Nellie R. Santiago is a New York State Senator representing the 17th Senatorial District in Brooklyn, New York. She holds an Ed.D. from the University of Massachusetts, Amherst, an M.A. from Columbia University and a B.A. from Hunter College.

** Thomas T. Holyoke is Legislative Director for Senator Nellie R. Santiago. He holds an M.A. in Political Science from Syracuse University and a B.A. from Drake University.

*** Ross D. Levi is a Senate Legislative Fellow with Senator Nellie Santiago. He holds a J.D. from Brooklyn Law School and a B.S. from Boston University.

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quote *Julius Caesar*, would “bestride the world like a colossus” as the nation’s largest bank.¹ The basis for this ultimately unsuccessful challenge was that neither of the banks involved had lived up to their legal requirements to lend and invest in the poor neighborhoods they served.² While this particular merger challenge drew a great deal of attention, it was simply one more in a long series of protests by local organizations claiming that some banks are failing to live up to their social obligations to invest in the communities where they conduct business.³ The primary weapons used in these

¹ *Inner City Press/Community on the Move v. N.Y.S. Banking Bd.*, 657 N.Y.S.2d 275, 275 (Sup. Ct. N.Y. Cty. 1996) (denying petitioners motion to vacate an order approving the merger of Chemical Bank Corporation and Chase Manhattan Corporation and their respective subsidiaries and to acquire North Fork Bancorporation, Inc.). For a discussion of the merger of Chemical Bank with Chase-Manhattan Bank, see Press Release from the New York State Banking Department, *Court Upholds Banking Board’s Actions in Chase-Chemical Merger*, May 20, 1996 (on file with *Journal of Law and Policy*). See also Kelly Holland, *Wow! That’s Some Bank. Chase and Chemical: Will Clout Rule?*, BUS. WK., Sept. 11, 1995, at 36; Thomas J. Lueck, *Banking’s New Grant: Chase and Chemical Agree to Merge in \$10 Billion Deal Creating Largest U.S. Bank*, N.Y. TIMES, Aug. 29, 1995, at A1; Jaret Seiberg, *New York’s Approval of Chase Merger Upheld*, AM. BANKER, May 22, 1996, at 4.

² *Order Approving the Merger of Bank Holding Companies and Banks by the Board of Governors of the Federal Reserve System*, Jan. 5, 1996; *Chemical Banking Corporation*, 82 FED. RESERVE BULL. 239, 260 (1996). See also Banking Board, New York State, Meeting Minutes (Feb. 1, 1996); New York State Banking Board Res. No. 6920 (Feb. 1, 1996) (approving the Application of Chemical Banking Corporation to acquire through merger the Chase-Manhattan Corporation pursuant to Banking Law § 142.1(b)).

³ Jennifer Brown, *First Union Announces Job Cuts, Branch Closings to Appease Critics*, ASSOCIATED PRESS, Feb. 24, 1998, available in 1998 WL 6642879; Elizabeth Moyer, *Activists Seek to Halt N.Y. Deal, Citing Buyer’s Record on Loans to Poor*, AM. BANKER, Jan. 28, 1998, at 4; Jaret Seiberg, *Nations Bank Deal for Boatmen’s Under Assault by Activist Groups*, AM. BANKER, Nov. 14, 1996, at 1. Professor Richard Marsico lists a number of challenges to bank applications in recent years. See Richard Marsico, *Fighting Poverty Through Community Empowerment and Economic Development: The Role of the Community Reinvestment and Home Mortgage Disclosure Acts*, 12 N.Y.L. SCH. J. HUM RTS. 281, 295-96 n.65 (1995). Also, some recent challenges to bank applications have gone beyond the fair-lending laws to addressing issues of deposit caps, ATM surcharges and electronic benefits transfer systems which provide state and federal payments to welfare recipients electronically. See

legal battles between community-based organizations and banks are the federal fair-lending laws.⁴ The centerpiece of this legal arsenal, and the law which most often lies at the heart of these conflicts, is the Community Reinvestment Act, often referred to simply as "CRA."⁵

The CRA, which essentially requires banks⁶ to lend and invest a portion of their assets in the communities from which they solicit deposits, has been a lightning rod of controversy. Because the statute is vague with respect to its requirements of the banking industry, CRA has resulted in fierce competition among different interests seeking to provide the "correct" interpretation of the law.⁷ Combining a wide range of legal, economic and social issues, this competition has generated a heated debate both over the role of big business in rebuilding communities and over government efforts to harness market forces for goals other than profit-making. Caught between these ideologies and their proponents, and more often than not serving as scapegoats for all that has gone wrong with CRA, are the federal and state banking regulators⁸ who have attempted

generally Activists are Challenging Bank Expansion on Much More than CRA Performance, 16 BANKING POL'Y REP. 7 (Feb. 3, 1997).

⁴ The fair-lending laws are generally considered to be comprised of the Fair Housing Act of 1968, 42 U.S.C. §§ 3601-3619 (1997); the Equal Credit Opportunity Act, 15 U.S.C. § 1691 (1997); and the Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801-2811 (1997).

⁵ 12 U.S.C. §§ 2901-2907 (1997).

⁶ The term "banks" refers to standard commercial banks, savings banks and savings and loan associations (the latter two are collectively called "thrifts"). The term does not include other types of financial institutions such as mortgage banks, investment banks and credit unions.

⁷ It is interesting to note, in the twenty-one year history of CRA, the virtually complete lack of case law on the issue. While conflicts over CRA have used legal tools, these battles have always been fought before the regulators, legislatures and in the court of public opinion.

⁸ There are four primary banking regulators: the Office of the Comptroller of the Currency (OCC) which regulates federally chartered national banks; the Board of Governors of the Federal Reserve System (Federal Reserve) who regulate bank holding companies; the Federal Deposit Insurance Corporation (FDIC) which through its regulation of deposit insurance, has some regulatory authority over nearly every bank of every description in the nation; and the Office of Thrift Supervision (OTS) which regulates savings banks and savings

to formulate a functional interpretation of this confusing law.⁹ Not surprisingly, given this atmosphere, their efforts have resulted in the development of a variety of policies and procedures which satisfy virtually no one. The complicated regulatory framework they have developed has drawn fire from the banking industry, which claims that CRA is a harsh mechanism for "exacting tribute" and forcing the allocation of credit contrary to market forces.¹⁰ At the same time, community activists¹¹ dismiss the law as toothless

and loan associations, the so-called thrift industry. In addition to these agencies, each state government has a banking regulating arm, either standing alone or as part of a larger agency such as a state insurance and/or commerce department. State chartered banks are therefore subject to the regulation of these state entities in addition to that by the FDIC and the Federal Reserve if the state bank is part of a holding company.

⁹ Ironically, the vagueness of the statute is one of the few points of agreement among all sides concerned with CRA. Beyond that there is very little agreement on the legality and practicality of the way the regulators have chosen to interpret and enforce the statute. See Patrick A. Broderick & David E. Teitelbaum, *Recent Developments Under the CRA: 1991-1992*, 48 BUS. LAW. 1063 (1993); Griffith L. Garwood & Dolores S. Smith, *The Community Reinvestment Act: Evolution and Current Issues*, 79 FED. RESERVE BULL. 251, 252 (1993); Richard Marsico, *A Guide to Enforcing the Community Reinvestment Act*, 20 FORDHAM URBAN L.J. 165, 171 (1993); Lawrence J. White, *The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction*, 20 FORDHAM URB. L.J. 281, 281-82 (1993).

¹⁰ See White, *supra* note 9, at 281-87.

¹¹ The terms "community activist," "community organization" and other variations on the same theme are used rather loosely in this article, as they so frequently are in most of CRA literature. Generally the authors mean those organizations which are established to provide some form of service to a particular community, such as building affordable housing, assisting in small business development or other economic development activities, training welfare benefits recipients for work, providing counseling services, etc. These are community based "organizations" and are frequently led by an "activist," or some person or group of people who are interested, often passionately so, in achieving the goals of the organization.

It is a mistake to give the impression that all of these organizations and their activists are anti-bank, for this is simply not the case. Many have very productive and peaceful relationships with local banks (though some might say that this is the result of CRA). However, for the most part there has existed a high level of distrust and therefore hostility between these actors, as one side seems to feel that its success can only come at the expense of the other side.

and blame regulators for not applying more pressure on banks to meet their "social" responsibilities to poor urban and rural communities.¹²

In an attempt to address these criticisms, President Clinton in 1993 instructed federal banking regulators to promulgate a set of regulations which would establish a new compliance framework.¹³ His primary philosophical requirements for the new rules were to reduce the divisiveness the law had inflamed between community activist groups and banks, and to build a system which stimulated the creation of productive partnerships between these long-time rivals. While these new rules, which were not fully in effect until 1997,¹⁴ are still too new to evaluate their full impact on low and moderate-income ("LMI") communities,¹⁵ the authors of this

¹² Richard Marsico criticizes the law, which he believes has a great potential for fighting poverty, because it does not "establish loan quotas for low-income neighborhoods or require a bank to meet all community credit needs," and then goes on to state that a stricter CRA enforcement by the regulators can be divined from the legislative intent of the law. See Marsico, *supra* note 3, at 284. See Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement is Needed*, 20 FORDHAM URB. L.J. 293, 296-97 (1993).

¹³ 60 Fed. Reg. 22,156 (1995). The CRA regulations appear at four different places in the Code of Federal Regulations, one set for each of the four banking regulating agencies. For the Comptroller of the Currency, they appear at 12 C.F.R. Part 25 (1998); for the Federal Reserve System they are at 12 C.F.R. Part 228 (1997); for the Federal Deposit Insurance Corporation they are at 12 C.F.R. Part 345 (1997); and for the Office of Thrift Supervision they are at 12 C.F.R. Part 563e (1997). Since each set of regulations is virtually identical, differences are only technical, reflecting minor differences between the kinds of institutions each agency regulates. The remainder of this article will only cite those CRA regulations from the Federal Reserve System at 12 C.F.R. Part 228, Regulation BB.

¹⁴ Due to the dramatic change the new regulations are creating in the CRA compliance framework, including an entirely new set of lending data to be reported by covered financial institutions, different aspects of the rules are being implemented at different times. 12 C.F.R. § 228.51 of the new regulations sets up a staggered schedule which phased in the new regulations on January 1, 1996 and was completed by July 1, 1997.

¹⁵ This refers to geographic areas (census tracts and block numbering areas) used by the U.S. Census Bureau, updated every decade. In this case "LMI community" refers to an area where the median family income is classified in the

article believe they contain tremendous potential for fulfilling the President's goals.

The new CRA rules provide a number of innovative mechanisms that enhance the role of communities in the CRA process, ironically using the very community-based organizations which have often challenged the banking industry. By creating opportunities to inject positive relationships into the mix, the new rules have the potential to enhance the viability of these local organizations and to strengthen their ability to serve the economic development needs of LMI neighborhoods. These new mechanisms allow and encourage banks to invest indirectly in communities by providing loans and investments to a special form of community-based organization known as a community development financial institution ("CDFI") — a financial entity capable of accepting loans and investments from banks, private corporations and the government that allows it to provide a wide range of financial services to residents and businesses in its community.¹⁶

"moderate" or "low" income bracket range. See *Community Reinvestment Act; Interagency Questions and Answers*, 61 Fed. Reg. 54,652 (1996) [hereinafter *Interagency Questions*]. "Low income" refers to the median family income of no more than 80% of the metropolitan area.

¹⁶ Not everyone accepts the authors' contention that the new CRA rules promote indirect investing in CDFIs. A letter received by the authors from the New York Bankers Association in connection with this article states that:

the vast majority of banks in New York, both retail and wholesale banks, concentrate on direct lending and investment for the satisfaction of CRA. Under the revised CRA regulations now in effect both at the Federal and State level, banks are strongly encouraged to fulfill their CRA obligations through direct loans, investments and services in their local service areas.

Letter from New York Bankers Association to Senator Santiago (Jan. 27, 1998) (on file with authors). It is the authors' belief, however, that this refers to what banks are now doing under the new rules and not what they could be doing, and hopefully will be doing in the future. Banks are conservative institutions by nature because, as businesses, it is dangerous for them to take great risks with their resources. However, the authors believe the new rules offer enough new options to make a wide variety of opportunities possible, and that the language in the regulations will encourage, if not exactly compel, banks to move into new and uncharted territory using indirect lending and investing with CDFIs. The new and highly innovative equity equivalent program (about which more will be said

In the long run, the support received by these community financial organizations should translate into more financial resources; investment in CDFIs means those members of the community involved with the organizations must themselves learn how to better lend, invest and use money to generate additional capital in their communities, thereby rebuilding the local financial infrastructure through interconnected networks of community-based lending and investing organizations. The most important part of using CRA to make LMI communities financially, economically and even socially strong and independent is that rather than providing a one time bail-out, investing in CDFIs can give a community the resources and expertise it needs to help itself. This, in the authors' opinion, is true empowerment.

This article will analyze the new Community Reinvestment Act rules, describing how they can change the way banks and community organizations interact and how they may provide new opportunities to build mutually productive partnerships through supporting CDFIs with enhanced indirect funding mechanisms. Part I gives an in-depth discussion of CRA itself, touching on the old and new regulatory compliance schemes implementing it. Part II discusses CDFIs as business entities. Part III discusses how the new CRA rules actually promote this mutually beneficial partnership between these traditionally hostile groups, outlining the kinds of work these entities can do together, how such work will benefit each group and how regulators are encouraging bank investment in CDFIs through CRA.

later) developed in a collaboration between Citibank and the National Community Capital Association (a trade group representing a form of CDFI known as a community development loan fund) for use by CDFIs, is an excellent groundbreaking example showing how positive working partnerships can be effective and may foreshadow even more innovations yet to come.

I. THE COMMUNITY REINVESTMENT ACT

A. Background

The CRA was created in response to a perceived abandonment of poor neighborhoods by the nation's banks. The 1950s and 1960s were times of decay in some of the nation's largest metropolitan centers, leaving many inner city neighborhoods impoverished and bereft of any financial infrastructure. Much of the blame, rightly or wrongly, was laid at the feet of the banking industry.¹⁷ Banks were accused of "redlining," a process whereby loan officers allegedly outlined certain poor neighborhoods on their maps with red pencil to indicate areas considered too high risk for lending purposes.¹⁸ This financial discrimination was compounded by the

¹⁷ Garwood & Smith, *supra* note 9, at 251. See also Gregory D. Squires, *Community Reinvestment: A Social Movement*, in FROM REDLINING TO REINVESTMENT: COMMUNITY RESPONSE TO URBAN DISINVESTMENT 1, 2 (Gregory D. Squires ed., 1992).

¹⁸ "Redlining" is defined as a "term used to refer to a pattern of discrimination in which financial institutions refuse to make mortgage loans, regardless of the credit record of the applicant, on properties in specified areas because of alleged deteriorating conditions." BLACK'S LAW DICTIONARY 1279 (6th ed. 1990). The claim is based on the belief that financial lenders were actually drawing red lines on maps around communities where they would not make loans, even if they were soliciting deposits from those same communities. See *id.* Such practices were prohibited under the Home Mortgage Disclosure Act ("HMDA"), 12 U.S.C. § 2801-2811 (1997), which requires banks to disclose information regarding their mortgage lending activities in an attempt to identify discriminatory practices. *Id.* For more information on how the damage done to urban communities by this alleged practice led to the passage of the HMDA, see Barbara A. Kleinman & Katherine Sloss Berger, *The Home Mortgage Disclosure Act of 1975: Will It Protect Urban Consumers from Redlining?*, 12 NEW ENG. L. REV. 957, 957-63 (1977).

Amendments to the HMDA passed in 1989 as part of the Financial Institutions Reform, Recovery and Enforcement Act ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 524-26, (codified as 12 U.S.C. § 2803 (1989 & Supp. 1998)), expanded HMDA reporting to include race, gender and annual income as new methods to identify discrimination. For a more detailed discussion on how these are implemented, see Glenn B. Canner & Dolores S. Smith, *Home Mortgage*

banks' practice of receiving deposits from these "redlined" neighborhoods, creating an outflow of financial resources in a process called "community disinvestment."¹⁹ Without a financial

Disclosure Act: Expanded Data on Residential Lending, 77 FED. RESERVE BULL. 859, 861-63 (1991). For a discussion regarding the success of these new data disclosure requirements, see Glenn B. Canner & Wayne Passmore, *Residential Lending to Low-Income and Minority Families: Evidence from the 1992 HMDA Data*, 80 FED. RESERVE BULL. 80, 85-93 (1994); Glenn B. Canner & Dolores S. Smith, *Expanded HMDA Data on Residential Lending: One Year Later*, 78 FED. RESERVE BULL. 802 (1992); Douglas D. Evanoff & Lewis M. Segal, *CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending*, in ECON. PERSP. (Nov. 1996) (on file with authors); Paul Huck & Lewis M. Segal, *New Data on Mortgage Lending*, 119 CHICAGO FED. LETTER (1997) (on file with authors); Alicia H. Munnell et al., *Mortgage Lending in Boston: Interpreting HMDA Data*, in FED. RESERVE BANK OF BOSTON WORKING PAPER 92-07 (Oct. 1992) (on file with authors). All of this data is processed and collected by the Federal Financial Institutions Examination Council ("FFIEC"), an oversight body made up of the four federal banking regulators, which releases HMDA data analysis annually. Discrimination by financial institutions continues to be a concern despite attempts by CRA, HMDA and the other fair-lending laws to identify and eliminate the problem.

It would be a mistake, however, to give the impression that all of this data collection and analysis is occurring in a vacuum apart from CRA and CDFIs, for the use of this data has helped form the evidence for legal action taken against banks where community organizations have successfully convinced the United States Department of Justice to take action against banks. See *United States v. Decatur Fed. Sav. & Loan Ass'n*, (N.D. Ga. No. 1-92 CV2198) (Sept. 17, 1992). For commentary on the case see Richard Ritter, *The Decatur Federal Case: A Summary Report*, in MORTGAGE LENDING, RACIAL DISCRIMINATION, AND FEDERAL POLICY 427 (John Goering & Ron Wienk, eds., 1996); and *United States v. Chevy Chase Fed. Sav. Bank*, in MORTGAGE LENDING, RACIAL DISCRIMINATION, AND FEDERAL POLICY, *supra* at 623. Other recent cases of government crackdown have occurred just in the last year against Albank and Roslyn Savings Bank. See Jaret Seiberg, *U.S. Imposes Record Fine of \$9 Million in Bias Case*, AM. BANKER, Oct. 14, 1997, at 1. Significantly, the New York State Banking Department, for the first time, recently used a State Human Rights Law (as opposed to a federal law) to enforce fair lending. See Warren W. Traiger, *New York Seizes Fair Lending Initiative*, N.Y. L.J., Mar. 16, 1998, at 1.

¹⁹ The concerns and assumptions concerning the activities of the banking industry are spelled out in the hearings held by Senator William Proxmire on the original version of the Community Reinvestment Act. See *Hearings on S. 406 Before the Senate Committee on Banking, Housing and Urban Affairs*, 95th

infrastructure capable of accessing capital from banks, many people in these communities were forced to turn to alternative sources for financing, including check-cashers, informal and unsecured loan pools, credit cards, relatives and loan sharks.²⁰ Bankers denied these accusations, claiming they were merely doing what business dictated and that any government interference in this area would only result in gross distortions of the financial market, thereby damaging the industry itself and, if taken to an extreme, creating a socialist-style redistribution of wealth.²¹ Under pressure to react, Congress passed the fair-lending laws, including the Fair Housing Act, the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act.²² These laws, however, proved inadequate to achieve Congress' purpose. As a result, in an effort to encourage banks to increase lending activities in LMI communities, Congress enacted the original CRA, which was signed into law by President

Cong., 1st Sess. (1977) [hereinafter *Hearings on S. 406*]. In his opening statement on the first day of these hearings, Senator Proxmire noted that the charges of redlining and other failures in meeting community credit needs were not universally true of the industry, and in fact singled out the founder of one of the first community development banks, Ronald Grzywinski of South Shore Bank of Chicago, as a success story. *See id.*

This opinion is in contrast to the opinion of Lawrence White who writes:

The heavy hand of nineteenth century populism continues to have a powerful effect on late twentieth century banking policy in the United States. The American political system persists in treating banks as all-powerful financial institutions that must be shackled economically and, simultaneously, as hugely wealthy institutions from which substantial tribute can be levied.

White, *supra* note 9, at 281. *See also* Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 307 (1993).

²⁰ *See* E.L. Baldinucci, *The Community Reinvestment Act: New Standards Provide New Hope*, 23 FORDHAM URB. L.J. 831, 831 n.1 (1996); David Rohde, *Forced to Open, Branches Profit and Refute Stereotype*, N.Y. TIMES, Apr. 16, 1997, at B2.

²¹ *See* Garwood & Smith, *supra* note 9, at 251.

²² The initial groundwork for the fair-lending laws can be found as far back as 1956 in the Bank Holding Company Act of 1956, 12 U.S.C. § 1842(c)(2) (1997), which requires the Federal Reserve to examine how well a bank is addressing the needs of its community when it is considering an application.

Carter in 1977.²³ States such as New York quickly followed suit and crafted state versions of the federal law to place CRA requirements on their state-chartered banks.²⁴

²³ The original Community Reinvestment Act was part of Title VIII of the Housing and Community Development Act of 1977, Pub. L. No. 95-128, 91 Stat. 1147 (codified at 12 U.S.C. § 2907 (1998)). The original CRA was passed with little opposition in Congress. Garwood & Smith, *supra* note 9, at 252 n.1.

The CRA statute does not directly mandate that banks must serve low-income communities. Instead, under 12 U.S.C. § 2901 which lays out the statement of purposes, the statute states that banks must serve “the needs of the communities in which they are chartered to do business.” However, under 12 U.S.C. § 2903(1), regulators shall “assess the institution’s record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods.” This requirement provides the background for using CRA to emphasize bank lending to poor communities.

As a practical matter, banks are required to serve whole geographies which generally include low- and moderate-income neighborhoods. This is particularly true of the great “money center” banks which serve vast regions. In fact, there are probably very few banks which do not have an LMI community within their primary service area.

In addition, today’s banks do not tend to serve particular regions and communities, as they did in 1977. For example, wholesale banks, such as J.P. Morgan, primarily serve other banks or other financial institutions instead of a community.

However, CRA focuses on helping poor communities by providing capital. The legislative history of CRA demonstrates the importance that the drafters of the legislation placed on this type of service. Notably, in the conference committee between the House and the Senate which met to discuss the bill, the original wording of “primary service area” in what was to become 12 U.S.C. § 2903(1) was replaced by the current reference to LMI communities. *See* H.R. CONF. REP. NO. 643, 95th Cong., 1st Sess. (1977). Banking regulators have also acknowledged CRA as a tool to help provide financial services to LMI communities. *See* Statement of Federal Reserve Board Governor Lawrence B. Lindsey, 80 FED. RESERVE BULL. 286, 286 (1994) [hereinafter Lindsey].

Furthermore, there is no real evidence that CRA was designed to stop financial discrimination based on race; such a goal would be best reached through the use of anti-discrimination laws. *See* Macey & Miller, *supra* note 19, at 298-99.

²⁴ Section 28-b of the Banking Law in New York, enacted as Chapter 788 of the Laws of 1978 (codified at N.Y. BANKING LAW § 28-b (McKinney 1990 & Supp. 1997-98)). Under what is known as the dual-banking system, banks in the United States can either be chartered by the federal government or by an individual state. Those chartered by the federal government are regulated

The CRA, however, is a small and vague statute; it is more a statement of congressional intent than a detailed law that sets out procedures and goals backed by sanctions.²⁵ The law has no

primarily under federal banking laws and regulations, while state-chartered banks are regulated primarily by the state in which they are chartered.

²⁵ The original CRA legislation, which is list of Congressional Findings under § 801 of Pub. L. No. 95-128, states:

(a) The Congress finds that -

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

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

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

(b) It is the purpose of this title to require each appropriate Federal financial supervisory agency to use its authority when examining financial institutions, to encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institution.

Most of the remainder of the original statute merely defined the terms being used and the occasions when the financial regulators could take CRA considerations into account. It is important to note that there is no indication that CRA should itself act as a barrier to the application of a financial institution, in fact the original statute clearly states under § 801 of the Housing and Community Development Act of 1977 that regulators were to "encourage such institutions" to "take such record [of the institution's success in meeting the credit needs of its entire community] into account in [their] evaluation of an application for a deposit facility by such institution." "Application," the only time when CRA, even today, has any bite at all, refers to when a bank requests regulatory approval to merge with another institution, re-locate its home office, acquire assets or assume liabilities of another financial institution or any other change of status by the bank enumerated under § 803 of the original statute. Therefore if a financial institution has no need to make an application, it theoretically has no fear of non-compliance. Of course with the turbulent and unpredictable nature of the financial market, this is not a likely scenario, nor is there necessarily a more effective way for bank regulators to influence a bank's activity then during the application process (a "carrot" approach instead of a "stick" approach), see Thomas P. Vartanian et al., *Proposed CRA Rules Go Beyond Clear Boundaries of Law*, 6 BANKING POL'Y REP. 1, 15 (1994).

impact on a bank unless and until that institution files an application with banking regulators for a change of status, whereupon the regulators must consider how well the bank has complied with CRA as part of their decision on whether or not to approve the application.²⁶ In fact, it was not until the 1989 amendments to the CRA that CRA was provided any real "bite" at all, leaving banking regulators open to criticism for their failure to use the law aggressively.²⁷ In response to this criticism, as well as other glaringly obvious deficiencies, CRA has been amended at both the legislative and regulatory levels on numerous occasions. These efforts culminated in the complete rewriting of the regulations beginning in 1993.

B. CRA and Its Critics

As can be imagined, any law requiring a large and powerful industry to do something which it may not want to do engenders a great deal of criticism. In the case of CRA, criticism has come not only from the financial industry but also from the intended beneficiaries of the law or their representative organizations. This criticism has focused on both the actual philosophy of the statute and the way banking regulators have chosen to enforce CRA.

Many in the financial industry, and economic circles in general, attack the philosophy behind CRA, that is, that a private sector industry should be coerced by the public sector into providing a service which contradicts the dictates of the marketplace. Forced allocation of capital, these critics claim, is at best damaging to a financial institution and at worst a publicly mandated redistribution of wealth.²⁸ The case for CRA is best articulated by its author,

²⁶ The kinds of activities for which the bank must file an application with regulators include those for establishment or expansion of branch offices and public accommodation offices, mergers and purchases of assets, and interstate banking expansions.

²⁷ Even the CRA's legislative author, Senator William Proxmire, felt that the original law was little more than words on paper, providing no real compulsion for the regulators to use it aggressively. Fishbein, *supra* note 12, at 296.

²⁸ See Macey & Miller, *supra* note 19, at 308-10, 312, 319-24; White, *supra* note 9, at 241-42. However, in their article *Lending Discrimination: Economic*

Senator William Proxmire, then Chairman of the U.S. Senate Committee on Banking, Housing and Urban Affairs, who said:

A public charter conveys numerous economic benefits and in return it is legitimate public policy and regulatory practice to require some public purpose. . . . [T]hese institutions play a strategic role in allocating the public savings. Their collective decisions help to shape the communities we live in. . . . [Banks] who obtain new deposit facilities receive a semi-exclusive franchise to do business in a particular geographic area. The government limits the entry to other potential competitors. . . . [T]he government also restricts competition and the cost of money to the bank by limiting the rate of interest payable on savings deposits and prohibiting any interest on demand deposits. The government provides deposit insurance . . . [and] access to low cost credit through the Federal Reserve Banks or Federal Home Loan Banks.²⁹

Apart from these philosophical conflicts, controversy has raged between bankers and community groups over how, and to what degree, regulators should enforce CRA.³⁰ The 1989 amendments provided banking regulators with greater powers and are perhaps responsible for the dramatic rise in the regulatory enforcement of CRA.³¹ Other reasons for this new regulatory interest may include the emphasis placed on CRA in 1992 by President Bush,³² the

Theory, Econometric Evidence, and the Community Reinvestment Act, 85 GEO. L.J. 237, 279 (1996), Keith N. Hylton and Vincent D. Rougeau argue that it is the unregulated financial market which is at least partially responsible for lending discrimination in the first place, leading them to conclude that the "theoretical economic case against the CRA is not entirely persuasive."

It is also worth noting that in his opening statement for the original CRA hearings, the law's author, Senator William Proxmire, said that the bill "does not provide for credit allocation," and went on to criticize the Board of Governors of the Federal Reserve System for doing just that. *See Hearings on S. 406, supra* note 19, at 2.

²⁹ 123 CONG. REC. 1958 (1977) (statement of Senator Proxmire introducing S. 406)

³⁰ *See supra* note 8 (discussing banking regulators).

³¹ *See Fishbein, supra* note 12, at 297.

³² *See CRA 20th Anniversary*, AM. BANKER, Oct. 22, 1997, at 3.

evidence of minority lending discrimination brought to light through new HMDA data and the impact of the Los Angeles riots of 1992.³³ In fact, the real history of the evolution of CRA, particularly after 1989, has occurred primarily at the regulatory level.

Essentially, the 1989 amendments to CRA required regulators to assign a bank one of four possible compliance ratings, ranging from "outstanding" to "substantial noncompliance," based upon an examination and report of the bank's performance.³⁴ Additionally, most of an examiner's report was required to be made available to the public.³⁵ This policy was mandated in order to provide a degree of public oversight, also referred to as "regulation from below," over how the banking regulators were enforcing CRA and to enable concerned parties to apply pressure accordingly. This disclosure has also been largely responsible for stimulating more CRA activity by the regulators.³⁶ In their attempts to properly evaluate banking institutions, regulators required banks to disclose data on "geocoding"—or information on the geographic distribution of loans accompanied by an analysis of the lending prepared by the banks themselves.³⁷ Regulators started holding public hearings on bank applications to solicit community input on CRA compliance

³³ See Macey & Miller, *supra* note 19, at 293; Marsico, *supra* note 9, at 172-73.

In the case of the new HMDA lending data, it would be a mistake to say that evidence of discrimination was conclusively found. While the data showed higher levels of minority loan application rejections compared to white applicants, other methods of examining the lending data tend to weaken the case for lending discrimination. See Canner & Passmore, *supra* note 18, at 85-93; Miriam Leuchter, *NY Banks Making More Mortgages to Area Minorities*, CRAIN'S N.Y. BUS., June 27, 1994, at 3, 39; John R. Wilke, *Mortgage Lending to Minorities Shows a Sharp 1994 Increase*, WALL ST. J., Feb. 13, 1996, at 1. Data on class discrimination was equally inconclusive.

³⁴ 12 U.S.C. § 2906 (1997). Bank examinations are generally conducted once every eighteen months. See Garwood & Smith, *supra* note 9, at 257.

³⁵ 12 U.S.C. § 2906(b).

³⁶ See Paul H. Schieber, *Community Reinvestment Act Update*, 110 BANKING L.J. 62, 63 (1993).

³⁷ There is nothing in the statute which requires this type of disclosure. See Schieber, *supra* note 36, at 63.

and in 1991, for the first time, they rejected a bank's application largely on CRA grounds.³⁸

This new role played by the regulators, leaving them squarely in the middle of competing interests, generated additional criticism from both the banking industry and community activists. Ironically, the one agreement reached by both sides was that the regulators' approach to CRA enforcement was flawed, although they diverged considerably when it came to suggesting improvements.³⁹

The banking industry complained that the lending data disclosure requirements imposed after 1989, such as geocoding, created a substantial paperwork burden in addition to that arising from the HMDA and Truth in Savings Act reporting requirements.⁴⁰ The occasional use of harsh sanctions, such as cease-and-desist orders, has left many bankers feeling that regulators have grossly exceeded their statutory authority.⁴¹ Bankers also feel that, with the public disclosure of bank compliance ratings and lending data, which provide new information and tools for challenges by community groups, the post-1989 CRA was becoming a bludgeoning tool with which community activists could force bankers to

³⁸ See Schieber, *supra* note 36, at 64. While it took roughly fourteen years, the denial of a bank application by regulators on CRA grounds and the use of public hearings on bank applications seems to embrace Senator Proxmire's concept of how CRA should work, as presented in his floor statement introducing the original bill. See *Hearings on S. 406*, *supra* note 19, at 2.

³⁹ See, e.g., Mike McNamee, Commentary, *Color-Blind Credit: How Banks Can Do It Better*, BUS. WEEK, June 29, 1992, at 99 (discussing how the diversity and size of the banking industry does not lend itself to "cookie cutter" rules).

⁴⁰ In fact, according to the industry, CRA consistently rates as the number one compliance burden on banks. See Broderick & Teitelbaum, *supra* note 9, at 1064; Barbara Rehm, *Cost of Compliance Equals 59% of Bank Profits*, AM. BANKER, June 18, 1992, at 1, 12; Matt Schulz, *Small-Bank Survey Ranks CRA, Truth-in-Savings Rules as Top Compliance Problems*, AM. BANKER, Apr. 18, 1996, at 8.

⁴¹ The cease-and-desist order is one of the harshest penalties available to banking regulators and is usually obtained when the financial stability of the institution is at stake. It can be followed by severe financial penalties and removal of bank staff. See Schieber, *supra* note 36, at 66; Broderick & Teitelbaum, *supra* note 9, at 1072-73.

make unprofitable loans.⁴² In fact, in light of this threat, many banks started making large financial commitments to LMI communities immediately before filing an application. These steps were taken in order to ward off damaging application approval delays by the regulators concerned over CRA issues.⁴³ Bankers, however, requested more “carrots” or incentives for compliance such as providing a “safe harbor” from application protests;⁴⁴ exempting small banks from the law;⁴⁵ and extending CRA to cover other

⁴² Broderick & Teitelbaum, *supra* note 9, at 1070-71; Macey & Miller, *supra* note 19, at 333-37. See also Marsico, *supra* note 3, at 297-304 (providing a detailed description of how a community organization can use available data and other resources to pressure banks into making community loans).

It should also be noted that the use of protests as a tool to generate commitments did not begin in 1989, but in fact have been occurring nearly as long as CRA has been around. However, with the new willingness on the part of the regulators to enforce CRA, these application protests have become a much greater concern for the banks.

It is also interesting to note how and when the industry uses the “rogue regulator” charge. For example, bankers have claimed that the National Credit Union Administration, the regulatory body with oversight of the credit union industry, has exceeded its authority by allowing occupational-based credit unions to serve more than one group with a common bond. Anthony S. Abbate, *A Privileged Class, Credit Unions Compete Unfairly at Taxpayers Expense*, THE RECORD (N.J.), Feb. 7, 1997, at L9. As credit unions use this as a way to expand their customer base, and therefore their deposit base, the banking industry has found itself coming into increased competition with them. *Id.* However, bankers have supported regulators for allowing banks to expand into the insurance and securities investment industries, while community groups and lawmakers complain that this exceeds regulators authority.

⁴³ See Broderick & Teitelbaum, *supra* note 9, at 1070-71.

⁴⁴ A “safe harbor” is an incentive which grants a bank that has consistently been awarded a top CRA rating immunity from CRA protests for a period of time. For a discussion of the Safe Harbor incentive, see Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349, 352 (1993).

Another incentive which has actually been enacted is the Bank Enterprise Award (“BEA”) Program, 12 U.S.C. § 4713 (1994), which is part of the Federal CDFI Fund. The BEA program provides cash incentives to insured depositories that expand their lending into very low-income communities. Olaf de Senerpant Domis, *\$13 Million Awarded for Community Development Series*, AM. BANKER, Oct. 8, 1996, at 2.

⁴⁵ See Fishbein, *supra* note 12, at 305.

forms of financial institutions such as mortgage companies and securities brokers, which are starting to engage in the business of banking.⁴⁶

Community groups, on the other hand, used increased public disclosure information and data to back their claims that the regulators were still not going far enough. They have advocated not only the use of more "sticks," like cease-and-desist orders, but have pushed for the use of a detailed market share analysis mechanism that would require banks to make investments in LMI communities proportional to the bank's total assets.⁴⁷ Other community group recommendations include hearings on all major bank applications, public input on a bank's community development activities, increased disclosure of lending data and the complete rejection of practices such as "safe harbors" and small bank exemptions.⁴⁸ While many community organizations may not actively support the combative protest process, they believe it has succeeded in leveraging financial commitments from banks that might not otherwise have been made.⁴⁹ Community activists claim the reason

⁴⁶ See *Testimony Before the House Banking Committee*, 104th Cong. (1993) (testimony of James L. Bothwell, General Accounting Office) available in GAO/T-GGD-95-113, at 2 (on file with authors) [hereinafter Bothwell].

⁴⁷ A form of market-share analysis was included in the original 1993 CRA proposal but was removed when the industry complained that this was a form of forced credit allocation. See 60 Fed. Reg. 22,157 (1995).

⁴⁸ See Fishbein, *supra* note 12, at 306-09; Bothwell, *supra* note 46, at 4.

⁴⁹ The amount of money that has actually been leveraged by protests, and by CRA in general, is not clear. Estimates reported by the Center for Community Change start at \$30 billion in 1993 and move upwards. Fishbein, *supra* note 12, at 294; Lindsey, *supra* note 26, at 287. More recently, Comptroller of the Currency Eugene Ludwig noted that bank CRA commitments were dramatically on the rise, rising \$270 billion between 1993 and 1997. See Speech by Comptroller Ludwig delivered at the Forum on Community Reinvestment and Access to Credit, *California's Challenge in Los Angeles* (Jan. 12, 1988) (on file with authors).

An excellent example of this success is the Chase-Chemical Bank merger in New York City. Although Inner City Press lost its challenge, Chase-Manhattan Bank promised that it would make \$18.1 billion in loans and grants available to low-income communities. See James B. Arndorder, *Chase Trying to Prove Its Not Too Big for Little Borrowers*, AM. BANKER, June 17, 1996, at 32; *Chase, Chemical Banks Commit to Community Lending Programs*, ASSOCIATED PRESS,

they have resorted to more CRA application protests is that they are often unable to voice their concerns when bank's design their CRA lending strategies and when regulators choose to approve bank applications.⁵⁰ In addition, community groups have criticized the regulators for placing too heavy an emphasis on documenting a bank's different arrangements and data disclosures showing compliance rather than pushing the banks to actually fund new and innovative ways to get financial resources into the communities.⁵¹ Finally, community groups have been very critical of the regulators for using an overly qualitative review process resulting in too many banks receiving an easy ride on their CRA exams. Groups claim that too many banks are awarded "outstanding" and "satisfactory" ratings, despite information provided by the communities that the

Feb. 28, 1996, available in 1996 WL 4413961. But see Susan Harrigan, *Minority Lending at Issue in Chase-Chemical Merger: Minorities Doubt Merger Benefits*, NEWSDAY, Nov. 17, 1995, at A57 (noting a great deal of skepticism regarding Chase's commitment).

⁵⁰ It is debatable to what degree this is still a problem for community groups, despite the improvements under the new rules. For example, recent changes made by the Federal Reserve and subsequently adopted by all four banking regulators reduce the public comment period on a bank application in half for banks with consistent "satisfactory" or "outstanding" CRA compliance ratings. See Jaret Seiberg, *Comptroller Puts Squeeze on CRA Protests*, AM. BANKER, Nov. 22, 1996, at 1; Jaret Seiberg, *Small Banks Dissent on Plan by Fed to Ease Merger Rule*, AM. BANKER, Nov. 12, 1996, at 2; Heather Timmons, *Activist Group Says Fed Plan for Fast Merger Approvals Would Kill Minority Gains*, AM. BANKER, Nov. 7, 1996, at 8. Also, the Second Circuit recently ruled against community groups bringing an action challenging a bank merger, on the ground that the groups lacked standing because they were not being directly hurt by the bank's merger. This has the potential to shut down many community challenges because groups will not have the legal authority to bring such a challenge. See *Lee v. Board of Gov. Fed. Res. Sys.*, 118 F.3d 905 (2d Cir. 1997).

However, it is unclear whether community activists are truly being shut out of the application approval process. See Bill McConnell, *Delay in CRA Rating Suggests New Rule is Helping Activists*, AM. BANKER, Jan. 28, 1998, at 2; Jaret Seiberg, *Activists Getting Their Say at Start of CRA Exams*, AM. BANKER, Apr. 18, 1997, at 3.

⁵¹ See 60 Fed. Reg. 22,156-57; Bothwell, *supra* note 46, at 2.

banks are not providing all of the support that they could.⁵² This final criticism has been a major deterrent to enabling banks and community groups to end their hostilities and build mutually beneficial relationships.

C. *The New CRA Rules - Answering the Critics*

In 1993, President Clinton called on the four federal banking regulators to pool their knowledge, experience and resources to develop new CRA regulations which would address these criticisms. They were charged with producing a set of rules emphasizing the actual provision of capital to communities instead of paperwork, developing more objective evaluation methods and, above all, reducing the conflict between banks and community groups.⁵³ Later that same year, the regulators released a first proposal for public comment.⁵⁴

After receiving more than 6,700 public comment letters, a somewhat modified proposal was issued in 1994 which placed a more qualitative element back into the first, more quantitative-based proposal.⁵⁵ An important change included in the second proposal was the addition of wholesale and limited purpose banks to the list of financial institutions covered by CRA.⁵⁶ Over 7,200 comment

⁵² A list of such bank applications is provided by Richard Marsico in his article *Fighting Poverty Through Community Empowerment and Economic Development*. See Marsico, *supra* note 3, at 296 n.70; Garwood & Smith, *supra* note 9, at 257.

⁵³ 60 Fed. Reg. 22,156-57 (1995).

⁵⁴ 58 Fed. Reg. 67,466 (1993). Many of the provisions in the new rules were modeled after earlier reform proposals put forth by states like New York which had similar laws. See, e.g., Proposed Rule by Derrick D. Cephas, former Superintendent of the New York Banking Department (Oct. 7, 1992) (on file with authors).

⁵⁵ 59 Fed. Reg. 51,232 (1994).

⁵⁶ "Wholesale bank" and "limited purpose bank" are official designations given by the regulators. A wholesale bank is a financial institution which is not in the business of making home mortgage, small business, small farm or consumer loans to customers at the retail level. Instead, it provides bulk financial products to other banks or financial corporations.

letters pertaining to the second proposal were subsequently received by the regulators from interested parties⁵⁷ and the final rules were issued on April 24, 1995.⁵⁸

The final rules provide regular commercial banks and thrifts with the choice of being evaluated either under a tripartite test which examines for lending, investing and financial service provision activities, or the opportunity to develop their own strategic test.⁵⁹ The rules provide a lengthy list of details for both options, clarifying the kinds of activities expected of banks and what they must do to qualify for the top compliance ratings, although this is done without giving specific lending and investing targets.⁶⁰ Instead, regulators examine bank activities taking into account the kind of community in which the bank is doing business. This "performance context" provides a crucial qualitative element that allows examiners to adjust bank compliance scores to account for special circumstances related to the context of their local business environment.⁶¹

Perhaps the most important aspect of the 1995 rules, representing a crucial step taken by regulators to reduce the traditional bank-community conflict, is the new and repeated emphasis on indirect, third-party intermediary lending and investing. In addition to providing for direct loans straight to individuals and businesses, the regulations now contain requirements and incentives for banks to lend money to, invest resources in, and provide financial services to and through a form of local organization called a community development financial institution ("CDFI"). These organizations, in

A limited purpose bank is a financial institution which only offers a narrow product line such as credit card or motor vehicle loans to a market which is regional or larger. See 12 C.F.R. § 25.25 (1998).

⁵⁷ 60 Fed. Reg. 22,156, 22,158 (1995).

⁵⁸ See Press Release from the Board of Governors of the Federal Reserve System (Apr. 24, 1995); 60 Fed. Reg. 22,156 (1995).

⁵⁹ See *infra* Part III (providing greater detail about the final rules); see *supra* note 6 (defining thrifts).

⁶⁰ Wholesale, limited purpose and small banks are subject to their own special tests, reflecting their business focus and size. The term "small banks" refers to banks with total assets of \$250 million or less or owned by a bank holding company of \$1 billion in assets or less. 12 C.F.R. § 25.12(t) (1998).

⁶¹ 12 C.F.R. § 228.21(b) (1998).

turn, re-lend or invest the money in the community, enabling the bank to receive CRA "credit" for the funding.⁶²

Before proceeding to a more comprehensive discussion of CDFIs, it is important to consider these new rules within the broader context of changes taking place in the financial industry, particularly those being pushed by the regulators in the late 1990s. The legal barriers traditionally separating banks from the insurance and securities investment industries since the Great Depression started to erode over recent decades and are currently in a state of wholesale collapse. Although Congress, to date, has not been able to pass legislation to formally remove these firewalls and establish a new industry framework,⁶³ banking regulators, particularly the OCC,⁶⁴ have stretched the law to the limit to allow banks to sell insurance in towns of 5,000 or less and increase their investing activities through Section 20 bank holding company subsidiaries.⁶⁵

⁶² The term "CRA credit" is sometimes abused when used in the CRA literature. It does not necessarily refer to a formal scoring system where an activity produces a credit of X number of points, but generally constitutes an activity that will be counted in some manner or fashion towards a positive CRA evaluation and a higher rating.

⁶³ House Bill 10 is one example of financial modernization legislation. H.R. 10, 105th Cong. (1997). It was introduced in the 105th Congress and passed out of the House Banking Committee. However, differences of opinion arose in the House Commerce Committee, where the bill was subsequently referred, and the two committees have not, at the time of this writing, been able to iron out differences. For an analysis of House Bill 10, see Committee Report on H.R. 10 (July 3, 1997) <<http://www.house.gov/banking/7397hr10.htm>>. Nor has the banking industry been united enough on the legislation to present a solid recommendation to Congress on how to proceed. See David Hasansky, *Paralyzed Congress on Sidelines in Financial Services Evolution*, 55 CONG. Q. 2292, 2293-95 (Sept. 27, 1997).

⁶⁴ See Hasansky, *supra* note 63, at 2293.

⁶⁵ A series of recent court cases, culminating with *Barnett Bank of Marion County, N.A. v. Bill Nelson*, 116 S.Ct. 1103 (1996), has cemented the right of national banks to sell insurance in towns of 5,000 or less. The authority to engage in this activity was formalized by the OCC with the issuance of Advisory Letter 98-6, advising banks on how to sell insurance and the restrictions that will be applied. Most states have enacted "wild card" laws which allow their state banks to have these powers to the same extent as the national banks. See, e.g., Chapter 3 of the Laws of New York of 1997. See Bill McConnell, *Legislative Action in 19 States Breaks Insurance Sales Logjam*, AM. BANKER, Aug. 19,

In other words, the banking industry is experiencing a period of considerable deregulation and expansion.⁶⁶ CRA is a part of this new environment, as a good portion of the new rules reduce paperwork for the banking industry and require regulators to examine banks in a “performance context” so as not to interfere with the bank’s regular business. This expansion, however, raises

1997, at 1, 2.

Banks have been largely prohibited from investing in securities and mutual funds by the Depression-era Glass-Steagall Act of 1933, 12 U.S.C. §§ 24, 78, 377 and 378(a) (1997). However, a provision of the Bank Holding Company Act of 1956, 12 U.S.C. § 1843(c)(8) (1997), does allow a non-bank subsidiary of a bank holding company to engage in certain securities brokerage activities as long as the revenue from this business does not exceed a certain percentage of the subsidiary’s total profits. This authority was enacted as § 20 of the Bank Holding Company Act and this section number has become a common reference for these types of subsidiaries. While essentially an end run around Glass-Steagall, this authority has been upheld by the courts in *Securities Industry Ass’n v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990); *Securities Industry Ass’n v. Board of Gov. Fed. Res. Sys.*, 458 U.S. 207 (1984).

⁶⁶ Nothing highlights this rapid expansion and merger-mania between banks, insurance and investments companies as does the recent merger announcement of Citicorp and Travelers Group. See Yvette DeCantrow & Elizabeth Moyer, *Citi, Travelers: A Global Leader Takes Shape*, AM. BANKER, Apr. 7, 1998, at 1. It should be noted that since the formal legal barriers separating banking and other forms of finance have not been taken down by Congress, there is some doubt as to whether or not the new Citigroup, Inc. can permanently exist as a legal entity. See Barbara A. Rehm, *Megamerger Plan Hinges on Congress*, AM. BANKER, Apr. 7, 1998, at 1.

Of course this deregulation has not always been good for CRA. On April 21, 1997, amendments were made to the Federal Reserve Board’s Regulation Y, 12 C.F.R. Part 225 (1997), to streamline the bank application review process. This is the same application process which provides CRA with its “teeth,” the principle portion being the reduction of the public comment period from thirty days down to fifteen for bank holding companies which are “well run,” meaning that in addition to other concerns, they have a CRA rating of “satisfactory” or better. See *Regulation Y: Revisions*, 83 FED. RESERVE BULL. 260, 260 (1997). Such a process makes it a great deal more difficult for community groups interested in protesting an application because it allows little time for the groups to find out about the application and then collect the necessary data to file a formal protest with the Federal Reserve. This, in a sense, has provided bank holding companies with a de-facto “safe harbor” from CRA protests.

new questions about the future of CRA.⁶⁷ With banks, insurance companies and investment banks gradually receiving new power to “cross-affiliate,” or acquire each other, the distinctions between these industries are becoming blurred. Will CRA remain applicable to a banking subsidiary of an insurance company? At the same time, insurance companies and investment firms, like banks, have become enormous money-center industries capable of providing a great deal of financial support to LMI communities. Should CRA be expanded to include insurance companies generally, or financial investment firms?⁶⁸ These are important questions and concerns

⁶⁷ Many excellent concerns and recommendations regarding CRA and financial modernization were provided by Allen J. Fishbein in his testimony before the House Banking Committee. See *Testimony Before House Committee on Banking and Financial Services*, 105th Cong. (1997) (testimony of Allen J. Fishbein, General Counsel, Center for Community Change), available in 1997 WL 10571811.

⁶⁸ This question presents an entire debate within itself. Insurance companies also have been accused of redlining in the past and many people have advocated applying some form of CRA to these companies. The New Jersey State Senate has proposed such a bill, S. 720. Senator Santiago, one of the authors of this article, has introduced legislation to apply the New York CRA to insurance companies and investment banks to the extent that they are engaged in banking activities. S. 6588 for the 1997-98 Legislative Session.

The idea of expanding CRA to cover the investment and securities industry has been promoted by former Comptroller of the Currency Eugene Ludwig, who, in a speech presented to the Director’s Roundtable in San Francisco, said:

CRA covers an ever-shrinking share of the financial services industry. [Nonbanks] still dominate those critically important markets and are not formidable competitors in markets which banks once dominated. The rise of full-service nonbank providers as relatively unregulated competitors for the business that once belonged to bankers is a phenomenon with which all of you are familiar. In 1990, nonbanks held a larger share of the nation’s financial assets than commercial banks and thrifts combined. [Today] Americans have close to \$4 trillion invested in mutual funds, compared to under \$3 trillion in bank and thrift deposits . . . banks are subject to rules and regulations not applicable to their nonbank competitors . . . and none [of the competitors] are subject to CRA. . . . [D]oes this make sense? In an era where all financial services are converging, why does only one segments of the financial services industry have to comply with a CRA-type responsibility? [Our] low and moderate income communities would

to keep in mind when considering the subject of community reinvestment.

II. COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

A. Definition and Structure

In order to see how the new CRA rules encourage CDFI funding and reflect the role CDFIs can play in rebuilding communities, it is important to formulate a working definition of CDFI.⁶⁹

welcome with open arms the special expertise, the products, and the resources that our nonbanks have to offer.

Speech by Comptroller Ludwig given on July 15, 1997 (on file with authors).

⁶⁹ The federal government also supports the development of CDFIs through means other than CRA. In 1994, the federal government recognized the importance of CDFIs in community development by establishing a fund to help capitalize CDFIs administered by the U.S. Treasury Department and to provide financial investments, technical assistance and lending capital support. 12 U.S.C. §§ 4701-4718. For the first time, CDFIs appeared in a federal statute providing investment capital through a system of award rounds. To date, two rounds of funding have been offered, totalling almost \$66 million for CDFIs. *See* Press Release from U.S. Treasury Department (Sept. 30, 1997) (on file with authors). The Fund also provides an incentive for banks, called the Bank Enterprise Award Program, to support CDFIs by awarding funds to banks which make investments in CDFIs and other activities which support low-income communities. The Bank Enterprise Award Program has awarded a total of \$83 million, although the number of banks which have participated in the program has been small. *See id.*; Reginald Roberts, *In the Towns: Banking on the City Pays Dividends, Community Development Turns It Around*, STAR-LEDGER, Oct. 9, 1997, at 1. The qualified investments made by the banks for the BEA Program also count under CRA investment test. The CDFI Fund, however, has come under recent attack for making awards to institutions with political ties to the Clinton Administration, thus casting a shadow over the re-authorization of the fund in 1998. Barbara F. Bronstien, *Losers Hit Treasury on Community Lending Grant Series*, AM. BANKER, Aug. 7, 1996, at 6; Letter from Representative James A. Leach, Chairman of the House Banking Committee, to Treasury Secretary Robert Rubin (July 15, 1997) (on file with authors).

Notwithstanding this criticism, there does seem to be a good deal of hope for the future of the fund which is under new management and has recently announced a third round of awards for this year.

While the term CDFI is general,⁷⁰ federal law defines a CDFI as an institution that:

- (i) has a primary mission of promoting community development;
- (ii) serves an investment area or targeted population;
- (iii) provides development services in conjunction with equity investments or loans, directly or through a subsidiary or affiliate;
- (iv) maintains, through representation on its governing board or otherwise, accountability to residents of its investment area or targeted population; and
- (v) is not an agency or instrumentality of the United States, or of any State or political subdivision of a State.⁷¹

The CDFI industry, through its representative trade association, describes itself as comprised of "private-sector financial intermediaries with community development as their primary mission . . . [making] loans and investments that conventional financial institutions would consider unbankable, [linking] financing to other developmental activities."⁷²

While any real definition will almost certainly exclude perfectly legitimate organizations, it is fairly safe to say that a CDFI is primarily two things. First, it is a private, community-based organization which provides a service to a particular urban or rural community (though not necessarily a low-income one); is located within that community; is run by members of that community (both as management and on the board of directors); and is accountable to the community. Second, it is engaged as its primary purpose in the business of lending, investing, and providing basic banking services like savings and checking accounts, or a combination of all of these.⁷³ It may also help link development projects to other

⁷⁰ Many of the sub-designations of CDFI are also generalized. For example, community development credit union ("CDCU") is a term referring to a variety of different forms of credit unions which can be designated, if they so choose, as a CDCU (or a CDFI, for that matter).

⁷¹ 12 U.S.C. § 4702 (5)(a) (1997).

⁷² See Coalition of Community Development Financial Institutions, *What Is A CDFI?*, (visited Feb. 11, 1998) <<http://www.cdfi.org/cdfi/whoweare.html>>.

⁷³ The lending and investing can be for a wide variety of projects, often depending on the capacity of the business start-up and expansion through bridge loans and other short term loans, equipment purchases, loans and investments in

sources of financing.⁷⁴ In other words, it is in the business of banking and finance. CDFIs may also be owned by a larger organization, although these parent companies should also reflect the community-oriented CDFI criteria set forth above.

CDFIs, as locally-based organizations, harness the forces of the financial market and provide capital to stimulate community economic development. They do so by providing funding that allows local entrepreneurs and recipient organizations to run their own projects and businesses—essentially helping them to learn to help themselves. As was recently stated by a banking industry representative:

Community development financial institutions focus on the strengths of individuals and organizations. CDFIs must create independence and self-sufficiency in their clients or customers in order to ensure their loans are repaid and that their deposit base grows. CDFIs are only successful when their customers are successful. CDFIs are a free market invention!⁷⁵

Loans and investments by CDFIs are often made to individuals and businesses which are having difficulty raising sufficient assets or generating enough income to qualify for a standard bank loan or accept a loan at market rate.⁷⁶ Therefore, CDFIs not only make use of the financial lending and investing business market but do

other organizations, IRAs, CDs and mortgages—the list is limited only by the institutional structure and imagination. For examples see Ronald Brownstein, *From White House to a Dream House: A Flow of Funds to Lift Communities*, L.A. TIMES, July 29, 1996, at A5; Lore Croghan, *South Bronx Enjoys Good Credit: Loan Pool for Small, High-Risk Businesses Solicits More Bank in Effort to Double Size*, CRAIN'S N.Y. BUS., June 16, 1997, at 15.

⁷⁴ See Valjean McLenighan & Kathryn Tholin, *Partners in Community Building: Mainstream and Community Development Financial Institutions*, in WOODSTOCK INSTITUTE REPORT 1 (1997).

⁷⁵ Janet Thompson, Vice-President of Citibank, Speech at the CDFI Leadership Forum sponsored by the Ford Foundation 1 (Sept. 16, 1996) (transcript available at <www.cdfi.org/cdfi/paper2.html>).

⁷⁶ See COALITION OF COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS, COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS: KEY TOOLS FOR REBUILDING COMMUNITIES 2 (on file with authors) [hereinafter REBUILDING COMMUNITIES].

so with as much of an eye to social benefit as to a profitable bottom line, sometimes sacrificing a portion of the latter to help the former.⁷⁷

B. Brief History

Although they have only existed by statute since 1994, CDFIs themselves, in one form or another, are much older. Existing as hybrids between standard financial institutions, community development organizations or local development corporations, CDFIs have deep historical roots. The modern banking industry has existed, essentially, since the passage of the National Bank Act of 1864, the thrift industry since the creation of the Federal Home Loan Bank System in 1932, and the credit union industry since the State of Massachusetts passed the first credit union statute in 1909 (fifteen years prior to the passage of the Federal Credit Union Act of 1934).⁷⁸ While the Coalition of Community Development Financial Institutions traces the origins of its industry back to “the immigrant guilds of New York City’s Lower East Side [and] the Prairie Populists of the late 1800s,”⁷⁹ CDFI history evolves philosophically along lines similar to the early credit union movement of the 1990s as an attempt to pool scarce financial resources during times of hardship for mutual support.

Community-based organizations (“CBOs”) and similar institutions grew out of a need to address the rapidly escalating problem of urban decay in the second half of the twentieth century. They were based on the idea of local residents learning to help them-

⁷⁷ For example, the Self-Help organization in North Carolina owns subsidiaries such as the Center for Community Self-Help, Self-Help Credit Union and Self-Help Ventures Fund. See *Self Help, Creating Ownership and Economic Opportunity* (visited Apr. 24, 1998) <<http://www.self-help.org>>.

⁷⁸ See CREDIT UNION NAT’L ASSN, CREDIT UNIONS: THEIR ORIGINS AND PURPOSES § 1.02 (1988); J.T.W. HUBBARD, FOR EACH THE STRENGTH OF ALL: A HISTORY OF BANKING IN THE STATE OF NEW YORK 121-22 (1994); UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS, HANDBOOK OF SAVINGS INSTITUTIONS 4-8 (1980).

⁷⁹ See Coalition of Community Development Financial Institutions, *What Is A CDFI?* (visited on Feb. 11, 1998) <<http://www.cdfi.org/cdfi/whoweare.html>>.

selves after the failure of various government programs.⁸⁰ Since CDFIs are as much CBOs as they are financial organizations, they share this heritage. In fact, many CBOs were created to answer financial institution redlining through specializing in housing development for low-income families, and the use of small business lending and real estate development for commercial purposes.⁸¹ Some large CBOs have formed a CDFI of some description as part of their own organizations, such as the Union Settlement Federal Credit Union, a community development credit union which operates under the wing of the Union Settlement Association of East Harlem, New York.

C. *Variety and Functions*

There are a variety of CDFI forms which utilize different organizational structures and business focuses in order to stimulate economic and community development. While the primary focus of CDFI discussion tends to center on the ways they serve LMI communities, there is no requirement which states that a CDFI must do so. Nor are CDFIs exclusively an urban phenomenon, since many rural communities suffer from poverty so extreme that it rivals the most depressed urban wastelands.⁸² Many CDFIs do

⁸⁰ Michael H. Schill, *Assessing the Role of Community Development Corporations in Inner City Economic Development*, 22 N.Y.U. REV. L. & SOC. CHANGE 753, 753-54 (1996-1997).

⁸¹ *Id.* at 766.

⁸² According to the U.S. Department of Agriculture, 25% of all rural workers in 1993 had an annual salary of \$10,400 or less, with 50% earning \$16,640 or less annually. See *Rural Housing Service 1996 Progress Report*, in U.S. DEPARTMENT OF AGRICULTURE, RURAL DEVELOPMENT AND RURAL HOUSING SERVICE 1 (1997).

One prominent CDFI which exclusively serves rural communities is the RCAC Loan Fund, operated as a subsidiary of the Rural Community Assistance Corporation. RCAC is a multi-state community development corporation which specializes in multiple strategies to assist poor rural communities, including the use of financing, but also making other efforts to provide "a wide range of community development services which increase the availability of safe and affordable housing; improve drinking water, wastewater and solid waste management; build the capacity of local officials and community-based

not focus solely on a single community but serve multiple communities in a variety of states.⁸³ While the vast majority of CDFIs, both free-standing entities and subsidiaries of other community development corporations, operate outside of the mainstream financial industry, many of the great banks actually have their own CDFI-like entities within their holding company structures that act as community development corporations.⁸⁴ Because many of these holding company CDFIs work in conjunction with the banks, they can leverage large amounts of borrowed and permanent capital to be lent or invested either directly or through another outside CDFI.

Some CDFIs do not serve a community but particular groups of people, often traditionally disadvantaged groups such as minorities or women.⁸⁵ Others are based in religious organizations

organizations; and develop the knowledge base of the rural public through education, publications and training." See *RCAC Home Page* (visited Apr. 24, 1998) <<http://www.rcac.org>>.

⁸³ Examples of these multi-state organizations include: the Rural Community Assistance Corporation, *RCAC Home Page* (visited Apr. 24, 1998) <<http://www.rcac.org>>; the South Shore Bank of Chicago, Matt Schulz, *Shorebank Buys Bank in Rural Washington With Eye Toward Community Development*, AM. BANKER, Feb. 1, 1996, at 4; the North Carolina Community Loan Fund, *NCCLF* (visited Apr. 24, 1998) <<http://www.ncclf.org>>; and the Self-Help Federal Credit Union, *Self Help, Creating Ownership and Economic Opportunity* (visited Apr. 24, 1998) <<http://www.self-help.org>>.

⁸⁴ For example, both the Chase Corporation and Citicorp own community development corporations alongside of Chase-Manhattan Bank and Citibank which work in tandem with the main banks, but specialize in development financing in LMI communities, often in conjunction with the bank for CRA credit. Many of these special affiliate corporations also work in the business of subprime lending and investing to LMI communities and can help make customer referrals to the main bank and vice-versa.

⁸⁵ REBUILDING COMMUNITIES, *supra* note 76. Such CDFIs include the Coalition for Women's Economic Development in South Central Los Angeles, California; the Women's Self Employment Project in Chicago, Illinois; the Center for Southeast Asian Refugee Resettlement in San Francisco, California; the Latino Economic Development Corporation in Washington, D.C.; the Puerto Rican Society Federal Credit Union in Waukegan, Illinois; and the Lakota Fund in Kyle, South Dakota.

such as churches.⁸⁶ Many support only specific kinds of projects such as the building of affordable housing, small business lending or welfare-to-work programs.⁸⁷ In addition, many CDFIs are for-profit while others are not-for-profit; some have their deposits insured by the federal government, and are therefore regulated by federal agencies, while many do not.⁸⁸

CDFIs receive their operating support and lending capital from a variety of sources, depending on the institution's structure. Funds can be raised through: selling stock and raising equity capital (for-profits only); deposits accepted from institution members; short and long term loans from banks at below-market rates for debt capital; loans sold on the secondary market; profit revenue from financial services; and grants from banks, private foundations, government programs and corporations.⁸⁹ Unfortunately, it tends to be easier for established CDFIs which have developed strong partnerships with banks and other corporations to raise operating and lending capital than for those just starting up. With little or no track record with which to make a pitch, it is difficult for a community entrepreneur interested in establishing a CDFI to receive bank funding. Routinely, start-up CDFIs end up struggling for individual

⁸⁶ For example, Mount Zion Baptist Federal Credit Union in Taylor, Texas; Cory Methodist Church Credit Union in Cleveland, Ohio; Brooklyn Ecumenical Federal Credit Union in Brooklyn, New York; and Tabernacle Federal Credit Union in Augusta, Georgia.

⁸⁷ For example, the Community Service Programs of West Alabama in Tuscaloosa, Alabama; Valley Small Business Development Corporation in Fresno, California; McAuley Housing Fund in Denver, Colorado; Greater Atlanta Small Business Project in Atlanta, Georgia; Worcester Community Housing Resources in Worcester, Massachusetts; and the Detroit Self-Employment Project in Detroit, Michigan.

⁸⁸ CDFIs which are thrifts or commercial banks, including community development banks, will have all of their deposits insured by the Federal Deposit Insurance Corporation ("FDIC"), while those which are credit unions or community development credit unions will be insured by the National Credit Union Administration ("NCUA"). See COALITION OF COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS, COMPARISON OF CDFI TYPES (on file with authors) [hereinafter CDFI TYPES].

⁸⁹ This includes support received from government-supported private corporations such as Fannie Mae. See *Fannie Lending a Hand to N.Y. Minority Thrift*, AM. BANKER, Oct. 9, 1996, at 9.

investors and government grants.⁹⁰ In order to have a clearer understanding of CDFIs and the way different aspects of CRA tend to provide a greater benefit to certain kinds of CDFIs, it is important to be aware of the wide variety of CDFI types.

1. *Community Development Banks ("CDBs")*

Community Development Banks⁹¹ can be either commercial banks or thrifts which have chosen to specialize in community development, often in their own neighborhoods, and can adhere to either a stock form or mutual form of ownership.⁹² They are for-profit institutions⁹³ which are regulated by the Office of the Comptroller of the Currency, the Federal Reserve System and/or state banking regulators, with deposits insured by the FDIC.⁹⁴ Some are banks which have been in business for years and have chosen to refocus their efforts and resources on community banking as their prime line of business,⁹⁵ while others were originally

⁹⁰ Janine S. McDonald & Christopher Rhoads, *Community Development Start-Up Too Short of Capital to Open Doors*, AM. BANKER, Feb. 1, 1996, at 10.

⁹¹ The number of community development banks in the nation is quite small. In fact, at the time of this writing, the authors know of only eight.

⁹² Mutual companies are corporations in which shares are held exclusively by members to whom profits are distributed as dividends in proportion to the business which the members did with the company. BLACK'S LAW DICTIONARY, *supra* note 18, at 1020. For a discussion of stock form thrifts, see Rochelle E. Lento, *Community Development Banking Strategy for Revitalizing Our Communities*, 27 U. MICH. J.L. REFORM 773, 779-80, 786-89 (1994) (regarding the example of the Shore Bank Corporation's affiliates).

⁹³ For purposes of satisfying CRA, little distinction is made between for-profit and not-for-profit institutions. Instead, it is the organization's designed purpose which guides regulatory determinations of how a bank investment qualifies under CRA, not the corporate structure of the community based organization. See Letter from New York State Banking Department to Senator Santiago (Jan. 13, 1998) (on file with authors). The CRA regulations of the State of New York, Part 76 of the General Regulations of the Banking Board, are largely identical to the federal regulations, and the State Banking Department coordinates its examination efforts with the federal regulators, so the authors are comfortable with using a state level CRA interpretation here.

⁹⁴ See Lento, *supra* note 92, at 776.

⁹⁵ Greg C. Gilbert, *Convincing a Private Bank to Become a Community*

established as community development banks.⁹⁶ Some may stand alone, while others may be part of a larger holding company. Some may even have other forms of CDFIs as affiliates in the holding company structure which can help provide a diverse range of community development services.⁹⁷ These forms of CDFIs have a tendency to be larger in size than most others and have greater financial resources to draw upon due to their minimum capital requirements,⁹⁸ their sale of shares to stock holders, and their wide variety of products offered. They are therefore able to provide a wide variety of services ranging from home mortgage financing and small business lending to consumer lending and regular consumer banking services (such as savings and checking accounts). Many other CDFIs, due to their limited resources, must specialize. Some of the large CDBs even specialize in aiding other CDFIs around the nation in starting up and maintaining themselves.⁹⁹ CDBs also provide funding for other CDFIs in their communities as well as individual customers and non-financial not-for-profit organizations.¹⁰⁰ However, starting a CDB, especially by the residents of an LMI community, can prove difficult as banks require a higher level of capitalization in order to be viable, must comply with state

Development Bank: One Group's Experience, 6 J. AFFORDABLE HOUSING 275, 278 (1997).

⁹⁶ An example is the Community Capital Bank of Brooklyn, New York. See Lento, *supra* note 92, at 795.

⁹⁷ Community Capital Bank of Brooklyn, New York, is an example of a CDB which stands on its own, while South Shore Bank of Chicago is a CDB which is part of a larger holding company, the Shorebank Corporation. See Kathryn Tholin, *Community Development Financial Institutions: Investing in People and Communities*, in WOODSTOCK INSTITUTE REPORT 8-9 (1994).

⁹⁸ Banks are required to maintain a minimum amount of capital in order to be considered safe and sound by banking regulators. They are also required to have an initial amount of capital on hand when they are chartered. These capital requirements are set by the regulators and range roughly from \$3 to \$10 million. This requirement often represents approximately eight percent of the bank's total assets, and must be able to cover operating losses for three years.

⁹⁹ Lento, *supra* note 92, at 789. See Schulz, *supra* note 83, at 4.

¹⁰⁰ CDFI TYPES, *supra* note 88.

and federal laws and regulations as well as pay a variety of taxes and deposit insurance.¹⁰¹

2. *Community Development Credit Unions ("CDCUs")*

Like community development banks, CDCUs¹⁰² are self-designated institutions that choose to focus their business primarily on local community development.¹⁰³ The majority of these neighborhood-oriented credit unions have established themselves with a "community charter," meaning that their customers can only be drawn from members of the community in which the organization is based.¹⁰⁴ They stand in contrast to the more common occupational-based credit unions, though this traditional form does constitute a portion of the CDCU industry.¹⁰⁵ Credit unions serving low-income communities may also apply to the National

¹⁰¹ See McDonald & Rhoads, *supra* note 90, at 10.

¹⁰² While there seems to be no comprehensive count of CDFIs nationwide, community development credit unions appear to be the most numerous form of CDFI. As of April 1998, the membership of the National Federation of Community Development Credit Unions stands at 165 CDCUs. See National Federation of Community Development Credit Unions, *Frequently Asked Question #4* (visited Apr. 24, 1998) <<http://www.natfed.org/nfedfaq.htm>>. The Federation estimates, however, that there may actually be at least 300 CDCUs in the nation and perhaps as many as a thousand. *Id.*

¹⁰³ As with community development banks, there is no official community development credit union designation. It is simply a business focus chosen by the organization.

¹⁰⁴ 12 U.S.C. § 1759 of the federal banking law requires that credit unions be formed around a group of people with a commonality. One of the options is for a credit union to opt for a community-charter where they commit to serve all of the residents of a particular community. Here "community" refers to a geographic region, a church congregation or even an ethnic bond. See National Federation of Community Development Credit Unions, *Frequently Asked Question # 8* (visited Apr. 24, 1998) <<http://www.natfed.org/nfedfaq.htm>>.

¹⁰⁵ The United States Supreme Court has ruled that the interpretation of this statute by the National Credit Union Administration is too expansive by allowing multiple groups with a common bond to be members of an occupation-based credit union. The Court instead decided that the statute only permits one group with a common bond per credit union. See *National Credit Union Admin. v. First Nat'l Bank & Trust Co.*, 118 S. Ct. 927, 939-40 (1998). It is too early to tell if this decision will have an impact on community development credit unions.

Credit Union Administration to be designated as a “low-income credit union” (“LICU”) tied to a particular income level.¹⁰⁶ The LICU designation greatly expands the powers of a CDCU, enabling it to accept deposits (which are insured by the NCUA) from people, organizations and corporations outside of their fields of membership, such as other financial institutions and foundations, as well as raise secondary capital through long-term subordinated debt. This allows an LICU to take far greater advantage of the kinds of investments and services they can receive from banks under different CRA requirements.¹⁰⁷ While CDCUs, like CDBs, can offer a wider range of services and products than most other forms of CDFIs, quite a number of CDCUs focus on lending to low-income people, families and small businesses.¹⁰⁸

3. *Community Development Loan Funds (“CDLFs”)*

Community Development Loan Funds¹⁰⁹ are perhaps best described as formalized lending pools. Essentially, CDLFs are collectors and low-interest lenders of aggregated capitals which is primarily pooled capital from government and such varied institutional investors as private corporations, banks and foundations, often at below market rates.¹¹⁰ Unlike CDBs, but like most other forms of CDFIs, CDLFs are primarily not-for-profit § 501(c)(3) organizations.¹¹¹ In addition, CDLFs are unable to

¹⁰⁶ 12 C.F.R. § 701.34 (1998). According to the National Federation of Community Development Credit Unions, a low-income credit union can receive this designation from the NCUA if at least 51 percent of its members have an annual household income of \$25,000 or less. *See Frequently Asked Questions #3* (visited Apr. 24, 1998) <<http://www.natfed.org/nfedfaq.htm>>. This designation can be applied for by any type of credit union, not merely a CDCU.

¹⁰⁷ *Id.*

¹⁰⁸ *See* McLenighan & Tholin, *supra* note 74, at 2.

¹⁰⁹ While community development loan funds seem to be springing up frequently, the recorded number of existing loan funds around the nation in 1997 was tallied around 47 with \$300 million in outstanding loans. McLenighan & Tholin, *supra* note 74, at 3.

¹¹⁰ CDFI TYPES, *supra* note 88.

¹¹¹ *Id.* *See also* Lento, *supra* note 92, at 777-78 (noting that there are for-profit community development loan funds).

take deposits because they are not insured depository institutions, thus these loan funds cannot offer the wide range of financial services offered by CDBs and CDCUs. On the other hand, they are largely self-regulated, while the former two forms of CDFIs are subject to a number of federal and state laws and regulations.¹¹² This permits CDLFs more flexibility in lending activity and fewer restrictions on how to raise capital.¹¹³ CDLFs exist on a variety of scales and with varied ranges of capital and assets on hand, thus impacting the scope of their work.¹¹⁴ Generally, their activities consist of housing and small business loans and investments, often working through other local CBOs and helping to leverage additional financing.¹¹⁵ They also lend to other non-profit organizations which are involved in affordable housing, child-care facilities and other community service work. Again, like other CDFIs, loan funds are affiliated with or are subsidiaries of larger corporations.¹¹⁶

501(c)(3) organizations refers to tax-exempt organizations under the Internal Revenue Code. I.R.C. § 501(c)(3) (1998). These organizations include:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment).

¹¹² Lento, *supra* note 92, at 778, 803.

¹¹³ Lento *supra* note 92, at 778, 803. Such flexibility, however, may make it difficult for loan funds to raise additional capital by packaging their loans for sale on the secondary market.

¹¹⁴ See CDFI TYPES, *supra* note 88. See also KATHERINE STEARNS & VALERIE L. THRELFALL, REPORT ON THE MEMBERSHIP OF THE NATIONAL ASSOCIATION OF COMMUNITY DEVELOPMENT LOAN FUNDS, 1996 (1997) (noting at several points how large variations in the size and scope of different loan funds members tended to distort their aggregate statistics). For example, while the average growth in total capital managed by their members increased by an average of 36 percent per year from 1986 to 1996; the NACDLF also notes that a "significant portion of this capital growth is concentrated in a relatively small number of members." *Id.* at 7. The same problem applies to data on the disbursement of capital by loan funds. *Id.* at 8.

¹¹⁵ Tholin, *supra* note 97, at 9-10. See McLenighan & Tholin, *supra* note 74, at 3.

¹¹⁶ Tholin, *supra* note 97, at 10.

4. *Community Development Venture Capital Funds* ("CDVCFs")

The type of CDFI with perhaps the smallest current representation is the community development venture capital fund.¹¹⁷ A fairly recent entrant into the community reinvestment realm, this form of CDFI specializes in providing financial equity investments in new and existing businesses which need something more than additional debt through bank loans.¹¹⁸

These small-scale investment corporations tend to assist organizations which are not seen as suitable clients for more traditional venture capitalists.¹¹⁹ While they exist to serve a fairly narrow function and are unable to provide most other financial services, they have a vital role to play in revitalizing low-income communities by helping to start up new businesses. This, in turn, provides badly needed jobs, inspires more businesses to relocate into the community and makes investment more appealing to traditional lenders and investors. Such activity can also lead to the leveraging of more funds for additional projects. Funds for venture capitalists can come through government programs or from banks seeking to fulfill investment requirements under CRA. Community development venture capitalists may not receive the same returns on their investments as their more bottom-line oriented counterparts, at least in monetary terms, but the reward comes in the contribution they make to the strength of the financial and social infrastructure of their communities.

¹¹⁷ The membership roster of the CDFI Coalition lists only four CDVCFs, though there are likely a few others in the nation. See *Coalition of Community Development Financial Institutions, Members* (visited Apr. 17, 1998) <<http://www.cdfi.org/cdfi/members.html>>. CDVCFs can exist on their own or as a subsidiary of another CDFI or another form of community based organization.

¹¹⁸ This classification would also most likely include Small Business Investment Companies ("SBICs") which are "private venture capital firms licensed and regulated by the U.S. Small Business Administration." See Elijah Brewer III et al., *How are Small Firms Financed?: Evidence from Small Business Investment Companies*, in *ECON. PERSP.* (Nov. 1996) (on file with authors).

¹¹⁹ McLenighan & Tholin, *supra* note 74, at 3.

5. *Micro-Enterprise Loan Funds ("MELFs")*

Not every entrepreneur needs a large infusion of capital, debt or equity to get their business venture up and running. Some businesses, especially those based out of the home, require only a few thousand dollars, perhaps even less.¹²⁰ Frequently, these small businesses cannot afford to pay the interest on thousands of dollars worth of debt associated with a large loan. Unfortunately, many banks simply do not deal in these kinds of small scale loans. In more high-income communities, personal savings and loans from friends and family can frequently be used to provide financing. But people living in low-income communities, some of whom may be welfare recipients,¹²¹ cannot rely upon such resources. Micro-loan funds can help provide the crucial, small-scale financing needed, often without collateral. They are perhaps the fastest growing category of CDFI with at least 190 known MELFs in 1996 and \$125 million in loans made.¹²²

This is not to say that a micro-enterprise loan fund itself must be small. In fact, it may simply be an arm of a larger institution. These loan funds can range from full scale institutions like South Shore Bank of Chicago, which has over \$310 million in total assets, to the church-based Leviticus 25:27 in Yonkers, New York, and from stock-form corporations to mutual arrangements to very informal groupings like the parishioners of a church.¹²³ They can also be found in rural communities, such as Rural Opportunities,

¹²⁰ Examples of the kinds of businesses which can benefit from a micro-enterprise loan fund include tailors, caterers and haircare shops. Many of these businesses are run by women and/or minorities and frequently are run by low-income welfare recipients. Small loans to these tiny businesses can be the catalyst which can "spark a process of community renewal," for any economic development effort must first start at the micro-level before it can begin rolling into the large projects. McLenighan & Tholin, *supra* note 74, at 3; Tholin, *supra* note 97, at 10.

¹²¹ Carl Horowitz, *Another Way Off Welfare Rolls?*, INVESTORS BUS. DAILY, Jan. 31, 1997, at A1.

¹²² McLenighan & Tholin, *supra* note 74, at 3 (citing figures from a 1996 survey of micro-lenders by the Aspen Institute).

¹²³ Schulz, *supra* note 83, at 4.

Inc., a statewide lender based in New York. Funding can come through grants, bank loans and lines of credit, stock offerings or affiliates in a holding company, depending on the nature and structure of the micro-fund. Size and structure is largely immaterial so long as the basic focus and activity is primarily oriented at community economic development.

Despite the wide variety of CDFIs, they all share—as the federal statute suggests—a focus on the common goal of providing financial resources for people, families, businesses and organizations which would otherwise be unable to obtain such financing, thus benefiting the communities they serve.

III. THE NEW CRA RULES AND CDFIS

As a result of the 1994 CRA rules, CDFIs can potentially become symbiotic partners with banks in a way they never were before. Because the new CRA rules invoke CDFIs, banks should become more involved with CDFIs so that communities benefit from productive investment and banks benefit from efficient compliance with CRA.¹²⁴

A. CDFIs in the New CRA Regulations

Essentially the new CRA regulations give commercial banks and thrifts a choice over how they are to be examined for compliance with CRA.¹²⁵ Banks can either opt for a tripartite exam consisting of a lending test, an investment test and a service test, or they may choose to design their own compliance test allowing them to define a level of compliance referred to as a strategic plan.

¹²⁴ It should be noted that, unless otherwise indicated, this material represents the authors' opinions regarding how the new CRA regulations can and should be used to benefit CDFIs. This is not necessarily the way banking regulators will actually be carrying out the enforcement, although, to the extent possible, this analysis is based on how the regulators are presently using CRA.

¹²⁵ The new regulations do not grant this choice to wholesale banks, limited purpose banks and small banks (defined as banks with total assets of \$250 million or less). See *supra* notes 56 and 60 (defining wholesale, limited purpose and small banks).

For each piece of the tripartite test, a bank is awarded one of five possible ratings ranging from "substantial noncompliance" to "outstanding" based on a regulatory examination of the bank's compliance activity. The three ratings are then averaged into the final statutorily required rating.¹²⁶ Regulators conduct all of the compliance tests in a "performance context," where they take into account the special characteristics and demographics of the bank's local service community, including information about the institution itself, its business strategy and its competitors in the area, adjusting the ratings accordingly.¹²⁷

The earlier CRA regulations focused on twelve assessment factors that the regulators were to consider when examining a bank. These factors largely emphasized direct lending, spelling out for a bank the kinds of activities and documentation which were necessary for a high rating. The new rules replaced the old assessment factors with new language that stresses flexibility for banks in CRA compliance and emphasizes activities which the bank has actually performed that benefit the community.¹²⁸

By utilizing a wider variety of financial powers that are at the disposal of banks, the new rules promote a wider range of mechanisms to promote community reinvestment, many of which are either best done through a CDFI or largely cannot be done otherwise. This ability to use non-traditional financial institutions is particularly useful where a bank needs portfolio diversification or is required to serve a low-income community but has not yet penetrated into that market to find the most beneficial and productive investment opportunities. CDFIs, however, because they

¹²⁶ The four statutory ratings are set forth in 12 U.S.C. § 2906(b)(2) (1997). The ratings include "outstanding," "satisfactory," "needs to improve" and "substantial noncompliance" with respect to meeting community credit needs. *Id.* The individual test ratings are found at 12 C.F.R. § 228.28 (1997).

¹²⁷ 12 C.F.R. § 228.21. The rules under 12 C.F.R. § 228.21(d) and CRA statute itself in 12 U.S.C. § 2901(b) states the importance of also evaluating a financial institution in a manner consistent with the safe and sound operation of that institution.

¹²⁸ Although the twelve assessment factors were replaced, many of them can still be found in the new rules in one form or another. See Warren W. Traiger, *Wherefore Art Thou, Twelve Assessment Factors?: Not Too Far Away, After All*, in ABA BANK COMPLIANCE (Summer 1996).

are active in the area, often know the best opportunities.¹²⁹ Most importantly for banks, CDFIs, by their own activity, can provide a bank with CRA credit even though all the bank may have done is provided financial support for the intermediary CDFI.¹³⁰

It seems that the references in the new rules to “third party intermediaries,” or other variations of this term, is understood to possibly and even likely mean CDFIs. Although CDFIs are only mentioned in the footnotes of the regular preamble published in the Federal Register accompanying the issuance of the final proposal,¹³¹ there are quite a number of references in the new rules to “third party intermediaries,” or organizations with which a bank can partner to fulfill its CRA requirements.¹³² While CDFIs are not the only form of organization with which a bank might cooperate, they are some of the most versatile — particularly the more multi-service community development banks and credit unions. They therefore seem ideally suited to fit the role outlined for “third party intermediaries” in the new CRA regulations.

Also, the rules seem to have created another opportunity for banks to involve CDFIs through CRA requirements regarding community development loans and services, as well as qualified investments. Often these forms of activities are most practically carried out by involving a CDFI.

B. Defining Community Development: A New Emphasis on CDFIs

The definition section of a statute, where terms used within the statute are explicitly spelled out, often provides an indication of how regulators plan to actually enforce their rules. The CRA is no exception. The new definitions of “community development,”

¹²⁹ McLenighan & Tholin, *supra* note 74, at 4-5.

¹³⁰ See *infra* notes 166-170 and accompanying text (discussing how CDFIs can provide a bank with CRA credit through their own activity).

¹³¹ There are also a few direct references to CDFIs in the *Interagency Questions*, *supra* note 15, at 54,650, 54,653, 54,657. There are also multiple references to community development organizations throughout the questions and answers.

¹³² See, e.g., 12 C.F.R. §§ 228.22(a)(3), 228.25(c)(2).

“community development loans,” “community development services” and “qualified investments” all place an important new emphasis on indirect investing and CDFIs.

The new rules place a strong emphasis on “community development” activities as a means for banks to satisfy their CRA requirements.¹³³ Many commentators were concerned that the lack of a clear definition of “community development” in the 1993 and 1994 rule proposals might permit too broad a working application which would not go as far in focusing bank resources into LMI communities as they felt were needed. Others felt that too narrow a focus might cut out many possibly innovative activities of banks beneficial to those communities.¹³⁴

The new CRA rules define “community development” as including:

- (1) Affordable housing (including multifamily rental housing) for low- or moderate-income individuals;
- (2) [c]ommunity services targeted to low- or moderate-income individuals;
- (3) [a]ctivities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration’s Development Company or Small Business Investment Company programs (13 C.F.R. § 121.301) or have gross annual revenues of \$1 million or less; or
- (4) [a]ctivities that revitalize or stabilize low- or moderate-income geographies,

with subsection four really summarizing the general definition of community development.¹³⁵ The Federal Register statement

¹³³ The definition of “community development” is found at 12 C.F.R. § 228.12(h). *See infra* note 135 and accompanying text (defining “community development”).

¹³⁴ 60 Fed. Reg. 22,159 (1995).

¹³⁵ 12 C.F.R. § 228.12(h) (1998). The reference to “small business” means a business defined as such by the U.S. Small Business Administration under 13 C.F.R. § 121.301 and which does not have gross annual revenue in excess of \$1 million. Also, the use of the “individual” instead of “area” is explained as an attempt to make sure that activities classified as community development can reach an LMI individual in an otherwise more up-scale geographic region instead of only serving individuals in LMI geographies. *See* 60 Fed. Reg. 22,159 (1995).

accompanying the issuance of the new rules (often referred to as the “preamble”) states that all activities by financial institutions which are to be classified as “community development” must primarily be for the betterment of the welfare of the community, and must be met in diverse ways which can range from child care, to education, to health and so forth as long as its purpose is to “revitalize or stabilize low- or moderate-income geographies.”¹³⁶ There are CDFIs and other forms of community-based groups which already provide these non-economic development or housing forms of services as well, and these CDFIs do not themselves have to be located in the LMI community as long as they provide services there for the banks to receive “community development” CRA credit for investing in them.¹³⁷

The definition of community development, particularly as it is used in the three CRA tests,¹³⁸ does not emphasize direct lending,¹³⁹ though forms of direct lending can be used to meet a

It should be remembered that CRA does not require a bank to lend and invest in an LMI community if that community is not in that bank’s primary service area. For example, a hypothetical bank whose service community is only the Upper West Side of Manhattan would not be required to comply with the law by lending in the South Bronx unless it was actually taking deposits from there.

¹³⁶ 60 Fed. Reg. 22,159 (1995). See *Interagency Questions*, *supra* note 15, at 54,560.

¹³⁷ See *Interagency Questions*, *supra* note 15, at 54,650.

¹³⁸ See *infra* Parts III.D, III.E and III.F (discussing the three tests).

¹³⁹ Direct lending and investing cuts out “intermediaries” or “third parties,” thereby providing a financial benefit from a bank directly to the final intended recipient. Indirect lending and investing utilizes an intermediary. Thus, when the bank provides resources, it does so not to the target recipient(s), but to another organization capable of receiving such resources and redistributing them. CDFIs are the principal form of intermediary or third party. Therefore, as a general rule, the regulatory promotion of indirect lending is also a promotion of the use of CDFIs. However, direct and indirect lending are not mutually exclusive when it comes to the way a bank satisfies its CRA requirements. Often a bank will support a project both by a direct loan for the project and a loan to a CDFI also working on the same project (and which is therefore an indirect loan and assuming the project counts as “community development”) and receive CRA credit for both activities. However, this credit may not always benefit the bank under the same CRA test. See Letter from New York State Banking Department to Senator Santiago, *supra* note 93, at 6.

community development requirement. This perhaps points out an important difference between direct financial services and community development activities. The former is aimed at providing assistance to particular targets, while community development activities are aimed at "stabilizing" an entire low income community and is therefore the more critical form in the long run. This may be especially true in the case of CDFIs where the loans and investments they receive act to provide stability to the local financial infrastructure, which in turn leads to greater overall community economic health. A bank looking to fulfill its community development obligations could largely do so by turning to a CDFI for assistance.

The definitions of "community development loan," "community development service" and "qualified investment" provided further scope to the community development aspect of the new CRA rules. Community development loans, as defined in the rules, are loans which serve the purpose of "community development," that is, that stabilize and revitalize LMI communities over the long term, often made at below market rates with repayment schedules which consider the circumstances of the recipient.¹⁴⁰ Since the regulations clearly state that these loans cannot be reported by the bank as a home mortgage, small business, small farm or consumer loans except for multifamily dwellings,¹⁴¹ this classification of lending acts of something of an "everything else" category, even though home mortgage and small business loans certainly help to revitalize poor neighborhoods. Thus this definition encourages lending to CDFIs because loans to CDFIs, as third party intermediaries, also count as "everything else." In fact, the rules state that all loans

¹⁴⁰ Not all bank loans and investments in an LMI community are immediately considered to be "stabilizing." Loans which provide long term community stability are the ones which will be counted, such as a loan which supports an anchor store of a commercial strip. See *Interagency Questions, supra* note 15, at 54,651.

An example of particularly beneficial lending terms is Chase-Manhattan Bank's "recoverable grant," a very low interest (0%-2% depending on the length of repayment time) loan which is repaid in 3-5 years. See Letter from Chase-Manhattan Bank to Senator Santiago (Dec. 15, 1997) (on file with authors).

¹⁴¹ 12 C.F.R. § 228.12(i) (1998).

made through a third party must be classified as community development.¹⁴² The preamble to the rules specifically lists loans to CDFIs as an example of a community development loan.¹⁴³ While this new definition is important to the lending test, its largest impact may be in the test for wholesale banks.

The definition of "community development services"¹⁴⁴ is similar to that of community development loans in that these services must have, as their primary purpose, a provision of financial services to the communities which can be classified as "community development," but not classified as one of the regular retail banking services listed in the service test.¹⁴⁵ For example,

¹⁴² 12 C.F.R. § 228.22(a)(3).

¹⁴³ 60 Fed. Reg. 22,160 n.1 (1995). *See also Interagency Questions, supra* note 15, at 54,650.

¹⁴⁴ 12 C.F.R. § 228.12(j).

¹⁴⁵ While this is referenced under 12 C.F.R. § 228.24(a), there is no direct definition of "retail banking services." However, as the phrase is generally used in banking, it often refers to the offering of savings and checking accounts, certified time deposits, loans and other "regular services" which may not specifically be designed to assist LMI communities.

Therefore, as pointed out in 60 Fed. Reg. 22,151 (1995), special services like electronic benefits transfer, a program which distributes government benefits electronically and therefore improves access to bank services in LMI communities, does count for CRA credit. The provision of the highly experimental individual development account ("IDA"), a special long term savings account with funds deposited by a person from a low-income neighborhood matched by the bank, can qualify as a community development service under the service test and investment test. *See* Letter from the New York State Banking Department to Senator Santiago (Dec. 16, 1997) (on file with authors).

The use of the term "financial services" is also ambiguous. The regulators provide clarification by saying that financial services in the case of CRA:

often involves informing community members about how to get or use credit or otherwise providing credit services or information to the community. For example, service on the board of directors of an organization that promotes credit availability or finances affordable housing is related to the provision of financial services. Providing technical assistance about financial services to community-based groups, local or tribal agencies, or intermediaries that help to meet the credit needs of low- and moderate-income individuals or small businesses and farms is also providing financial services

providing branch and ATM services in an LMI community would not count, nor would providing charge-free checking and savings accounts.¹⁴⁶ However, providing financial counseling services to customers in an LMI community at a CDFI would be creditworthy, as would similar services provided to and through CDFIs.¹⁴⁷ In a manner of speaking, community development services are distinct from retail banking services and beneficial to CDFIs because of their "indirect" nature. While a bank which supplies members for a CDFI board of directors or provides technical assistance to benefits the organization directly, it indirectly promotes the revitalization and stabilization of the community by enhancing the ability of the CDFI to provide a wider and more beneficial range of services. It is largely this definition which makes the service test important to CDFIs.¹⁴⁸

The third and perhaps most important definition for CDFIs under the new regulations is "qualified investment." A qualified investment "means a lawful investment, deposit, membership share, or grant that has as its primary purpose community development."¹⁴⁹ Unlike community development loans and services, the line between direct and indirect is blurred. Qualified investment is not an "everything else" category, but the principal form of compliance activity for a banking institution under the investment

and CDFIs are the kinds of organizations and intermediaries who actually do this type of work. See *Interagency Questions*, *supra* note 15, at 54,651.

Personal charity work provided by a bank employee outside of their regular employment is not counted as a community development service. See *Interagency Questions*, *supra* note 15, at 54,651.

¹⁴⁶ 12 C.F.R. § 228.24(d)(3).

¹⁴⁷ See Letter from the New York State Banking Department to Senator Santiago, *supra* note 93. See also *Interagency Questions*, *supra* note 15, at 54,651.

¹⁴⁸ See *infra* Part III.F (discussing the service test).

¹⁴⁹ 12 C.F.R. § 228.12(s). Because such investments must have as their primary purpose community development in order to qualify, the regulators have specified that mortgage backed securities and municipal bonds do not qualify unless they are designated specifically for the purpose of community development in an LMI community. See *Interagency Questions*, *supra* note 15, at 54,653.

test,¹⁵⁰ and one very beneficial to CDFIs. Virtually all activity performed under the investment test must meet the definition of community development.¹⁵¹ Therefore, an investment, grant, deposit or donation of real property which revitalizes and stabilizes an LMI community can be considered a qualified investment. The question then is what institutions will banks invest in since banks are not ordinarily allowed to purchase shares in most commercial businesses?¹⁵² As the preamble to the rules states, qualified investments can be “investments, grants, deposits or shares in or to financial intermediaries (including but not limited to CDFIs and CDCs) that primarily lend or facilitate lending . . . in order to promote community development.”¹⁵³ In other words, qualified investments refer to investments in a community based organization dealing in financing, which is precisely the definition of a CDFI.

Finally, when the community development definitions are used in the various bank compliance tests, they tend to appear in conjunction with the words “innovative and complex” or some similar variation.¹⁵⁴ Essentially, the more “innovative” the loan

¹⁵⁰ See *infra* Part III.E (discussing the investment test).

¹⁵¹ The preamble to the rules goes out of its way to make it clear what qualified investments are not, more so than describing what they are. They are not, for example, investments in an organization which do not directly serve a community in a community development capacity such as investing in the Federal Home Loan Bank (a government support wholesale bank dedicated to providing home mortgage funding) because it does not serve any particular community, although banks are allowed to work with the FHLB System in order to help them comply with CRA. Similarly, investing in mortgage backed securities and municipal bonds which are not specifically targeted for a purpose which can be defined as community development cannot be considered. See 60 Fed. Reg. 22,161 (1995).

¹⁵² The discussion under *Interagency Questions*, *supra* note 15, at 54,651, clearly states that CRA does not provide banks with any expanded investment powers beyond those presently allowed by law.

¹⁵³ 60 Fed. Reg. 22,162 n.3 (1995). See *Interagency Questions*, *supra* note 15, at 54,653.

In the case of some CDCUs, investments must be made in those designated as “low-income,” which are therefore legally able to accept deposits from outside of their memberships.

¹⁵⁴ See, e.g., 12 C.F.R. § 228.22 (setting forth the lending test); 12 C.F.R. § 228.23 (setting forth the investment test); 12 C.F.R. § 228.24 (setting forth the

or investment, the more CRA value it has to the bank. This is an important supplement requirement because not only is lending and investing in a CDFI innovative in and of itself, but many CDFIs are able to develop their own innovative lending and investment strategies for which the bank can receive CRA credit if it makes investments in CDFIs.

C. Performance Context

Before moving into the detailed discussion of the various bank compliance tests, there is one other important innovation in the new CRA rules which is important to the discussion. In addition to the more quantitative emphasis in the new rules, which focus more on the actual number, amount and distribution of loans and investments made by a banking institution, a new qualitative element was also added. Many bankers felt that an analysis of their activities which only considered an on-paper list of loans and investments but did not include an understanding of the community in which the investments were made missed a crucial point.¹⁵⁵ To address this concern, a “context” of CRA banking activity was added as a consideration to offset the reliance on numbers alone. All banks would be evaluated by regulators within their “performance context” — by the particular and unique economic and demographic conditions of their local service community.¹⁵⁶ For example, if a bank capable of providing a full range of financial services chose to make a large number of housing loans but virtually no small business loans due to the absence of a business-supporting infrastructure and a lack of potential applicants in their particular community, regulators familiar with that community

service test); 12 C.F.R. § 228.25 (setting forth the wholesale and limited purpose bank test); 12 C.F.R. § 228.27 (providing for the strategic plan). It is unfortunate that the small bank test does not mention some form of the word “innovative.” This may be because small institutions do not have the resources to develop alternative forms of lending and investing, however, their closeness to their local communities may have allowed for the natural evolution of very innovative lending and investing methods that should be recognized under CRA.

¹⁵⁵ 60 Fed. Reg. 22,156, 22,162-63 (1995).

¹⁵⁶ 12 C.F.R. § 228.21(b).

would understand the problem and not penalize the bank under the lending test for not having made small business loans.

This does not, however, relieve the bank of lending or investing responsibilities if other options are available. If the performance context makes it difficult for a bank to provide direct loans and investments in its primary service community but a strong community development infrastructure exists, then the bank should funnel a large portion of its services into intermediaries like CDFIs. The rules note that examiners will consider all lending, investment and service opportunities in the community, not just direct ones.¹⁵⁷ On the other hand, use of indirect activities through third parties would allow the bank to comply even when direct lending and investing opportunities are not readily available. The regulators, aware of conditions in the community, could permit banks to largely satisfy a requirement through an intermediary due to performance context concerns. Performance context, however, cannot entirely absolve a bank from any required activity.¹⁵⁸

The authors believe that the regulations could have been improved by giving evaluators greater leeway in allowing banks to use third party intermediaries over direct lending in the three tests, performance context notwithstanding. Still, the existence of the performance context combined with the indirect lending options under the three tests goes a long way towards promoting the use of third party intermediaries and providing some compliance relief.¹⁵⁹

D. The Lending Test

Having completed the discussion of significant CRA definitions, we now turn to how the actual compliance tests support CDFIs.

¹⁵⁷ 60 Fed. Reg. 22,163 (1995).

¹⁵⁸ Banks or bank holding companies that own CDFIs are generally not allowed to count the activities of these CDFIs as acceptable intermediaries for community development, but are instead counted as affiliates, to be considered under the various tests at the bank's discretion.

¹⁵⁹ See Marsico, *supra* note 3, at 304-08 (discussing CRA's support of CDFIs and arguing that such use of CRA promises to promote economic development and fight poverty more effectively).

The lending test is the first and arguably most important¹⁶⁰ of the three tests applicable to commercial banks that neither qualify for the small bank test nor opt for the strategic plan. This test "evaluates a bank's record of helping to meet the credit needs of its assessment area(s) through its lending activities."¹⁶¹ The test requires that banks comply through two different avenues: direct mortgage, small business and small farm lending and community development activities including indirect lending.¹⁶² The degree to which one kind of loan will be weighed against another will be determined by taking into account the performance context of the lending institution.¹⁶³

For the most part, lending test compliance activities potentially involving CDFIs are grouped under the third party intermediary portion of the community development lending requirement. The regulations promote indirect lending through intermediary organizations by considering, at the bank's request, all "loans originated or purchased by consortia in which the bank participates or by third parties in which the bank has invested only if the loans meet the definition of community development" (which demonstrates the importance of having a clear definition of "community development").¹⁶⁴ Essentially, this involves a bank lending—that is

¹⁶⁰ The lending test is most important because its compliance rating carries more weight in the final computation than either of the other two tests. See *infra* note 238 (discussing weight of lending test).

¹⁶¹ 12 C.F.R. § 228.22. Some critics feel that the weight given to the lending test is an example of how the new rules are forcing a credit reallocation scheme on the banking industry. See, e.g., David K. Hales, *Reallocating Credit: An Economic Analysis of the New CRA Regulations*, 15 ANNUAL REV. OF BANKING LAW 4 (1996).

¹⁶² 12 C.F.R. § 228.22. The rules also permit regulators to consider a bank's consumer loans if they are a significant part of the bank's regular business. The regulations define a consumer loan under 12 C.F.R. § 228.12(k) as "a loan to one or more individuals for household, family, or other personal expenditures." Consumer loans include motor vehicle loans, credit card loans, home equity loans and other similar forms of loans, both secured and unsecured.

¹⁶³ 60 Fed. Reg. 22,164 (1995).

¹⁶⁴ 12 C.F.R. § 228.22(a)(3). Consortium lending refers to group lending when a financial institution pools its resources with other financial institutions to make loans. While this often can use a CDFI, like a community development loan fund, as a holder of the funding, it is not necessarily a CDFI-oriented form

providing debt financing—to another organization which can then use those funds for either a specific purpose or for general work. The projects and programs implemented by these organizations do not have to be mortgage or economic development-oriented, but can include education, health, social services and child care as well.

While banks are not explicitly required to fulfill their community development lending requirements through indirect lending to intermediaries, there are strong incentives for banks to meet their community development lending obligations this way. Since the lending test is the most important of the three tests, banks, in order to score highly, will be looking for as many different ways to comply as possible. At the same time, they will be interested in making this compliance profitable and cost effective. Unlike the direct lending requirements of the test, utilizing the indirect lending intermediary options for community development relieves the bank of the burden of finding customers who are not overly high risk and learning how a particular local market works.¹⁶⁵ So in order to be able to serve their entire primary assessment area effectively, including low-income neighborhoods, banks have an interest in making use of local financial intermediaries so they can satisfy their community development obligations. Since established CDFIs are already serving a customer base, using them as intermediary partners relieves the bank of the need to find a way to successfully enter the local market.¹⁶⁶ A bank's support can take a variety of forms, not only lending straight to the CDFI, but also by purchasing loans originated by the intermediary which provides capital to the CDFI through a secondary-market mechanism.¹⁶⁷ The bank,

of compliance, particularly since the rule has separated it out from third party institutions.

¹⁶⁵ 12 C.F.R. §§ 228.22(a)(3), (d). The rule also states in no uncertain terms that all loans involving a third party will be counted only as community development loans.

¹⁶⁶ This can take on interesting forms of partnerships such as "packaging" where a CDFI finds a customer, figures out the kind of loan the customer needs, underwrites the loan and then presents the customer and his or her package to the bank for the actual loan. See McLenighan & Tholin, *supra* note 74, at 39.

¹⁶⁷ The lending test rules allow banks to count loans they have purchased from other organizations if the loans purchased also meet the definition of a "community development loan." 12 C.F.R. §§ 228.22(a)(2), (3). This also

it should be pointed out, does not need to be directly involved with the CDFI's day to day lending efforts in order to receive their credit.¹⁶⁸ However, under the lending test, loans made by a CDFI receiving financial support from a bank will only be counted as community development loans for the bank if the CDFI's loans can also be classified as community development.¹⁶⁹

While banks must request the consideration of loans to third parties by regulators and report the relevant data,¹⁷⁰ the rules otherwise give financial institutions a great deal of freedom to choose in whom they will invest as long as the activities of these organizations can qualify as community development.¹⁷¹ This has certain long term advantages for the bank beyond CRA compliance. By stimulating community development through CDFIs, banks are helping to develop a stronger, lower-risk potential customer base for direct loans and other financial services they may wish to offer in the future. A neighborhood which a bank once may have only served reluctantly with the expectation of loss becomes, several years down the road, a profitable source of business. Meanwhile, the CDFI will have already taught many people the basics of banking and finance and allowed them to develop the basic

includes purchasing loans originated by affiliates of the bank, *see* Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated Feb. 21, 1996*, (visited Apr. 24, 1998) <<http://www.ffiec.gov/cra/info/letters/1996/19960221>>.

For lending test credit on purchase of loans through the secondary market, *see* Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated June 26, 1995*, (visited Apr. 24, 1998) <<http://www.-ffiec.gov/cra/info/letters/1995/19950626>>.

¹⁶⁸ 60 Fed. Reg. 22,166 (1995). In addition, the bank may not claim full credit for a CDFI's loan if other banks are also investing in the same CDFI in a manner which contributed to the CDFI's ability to make that loan. *See* 12 C.F.R. § 228.22(d)(2).

¹⁶⁹ 12 C.F.R. § 228.22(a)(3). If multiple banks are investing in the same CDFI, then an individual bank receives a portion of CRA community development credit for loans made by the CDFI in an amount in proportion to its share of the investment made in the organization. *See* 12 C.F.R. § 228.22(d)(2); *Interagency Questions*, *supra* note 15, at 54,656.

¹⁷⁰ This requirement is discussed under 12 C.F.R. § 228.42(b)(2) and is found under 12 C.F.R. § 228.22(d)(1).

¹⁷¹ *See Interagency Questions*, *supra* note 15, at 54,656.

financial assets needed to apply for regular bank lines of credit. Indirect lending which builds up a local financial infrastructure, unlike direct lending, is a long term investment which benefits the bank, the CDFI and the community at large. Therefore, the success of the CDFI also translates into expanded opportunities for their supporting banks.

The requirement that banks make their community development lending activities complex and innovative is another important aspect of the lending test that benefits CDFIs.¹⁷² The new rules do not tell banks how to make community developments, but instead rewards them for using their expertise and experience to make the loans as supportive to LMI communities as possible. The requirement provides banks with the incentive of greater CRA credit for finding new ways to stimulate community development instead of simply meeting the bare minimum standards of compliance.¹⁷³ While it should not be assumed that all of this complexity and innovation will go into creative loans to CDFIs, these neighborhood institutions, partially due to their wide variety of types and organizational structures, can offer a broad range of innovative community development projects with a minimal risk. Experience with trying to meet a high demand with limited resources has forced many CDFIs to develop new and creative ways for banks to support them in order to expand their resource base. If necessity is the mother of invention, and banks combine their experience with the knowledge of CDFIs regarding the needs of poor communities, innovative forms of lending will be produced. It is a win-win situation creating more CRA credit for the banks, helping to increase debt financing for the CDFI and making more capital available to the community. Additionally, the "complexity and innovativeness" requirement under the test promotes not only the development of existing CDFIs but encourages the establishment of new ones in LMI communities that do not have comparable institutions.¹⁷⁴

¹⁷² 12 C.F.R. §§ 228.22(4), (5).

¹⁷³ See *Interagency Questions*, *supra* note 15, at 54,654.

¹⁷⁴ 60 Fed. Reg. 22,165 (1995).

Another crucial element, though perhaps not as paramount overall, is the requirement that loans under this test be "flexible."¹⁷⁵ This insures that the terms of a loan, direct or indirect, will be beneficial to the recipient. While this does not only apply to CDFIs and their activities, it can translate into loans made to a CDFI at a special rate or on terms beneficial to the CDFI, saving the community group precious resources in the long run.¹⁷⁶ These resources can then be put towards community development lending and will end up benefitting the supporting bank as well.

Finally, investments made by a bank in a CDFI (as opposed to loans made to a CDFI) may be considered for credit under the lending test if they generate community development loans made by the CDFI.¹⁷⁷ What makes this appealing for banks is that they may receive more lending test credit for the loans made by the CDFI than for the monetary amount of the bank's initial investment. The credit under the lending test will be awarded on a pro-rata basis,¹⁷⁸ meaning that a bank will receive credit for a percentage of the total value of all community development loans made by the CDFI equal to the percentage of the bank's investment in the CDFI's total capital. Therefore, if the percentage of the loans made by the CDFI equal to the percentage of the bank's investment in the organization exceeds in actual value the monetary amount of the investment made by the bank, the bank will receive CRA credit for a value greater than the original dollar amount provided to the CDFI.¹⁷⁹ The bank may continue to receive credit for its invest-

¹⁷⁵ 12 C.F.R. § 228.22(b)(5).

¹⁷⁶ See *supra* note 140 (discussing such a loan offered by Chase-Manhattan Bank).

¹⁷⁷ 12 C.F.R. § 228.22(d).

¹⁷⁸ See *Interagency Questions*, *supra* note 15, at 54,657; Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated May 30, 1997* (visited Apr. 24, 1998) <<http://www.ffiec.gov/cra/info/letters/1997/19970530>>; Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated June 14, 1996* (visited Apr. 24, 1998) <<http://www.ffiec.gov/cra/info/letters/1996/19960614>>.

¹⁷⁹ For example:

Assume an institution invests \$1 million in a CDFI with total capital of \$10 million . . . and \$18 million in community development loans. The amount attributed to the lending test would equal the bank's pro

ment under the lending test as long as the investment remains active at the CDFI, providing CRA credit for the bank over a long period of time for only a small amount of effort on the part of the bank.¹⁸⁰ While the bank may choose to have part of its investment counted under the investment test as well, it will only receive credit in proportion to the total amount of qualified investments made by the CDFI versus the amount the bank opts to have considered and no more.¹⁸¹ Here again it is in the best interests of a bank to work through a CDFI in order to satisfy the community development requirements of the lending test.

rata share of community development loans originated by the CDFI during the period under review. Assuming the CDFI's \$18 million in loans were made during the period under review, the bank's pro rata share would be \$1.8 million, because the bank has supplied 10 percent of the CDFI's capital. Therefore the bank may receive consideration for \$1.8 million in community development loans under the lending test.

McLenighan & Tholin, *supra* note 74, at 8. See also Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated June 26, 1995*, (visited Apr. 24, 1998), <<http://www.ffiec.gov/cra/info/letters/-1995/19950626>>.

¹⁸⁰ The equity-equivalent program developed between Citibank and the National Community Capital Association is an excellent example of an investment used to generate community development lending in CDFIs. This program is a form of unsecured loan which is completely subordinated to all other debts owed by the institution receiving the funds, meaning that the receiver will repay all other creditors before being required to repay the equity-equivalent funds to the issuing bank. The long term nature of the funds acts as a form of permanent capital instead of debt capital, but can be made available to not-for-profit institutions like credit unions which cannot normally sell regular equity. See Office of the Comptroller of the Currency, *CRA Interpretations - Letter 727, Issued June 27, 1996*, (visited Apr. 24, 1998) <<http://www.occ.treas.gov/interp/-july/cra727.htm>>; Michael Selz, *Citibank Pioneers a Way to Help Poorer Communities*, WALL ST. J., Oct. 24, 1996, at B2; Stephen Tarnoff, *New Sources of Funds to Non-Profits*, CRAIN'S SMALL BUS. (Chicago, Ill.), Nov. 1, 1996, at 5.

¹⁸¹ See *Interagency Questions*, *supra* note 15, at 54,657-58.

E. The Investment Test

More innovative than the lending test is the investment test, which may very well be the most beneficial part of the CRA package for CDFIs overall. This test involves the use of qualified investments by banks and therefore has a strong relationship to those parts of the new rules promoting community development.¹⁸² A qualified investment refers to any form of investment, deposit, membership share or grant with the principal purpose of community development.¹⁸³ This effectively ties the investment test to bank investment activities counting as community development as defined in the CRA rules. In other words, the definitions of “qualified investment” and “community development” truly provide the scope of the investment test. Drawing on these definitions, it can be said that the test is made up of bank investments in entities which support affordable housing, community service, economic development¹⁸⁴ and the stabilization of LMI communities. This focus means that banks must seek out investment opportunities in organizations, corporate or not-for-profit, which can help them meet their goals of providing investments which stimulate community development activities.¹⁸⁵ CDFIs are the obvious choice, though banks are not specifically required to make investments in CDFIs, and in fact can invest in any commu-

¹⁸² In order to be classified as a “qualified investment,” the investment must be for the purpose of community development. This is supported by the preamble to the regulations which states that the “definition of ‘qualified investments’ has been moved to the definition section for clarity and changed to reflect the new definition of ‘community development.’” 60 Fed. Reg. 22,161 (1995).

¹⁸³ 12 C.F.R. § 228.12(s).

¹⁸⁴ Under the investment test, “economic development” refers to “permanent job creation, retention, and/or improvement in low- or moderate-income geographies targeted for redevelopment by federal, state, local or tribal governments.” See Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated Sept. 2, 1997* (visited Apr. 24, 1998) <<http://www.ffiec.gov/cra/info/letters/1997/19970902>>.

¹⁸⁵ 60 Fed. Reg. 22,161 (1995).

nity-based organization as long as they do not violate regular banking restrictions.¹⁸⁶

In practice, the bank must find organizations which are both legally and structurally capable of accepting investments, deposits and/or grants and which specialize in a form of community development.¹⁸⁷ CDFIs are the perfect fit because they are capable of accepting different varieties of investments, and many of them, like community development banks and community development credit unions, are capable of making a wide variety of them.

Types of investments may include: purchase of equity in a CDFI;¹⁸⁸ purchase of shares, providing grant funding for particular projects, including projects involving the provision of tax credits;¹⁸⁹ or simply placing equity-equivalent forms of funding in those CDFIs which cannot sell shares, like community development credit unions and most loan funds.¹⁹⁰ As with the lending test, qualified investments which are innovative in nature will receive additional credit.¹⁹¹ Unlike loans, which the CDFI must

¹⁸⁶ It is important that a bank be able to make an investment through a non-banking affiliate in its holding company structure and still have that investment counted towards a high investment test score.

¹⁸⁷ The invested organization must provide financial services. However, it can also offer a wider range of services such as affordable housing and day care facilities. 60 Fed. Reg. 22,161 (1995).

¹⁸⁸ This may also include a bank investing in a CDFI which is an affiliate inside the same holding company structure as long as the affiliate is providing a service which can be considered as a qualified investment. See Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated Aug. 14, 1997* (visited Apr. 24, 1998) <<http://www.ffiec.gov/cra-info/letters/1997/19970814>>.

¹⁸⁹ See Federal Financial Institutions Examination Council, *Interagency CRA Interpretive Letter Dated June 10, 1997* (visited Apr. 24, 1998) <<http://www.ffiec.gov/cra/info/letters/1997/19970610>>.

¹⁹⁰ The downside which remains for banks using this form of compliance is that they often require some form of return on their financial investments, and many CDFI qualified investments may not produce the most spectacular of profits.

¹⁹¹ Innovative qualified investments are investments made under special circumstances, at rates beneficial to the CDFI and which help sponsor programs not routinely provided by the private market that help stabilize LMI communities. See Federal Financial Institutions Examination Council, *Interagency*

repay, investments supply the CDFI with permanent capital. This provides the organization with a solid base of assets and reserves it can use to keep itself financially sound, thereby making the CDFI more attractive to other banks, organizations and investors from which it may wish to leverage funds in the future. The CDFIs will, in turn, make qualified investments in small businesses and organizations throughout the community.¹⁹²

Therefore, these investments can build up the local financial infrastructure of a community, even more so than the support provided through the lending test, creating a larger future customer base as consumers become educated in banking and finance and prepared for direct bank lending. A bank which establishes a presence in a community through such investing activity, helping to build up the basic economic infrastructure of that community, may then find a new set of promising customers, such as small businesses, which can be supported at a low risk, all because the bank made foresighted investments years earlier.¹⁹³

True, there are other forms of investments which may be feasible and do not include CDFIs: for example the financing of a large grocery store which anchors a strip mall in an LMI community is an investment qualifying as "community development."¹⁹⁴ However, CDFIs are ready-made partners in which banks can invest in and receive CRA credit without seriously risking the

Interpretive Letter Dated Aug. 1, 1997 (visited Apr. 24, 1998) <<http://www.ffcra.gov/cra/info/letters/1997/199708012>>.

¹⁹² This provision of equity capital is critical for many small businesses, particularly those trying to establish themselves in LMI communities where the risk of failure is higher. Debt capital, which must be repaid, creates a difficult situation for the small business because the loans can become due before the business has been able to establish itself and reach a position of cash-flow. Permanent equity differs in that it provides the small business with a fixed capital base which the business can use to leverage additional funds. *See Issues in Funding in the Activities of Small Firms through SBICs*, 113 CHICAGO FED. LETTER (1997) (on file with authors).

¹⁹³ In fact, some banks, in order to increase their competitiveness in new markets, are looking to the small business market as a potential new source of business. *See* Chris Isidore, *Fleet Readies Big Guns to Challenge Citi, Chase*, CRAIN'S N.Y. BUS., Feb. 23, 1998, at 4.

¹⁹⁴ *Interagency Questions*, *supra* note 15, at 54,650.

bank's investment. Moreover, while the bank may only receive credit equal to the actual value of the investment,¹⁹⁵ it may receive test credit as long as the investment is actively supporting the CDFI.¹⁹⁶

Grants by financial institutions for the purpose of community development also fall under the investment test, including the provision of property and facilities. This is done either through a sale, on beneficial terms, or by direct donation to a minority or women-owned depository institution. Since this can take the form of a bank branch, including offices and equipment, these grants are something which could be (and have been) extremely valuable for CDFIs.¹⁹⁷ Examples of such activities include the donation of a Chemical Bank branch in New York City to the Central Brooklyn Federal Credit Union, a CDCU, for its main offices.

F. The Service Test

The service test focuses on the way an institution provides financial support services in its primary assessment community. For the most part, it focuses on direct delivery of these services, such as the number and convenient availability of bank branches, automated teller machines¹⁹⁸ and other bank owned points-of-access terminals, as well as their level of accessibility in the

¹⁹⁵ In contrast to the lending test, a bank may not receive a pro rata share of investment test credit for the community development work performed by the CDFI.

¹⁹⁶ 61 Fed. Reg. 54,657-58 (1996).

¹⁹⁷ 12 C.F.R. § 228.23 (1997). Minority and women-owned businesses are defined for these purposes as an institution where more than 50% of the corporation is owned by one or more women or minority individuals and more than 50% of the profits accrue to one or more women or minority individuals. See 12 U.S.C. § 2907(b) (1997).

¹⁹⁸ Notably, the final rule proposal does not consider an ATM facility equal to a "brick and mortar" bank branch when evaluating the distribution of a bank's services, thereby increasing the importance of the fully staffed branch. 60 Fed. Reg. 22,167 (1995). The issue of ATMs replacing bank branches in LMI communities has been an issue involved with CRA for some time. See generally Beth E. Secaur, *Automated Teller Machines Under the New York Banking Law: Do They Serve Community Credit Needs?*, 37 SYRACUSE L. REV. 117 (1986).

community, including the opening and closing of bank branches.¹⁹⁹ In fact, an initial glance through the regulatory specifics of this test may lead one to believe that there is little here to encourage banks to support third party financial intermediaries. After all, services provided to the public by a CDFI would be provided directly by that CDFI, not by the financial institution which is lending to or investing in the CDFI.

This, however, overlooks the fact that a bank will be rated on "the extent and innovativeness of its community development services,"²⁰⁰ referring to the provision of a financial service by the bank which supports affordable housing, economic development and revitalizing and stabilizing low-income communities. The provision of these services, in order to meet this community development requirement, must include innovative ways of utilizing the bank's business and human resources to provide these services in LMI communities.²⁰¹

The provision of financial services for community development purposes by the bank can be conveniently achieved through the utilization of CDFIs. Many banks have large service areas, with their actual brick and mortar portion of the bank, complete with staff, possibly located a considerable distance from the LMI community. One important goal behind the service test is to bring substantive financial services directly to the LMI community, which can be accomplished by having bank staff provide banking services through the CDFI. Sections 228.24(a) and (e) promote "innovation" in the delivery of community development services, meaning (as this expression has suggested everywhere else in the rules) that banks must find new ways to bring financial services which promote affordable housing, economic development and the revitalization of low-income neighborhoods. It is through this fundamental requirement that financial institutions should look for ways to use CDFIs to provide services that qualify under the service test.

¹⁹⁹ See 12 C.F.R. § 228.24(a), (d).

²⁰⁰ 12 C.F.R. § 228.24(a).

²⁰¹ See *Interagency Questions*, *supra* note 15, at 54,651.

It is entirely possible that a financial institution could make many of its own services available directly through a CDFI, turning the local organization into a pseudo-branch of the bank.²⁰² While this would not likely include offering accounts directly through the CDFI, it could mean financial counseling, assistance in conveniently paying loans, helping entrepreneurs craft business proposals and feasibility studies, and holding small business and home mortgage seminars.²⁰³ The community institution could arrange for an ATM to be operated on its premises on behalf of the bank, even one offering only a limited line of products. Customers requiring more advanced financial services than might be offered through the CDFI would be referred to a bank office for assistance. For example, a CDFI which did not normally provide mortgage services could easily refer the perspective customer to its supporting financial institution and perhaps could even keep literature from the bank handy and help prepare the customer for meetings with the bankers. The bank could even provide computer terminals at the CDFI to allow its customer in an LMI community access to his or her accounts.²⁰⁴ Thus, while CDFIs hardly become *de facto*

²⁰² Providing community development services through a CDFI instead of at the bank branch itself would likely be considered "effective alternatives to branches in providing needed services to low- and moderate-income areas and individuals." See *Interagency Questions*, *supra* note 15, at 54,658.

²⁰³ In fact, most of the community development services which the regulators have identified as counting under the service test can be provided by the bank through a CDFI, such as the provision of technical assistance of individuals, small businesses and other local not-for-profit organizations; credit counseling services; long term investment programs to help people in LMI communities save for college, retirement and other future goals; and teaching local residents how to use electronic transfer terminals and similar services. See *Interagency Questions*, *supra* note 15, at 54,651.

²⁰⁴ Many community activists may object to such a broad interpretation of "alternative banking" or "innovative" provision of services because participation on the part of the financial institution is far too indirect. Similar objections are found in the preamble to indirect bank lending in general. However, a CDFI can benefit from these activities, as it becomes a point of access for the bank, thus bringing the community to the CDFI for financial business. The CDFI can use this opportunity to promote its own products to the consumer while he or she is on its premises. Activists must remember that these alternatives, farfetched as they may be, will only be counted by the regulators as long as they are

branches of the bank, they can be an excellent method of outreach for the bank and a way to provide community development services to the community at a very low cost to the financial institution. Such approaches would be likely to qualify as "innovative" forms of service provision.²⁰⁵

The "community development service" component of the service test, however, extends beyond these innovative approaches to the provision of services.²⁰⁶ Provision of services does not merely mean operating a branch office, an ATM or some other point-of-access terminal, nor simply providing a range of services at such locations. It refers to providing consulting services and even loan servicing assistance to the actual CDFI,²⁰⁷ as well as providing community financial development services through the CDFI to other CBOs, by encouraging bank staff to sit on the advisory boards or boards of directors of CDFIs.²⁰⁸ Essentially, as the regulatory preamble states, community development service means an activity which takes "advantage of the [bank] employee's

considered to be an "effective alternative." 60 Fed. Reg. 22,165 (1995).

²⁰⁵ 12 C.F.R. § 228.24 (d)(3) promotes alternative delivery of retail banking services including cyberbanking and computer banking.

²⁰⁶ 12 C.F.R. § 228.12(j) (defining "community development" service); § 228.24(a) (incorporating community development service as part of scope of test); 12 C.F.R. § 228.24(c) (incorporating community development service as an affiliate service); 12 C.F.R. § 228.24(e) (incorporating community development service as part of performance criteria).

²⁰⁷ See *Interagency Questions*, *supra* note 15, at 54,651; Federal Financial Institutions Examinations Council, *Interagency CRA Interpretive Letter Dated Mar. 14, 1997* (visited Apr. 24, 1998) <<http://www.ffc.gov/cra/info/letters/-1997/19970314>>.

²⁰⁸ 60 Fed. Reg. 22,161 (1995) states that:

Service on the board of directors of an organization that promotes credit availability or affordable housing meets this requirement. Providing technical assistance in the financial services field to community-based groups, local or tribal government agencies, or intermediaries that help to meet the credit needs of low- and moderate-income individuals or small businesses and farms is also related to the provision of financial services.

It should be noted, however, that certain not-for-profit CDFIs, such as CDCUs, are not permitted to have non-credit union members on their boards of directors, which would exclude bank staff from providing this form of service.

technical or financial expertise.”²⁰⁹ Many CDFIs, particularly those which are just starting up, lack the experience and knowledge of the financial industry necessary to run and operate in a safe and sound manner to benefit the community while increasing the permanent and borrowed capital base of the institution.²¹⁰ It may even be feasible for a bank to make an arrangement to keep some of its staff, perhaps on some form of pro-bono arrangement, at the CDFI a couple of days out of the week to both assist the organization’s staff and provide financial planning and counseling services to the customers.

Such activity not only helps strengthen the CDFI, but provides the bank staff with firsthand knowledge and experience in dealing with the clientele of a neighborhood, and the possibility of turning them into a future customer base for the bank.

G. Community Development Test for Wholesale and Limited Purpose Banks

Another innovation in the new CRA regulations is the development of a special test for wholesale banks and limited purpose banks.²¹¹ In fact, because these institutions, by definition, are

²⁰⁹ 60 Fed. Reg. 22,161 (1995).

²¹⁰ Recently, a fairly well known CDCU in the Bedford-Stuyvesant community of Brooklyn, famous for its ability to bring in loans and grants from the banking industry, was seized by the NCUA because those in charge did not have experience in handling the money they were so adept at acquiring. See Louis Whiteman, *Brooklyn Activists Protest NCUA Seizure of Local Credit Union*, AM. BANKER, Mar. 11, 1998, at 7 (discussing the NCUA’s November 24, 1997 decision to seize the Central Brooklyn Federal Credit Union and place it in conservatorship).

²¹¹ 12 C.F.R. § 228.5. The regulations define a wholesale bank under 12 C.F.R. § 228.12(w) as “a bank that is not in the business of extending home mortgage, small business, small farm or consumer loans to retail customers.” Limited purpose banks are defined under 12 C.F.R. § 228.12(o) as “bank[s] that offer[] only a narrow product (such as credit cards or automobile loans) to a regional or broader market.” These primarily include banks which specialize in particular product lines instead of general retail banking with the standard range of products and services.

12 C.F.R. § 228.25(b) requires that financial institutions, including “nonbank banks” under the Competitive Equality Banking Act (“CEBA Banks”) as

normally unable to lend to individuals and organizations and are not even likely to have the staff resources and experience to engage in such lending, they are not expected to meet a direct lending test. With such limits on their capacity to contribute to community development, use of indirect lending and investing through third party intermediary institutions is the clear and logical option facilitated by the new regulations.²¹² The great advantage to CDFIs is that this test has been constructed by the federal regulators to rely almost entirely on indirect lending, with the main component being activities which meet the definition of "community development."²¹³ Fortunately, the definitions provided by the Preamble to the Federal CRA Regulations directly cite the use of third party intermediaries as a prime means to qualify under the tests. The principal requirement is that the activity undertaken by the institution must promote affordable housing, economic development and the revitalization of poor neighborhoods. The regulators demonstrate considerable flexibility in allowing these institutions to undertake these community development activities in the forms of community development lending, qualified investments

designated under 12 U.S.C. § 1843(f), which meet these requirements and desire to be considered either as wholesale or limited purpose banks for CRA purposes, must apply for designation from the proper regulatory agency no less than three months prior to the date they want their designation to become effective. These institutions, many of which do very little direct business with individuals, were likely included at the urging of the retail banking industry to prevent them from having a competitive advantage by being free of CRA constraints. *See* 60 Fed. Reg. 22,162 (1995).

There are not a large number of designated wholesale and limited purpose banks in the nation. The Office of the Comptroller of the Currency, as of October 8, 1997, had only 65 listed on its web page at <<http://www.occ.treas.gov/cra/limited.htm>>. As of February 2, 1996, the New York State Banking Department had nineteen institutions subject to their authority designated as either wholesale or limited purpose banks in New York State.

²¹² It is important to remember that "community development" is defined to mean activities including financial support for affordable housing, community services and economic development under 12 C.F.R. § 228.12(h). These are all activities which wholesale and limited purpose banks are unlikely to have the capacity and resources to do directly themselves, thus encouraging them to seek a community-based financial partner.

²¹³ *See* 12 C.F.R. § 228.25(a).

or community development services. In fact, these institutions may focus their compliance efforts on only one or two of these three criteria.²¹⁴ This will likely allow these institutions to push lending and investing over services, a desirable result since these institutions do not normally specialize in providing a broad range of financial services nor incorporate them as a regular part of their business strategies.

For those LMI communities fortunate enough to have a wholesale or limited purpose bank that delineates them into its primary service area, there is a great benefit to be had. By emphasizing indirect community development activity by these institutions, the CRA test on wholesale and limited purpose banks will likely provide a broad range of loans and qualified investments for CDFIs in these communities. In fact, CDFIs outside the delineated communities may also benefit since the rules permit banks to work with intermediaries not directly in their primary service areas. All that is required is that the activity involving the CDFI have some community development benefit to the primary service community.²¹⁵

H. The Small Bank Test

The new CRA regulations define a small bank as an institution with total assets of \$250 million or less for the two calendar years prior to its CRA evaluation, and one which is not an affiliate of a bank holding company with \$1 billion or more in total assets.²¹⁶ For these small institutions, a special, streamlined test was designed to keep their compliance burden at a minimum.²¹⁷ Part of the

²¹⁴ 60 Fed. Reg. 22,167 (1995).

²¹⁵ 12 C.F.R. § 228.25(e).

²¹⁶ 12 C.F.R. § 228.12(t). The regulators determine small-bank status using December 31 of the year prior to the evaluation as a starting point.

²¹⁷ 60 Fed. Reg. 22,167-68 (1995).

Under the CRA rules there are two main differences between small banks and regular banks. The first is the small bank performance standard test, laid out in § 228.26. The second is the special, streamlined data reporting requirements found in §§ 228.42(a), (b) and (g). Essentially, small banks are not required to report the amount, location and type (that is for a business or a farm with an

justification for this lighter burden comes from the claim that these small institutions are inherently community-oriented by virtue of their size, that their fundamental business strategy is, similar to credit unions, aimed at providing direct assistance to their local neighborhood and that they do not require the heavy hand of government to force them to do what they are doing already. In other words, these banks do not have the scope and assets necessary to pick and choose their customers from a large, diverse community, which is what CRA was designed to prevent. Another reason for applying a more lenient test is that these small banks have fewer staff and equipment resources with which to develop elaborate CRA compliance strategies or to record and report all of the data required of large banks under the new rules.²¹⁸ Particularly in the light of recent trends in the banking industry toward mega mergers, there is a greater interest in keeping small banks strong and viable.²¹⁹ It is interesting to note that CDFIs which are

annual revenue of less than \$1 million) of their loans in a special alpha-numeric identification symbol format. 12 C.F.R. § 228.42(a). 12 C.F.R. § 228.42(b) frees small banks from the requirement to report small business and small farm loan data, home mortgage loan data and assessment area data required under 12 C.F.R. § 228.42(g). However, if a small bank opts under 12 C.F.R. § 228.21(a)(3) to be assessed as a regular bank, these exemptions do not apply. Instead, the bank must report all but the assessment area data. 12 C.F.R. § 228.42(f).

²¹⁸ 60 Fed. Reg. 22,167-68 (1995). See also Marsico, *supra* note 9, at 254; Dean Anason, *Agencies Issue CRA Rules for Interstate Banking*, AM. BANKER, Mar. 12, 1997, at 1; Terrence O'Hara, *Regular Mailbag: A Chorus of Criticism for CRA Reform Plan*, AM. BANKER, June 1, 1994, at 8; Jaret Seiberg, *Making Rules Fit the Bank Instead of the Other Way Around*, AM. BANKER, May 2, 1995, at 4.

²¹⁹ In fact, there seems to be a small backlash against the enormous banks which are springing up, such as the new entity that will be formed out of the planned merger of NationsBank and BankAmerica and the multi-service financial conglomerate formed by Citigroup and Travelers Group. See Louis Whiteman & Alan Kline, *Community Bankers Say They Aren't Afraid of Merging Giants*, AM. BANKER, Apr. 16, 1998, at 1. Notably, there has been a recent rise in small bank start-ups which is being attributed to the high degree of merger activity. See Jonathan D. Epstein, *Years of Bank Mergers Trigger a Rise in Start-Ups Looking for their Niche*, AM. BANKER, Dec. 27, 1996, at 1.

also CDBs fit into this test classification and are required to comply with CRA, notwithstanding their CDFI status.²²⁰

Instead of using detailed data breakdowns from a variety of lending categories, examining types of loans and so forth, the small bank test examines data in the aggregate throughout the community. This includes: an analysis of the bank's loan-to-deposit ratios for all classifications of loans; the percentage of the lending done in the bank's delineated assessment community; the record of lending to various income levels and businesses and farms of various sizes and values (presumably to sort out the degree of lending to low-income families, businesses and farms in poor communities as well as to learn which are starting-up or struggling); the overall geographic distribution of loans throughout the bank's assessment area (to allow an analysis of lending patterns by population and income-level); and the way the bank responds to complaints from the community that it is not meeting its local credit needs.²²¹

Another major difference between the small bank test and the standard bank test is its exclusive focus on lending and "lending-related activities," with no mention of other forms of investments and services, nor any specific focus placed on community development loans and activities. While this is certainly easier on the small bank in terms of compliance, it has mixed results for supporting CDFIs.

True, there may be less of a reason to expect indirect and intermediary lending from a small, community-oriented bank, because many small banks are so much like CDFIs themselves that such requirements could be redundant. In addition, in terms of liquid capital, small banks have fewer resources with which to invest in CDFIs than do the large banks and they may prefer to focus all of their CRA-budgeted resources into direct lending.

²²⁰ For example, South Shore Bank of Chicago, with assets of over \$310 million, cannot qualify as a "small bank" under the regulations, but instead is subject to either the tripartite test discussed above or the strategic test discussed below. This is despite the fact that the entire business strategy of the bank is to serve the credit needs of its local community being that it is a federally designated CDFI.

²²¹ 12 C.F.R. § 228.26(a).

However, few institutions work in a vacuum, and there are reasons for encouraging even small community banks to practice intermediary lending and to perform some community service activities. While small banks should not be compelled to conform to the tripartite test required for large banks, it may have been a mistake to leave investment and service elements out of the small bank test.

Both small and large banks often overlook the clear advantages to working with intermediaries when focusing too tightly on direct lending. No bank or CDFI is likely to know all of its service community intimately. Clearly, it is the development of *networks* of community-oriented financial institutions that is essential to long-term community vitality, not simply having one single organization trying to do it all. Nor is there a readily apparent reason why one would want to try—the exclusive capture of the market is not reason enough.

Small banks are, logically, likely to have a smaller range of financial services and specialties. This does not, however, reduce the need for other particular services, especially in rural communities where there may not be another bank in the entire region for customers to utilize. A CDFI, including other banks and credit unions, could fill such market niches for that particular community with the support of the small bank. For example, the CDFI could partner with a small bank in order to work jointly on a project, with the former packaging and underwriting while the latter provides the actual loans. A second possibility would be for the CDFI to focus exclusively on a subset of the community (such as an especially poor neighborhood or population) and provide its members with the financial training necessary to turn the group into potentially viable customers for the bank.

Additionally, some particular kinds of CDFIs may be more beneficial to a community when partnered with a small bank. For example, instead of a community development bank or credit union that competes for deposits with the small bank, a loan fund or even a micro-enterprise loan fund could serve in a complementary position to the bank. It is important to remember that the role of CDFIs is not to replace regular banks when they are present in the community but to complement them where possible and develop networks of strong working partnerships.

Small banks could support such institutions by lending and providing debt capital which the CDFI could re-lend, allowing the bank to receive lending credit under the Small Bank Test. The bank could also provide community development investments, grants and community development activities to provide equity capital which would support the CDFI and allow it to make riskier loans to more people and entrepreneurs. Small banks could also provide some service test-like activity, such as assisting the staff of fledgling CDFIs and helping them to guide their lending activities. Small banks may have little in the way of staff resources to expend on helping a CDFI, but by acting together, the bank may gain by such an investment. In light of the fairly loose way regulators are interpreting bank interaction with CDFIs for CRA purposes, it is hard to imagine that these non-lending activities would not receive some form of CRA credit under the Small Bank Test. It is, therefore, entirely conceivable that a bank could loan money to a CDFI and still provide investment and service activities which could be counted as "lending related activities" under 12 C.F.R. § 228.26(a).

While at first glance the small bank test appears not to hold a great deal of promise for supporting CDFIs, the rules provide ample room for small banks and CDFIs to work together, even if somewhat lacking in regulatory emphasis. The partnership of small banks and CDFIs also makes logical sense from a business point of view as banks may find it more economically feasible to support CDFIs instead of complying with CRA solely through direct lending.

I. The Strategic Test

Arguably the most progressive part of the new CRA regulations is the option which allows banks to create their own self-designed compliance plans.²²² Opting for the strategic plan permits any banking institution subject to CRA to bypass the three standard tests²²³ and instead create its own special five-year compliance

²²² 12 C.F.R. § 228.27.

²²³ 12 C.F.R. § 228.21(a)(1).

plan under specific lending, investing and service goals developed by the institution, through which it will be evaluated by the regulators.²²⁴

While the strategic test does not require specific separate lending, investing and service sections, there are still a great number of similarities between the Strategic Test and the standard tripartite tests. Most importantly, all strategic plans are required to address lending, investing and the provision of services along the same lines as the regular tests, including the community development and innovative provisions included.²²⁵ This allows a bank to utilize all of the possible advantages of indirect lending, community development and third-party intermediary activity. In fact, like the standard tests, community development lending, qualified investments, community development services and other innovative and flexible practices are expected to remain a substantial portion of a bank's strategic plan, which includes activities such as investments and other forms of support for CDFIs.²²⁶

One of the most beneficial aspects of the strategic plan, for both CDFIs and other community interests, is that the bank can choose to design its plan so that one or two of the compliance elements are

²²⁴ 12 C.F.R. § 228.27(a) (permitting banks to choose strategic plan); 12 C.F.R. § 228.27(c)(1) (setting forth five year duration); 12 C.F.R. § 228.27(f) (allowing banks to design their own plans and goals and to direct the regulators to evaluate the bank's CRA compliance based on how well it meets these self-designated goals).

Unfortunately, while this approach to CRA compliance was first proposed by the banking industry itself, it has not become a popular alternative for most financial institutions because it involves a high level of detail and measured performance goals required by the regulators for approval. However, the effectiveness of this approach can be evaluated by examining how these self-designed compliance tests actually function in the few approved plans currently in place from large and small financial institutions.

²²⁵ 12 C.F.R. § 228.27(f)(1)(ii) states this generally and it is restated more specifically under 12 C.F.R. § 228.27(g)(3)(i) (lending); 12 C.F.R. § 228.27(g)(3)(ii) (investment); and § 228.27(g)(3)(iii) (service). The only exception to this requirement is if the bank has received an approved designation from the federal regulators as a wholesale or limited purpose bank under 12 C.F.R. § 228.27(f)(1)(ii).

²²⁶ 12 C.F.R. §§ 228.27(f)(1)(i), (g)(3)(i)-(iii).

emphasized over the others.²²⁷ Therefore, if a bank, for example, decides to highlight community development investments in third party institutions like CDFIs—the regulators would permit such an approach. Thus, if a bank's primary assessment area already has a strong network of CDFIs, the bank may choose to ease its own compliance burden by utilizing this network. These components and options create a wide range of opportunities for CDFIs, especially because banks are allowed to stress indirect lending through intermediaries if it is in their best interest—for example, if indirect lending allows the bank to spread its resources more broadly, etcetera.

The strategic plan allows banks to make their holding company affiliates a part of the test as well, though separate measures must be detailed in the strategic plan for each affiliate.²²⁸ This provides even greater flexibility for banks to provide loans and make investments in intermediaries by working in tandem with a community development corporation or a special subprime lending affiliate of its holding company. This interaction on projects benefits banks because it allows for risk spreading and brings a number of holding company organizations into a project. It also benefits CDFIs who then have access to a wider range of benefits provided with a higher degree of flexibility. Unfortunately, the rules prohibit affiliates to take credit for the same projects a bank is involved in, even though they may be working on it together.²²⁹ If an affiliate wants or needs to work on a project in the strategic plan with the bank, it may still do so, but it may not receive additional CRA credits. This may create a disincentive for the bank to utilize the affiliate's resources.²³⁰

Another crucial part of the strategic test, one even more important than flexibility and emphasis options, is the requirement that any approved plan be developed in full partnership with the

²²⁷ 12 C.F.R. § 228.27 (f)(1)(ii).

²²⁸ 12 C.F.R. § 228.27(c)(3).

²²⁹ 12 C.F.R. § 228.27(c)(3).

²³⁰ 12 C.F.R. § 228.27(c)(3); 60 Fed. Reg. 22,168 (1995). This is a restriction which regulators should consider removing in the future.

bank's primary service community.²³¹ This opportunity for community participation opens whole new possibilities, particularly for innovative approaches and long range community reinvestment planning involving CDFIs. Moreover, not only is the bank required to actively solicit public support, but it is required to clearly demonstrate to regulators that the public input was actually incorporated into the strategic plan.²³² Therefore, some reasonable and progressive community suggestions must be incorporated by the bank. This provides community-oriented financial entrepreneurs and other activists the opportunity to develop strong partnerships and programs with the bank by urging bank support for local financial institutions specializing in community development. Furthermore, with banks being required to throw their strategic plans open to public input, many existing organizations, including ones which may not have been in the business of community development financing, will be spurred to change their own strategies and approach the bank as potential new CDFI partners. The public input process may also galvanize community revitalization entrepreneurs merely contemplating the creation of a CDFI to mobilize their resources and establish their institution, expanding the community financial network. With such a strong incentive to incorporate this public input, the plan's developers will be looking for ways to accommodate public desires in the way most beneficial

²³¹ § 228.27(d) requires that before a bank can submit its plan to the regulators for approval, it must:

- (1) Informally seek suggestions from members of the public in its assessment area(s) covered by the plan while developing the plan; (2) Once the bank has developed a plan, formally solicit public comment on the plan for at least 30 days by publishing notice in at least one newspaper of general circulation in each assessment area covered by the plan; and (3) During the period of formal public comment, make copies of the plan available for review by the public at no cost at all offices of the bank in any assessment area covered by the plan and provide copies of the plan upon request for a reasonable fee to cover copying and mailing, if applicable.

All of this effort must be documented and submitted to regulators per 12 C.F.R. § 228.27(e) and the level and adequacy of public participation is considered by the regulators for plan approval under 12 C.F.R. § 228.27(g)(2).

²³² 12 C.F.R. § 228.27(g)(2).

to the bank and with the least amount of risk. As has been repeatedly mentioned, CDFIs are the logical partners. Community-oriented financial institutions would be solid partners for banks—far more attractive than a dangerous investment proposal that might require the bank to throw away money and other resources in a high risk venture for the sheer sake of complying with CRA.

Also, because five years can be a long time in the world of community banking, a large number of opportunities may come and go without being incorporated by the bank because these possibilities were not presented during the development of an approved five year plan. While the bank is permitted to file amendments to its plan, the amendment process is likely to be a fairly lengthy one that the bank may wish to undertake only when absolutely necessary.²³³ Therefore, the bank is likely to be looking for ways to ensure that its CRA obligations can be fulfilled without either binding itself too closely to projects and without being required to file amendments. Projects and proposals laid out during the development of the five year plan may, for whatever reason, become impractical or even impossible to carry out over the course of time. Banks must retain an element of flexibility which will permit them to redesign community development projects, without filing detailed and time consuming amendments to their strategic plan. Working in partnership with a CDFI can potentially offer this flexibility.

²³³ 12 C.F.R. § 228.27(h) deals with amending strategic plans. It also specifies that all amendments must be presented to the public for approval. Whether or not this is the same “public” which approved the original plan is not specified in the regulations. While this does offer a strong opportunity for members of the public to approach the bank with a good idea, such as starting a CDFI or supporting a CDFI project in a new or different manner according to changes in need, it is also a burden on the bank which may feel more comfortable closely following their approved plan which clearly sets forth the requirements for a high regulatory rating. At this point the only recourse left to the community entrepreneur would be to file a CRA complaint against the bank. While the regulators are required to consider public comments on the bank’s performance under the rubric of “interested parties,” 12 C.F.R. § 228.29(b), the weight regulators will give such a complaint, especially one filed by a single rejected entrepreneur, is dubious at best.

For example, the bank can specify ways of producing community development lending and qualified investment support for projects through a CDFI, or network of CDFIs over the five year period but leave the making of particular changes up to the intermediary institutions involved in the technical details. Under the tripartite tests, banks receive credit even when all they have done is provide the capital for the CDFI to use. There is no reason to believe that this guiding rule does not apply to strategic plans as well, although the latter must make certain that the projects qualify as community development. Therefore, if a bank agrees to undertake a joint venture with a CDFI—with the bank putting up both direct and indirect financial and technical support—the partner CDFI can deal with major changes without causing any great hardship to the bank itself. An endless stream of similar scenarios provide good reason for banks opting to comply with CRA through the strategic plan option to be inclined to partner with, and perhaps even help create, CDFIs over the course of the five years.

As stated before, the strategic plan is clearly the most innovative and progressive of the new CRA compliance methods, and one which has great potential for building strong and lasting partnerships between banks and CDFIs. Unfortunately, few banks are opting for this method and those that have chosen the strategic plan are experiencing great difficulty.²³⁴ Hopefully, as a few more daring banks have strategic plans approved, there will be enough examples and models to pave the way for a greater number of banks to select this approach.

J. Other Aspects of the New Regulations

The remainder of the new CRA regulations deals with assigning ratings, data collection requirements and public information and is

²³⁴ See Barbara A. Rehm, *FDIC Offers Plan for Approval for Customized CRA Plans*, AM. BANKER, Mar. 6, 1998, at 3; Matt Schulz, *Regulators Seek Specifics in Home-Brewed CRA Plans*, AM. BANKER, July 4, 1996, at 17; Matt Schulz, *The Regulators: CRA Strategic Plans Fall Short of Numbers, Details*, AM. BANKER, June 6, 1996, at 11; Matt Schulz, *To Customize CRA Exams, 5 Banks Try Strategic Plans*, AM. BANKER, Mar. 7, 1996, at 8.

relevant, although not as relevant as the topics previously discussed in this article, to the promotion of CDFIs through CRA.

1. *Assigned Ratings*

The new CRA rules dealing with regulators' assignment of compliance ratings hold very little which directly impact CDFIs.²³⁵ One aspect which has some importance, however, is the flexibility that regulators have to emphasize one portion of a bank's activity over another.²³⁶ Such flexibility is important as it allows regulators, based on what they have found under the performance context of the financial institution,²³⁷ to credit a bank for a high level of community development and third party intermediary lending and investing when direct options are not available. This flexibility allows more emphasis to be placed on indirect lending practices and elements from the investment test, which promotes permanent capital in CDFIs. This is also important since the actual structure of the lending test rating system weighs the entire examination for regular commercial banks in favor of this test.²³⁸

The more important elements under the discussion of the rating system for CDFIs focus on the level of emphasis for both flexible and innovative practices and other forms of indirect lending and non-lending activities. Every rating category under the lending test mentions these factors; in fact the factors are identical for qualification of each rating—only the degree of compliance differs in each factor.

²³⁵ 12 C.F.R. § 228.28.

²³⁶ § 228(a)(2) app. A.

²³⁷ See *supra* Part III.C (discussing performance context).

²³⁸ The new rules actually provide that if the final rating on the lending test is "outstanding," it cannot receive less than a "satisfactory" rating overall. This is not true of either the investment or service tests. 12 C.F.R. § 25.28(b)(1). Essentially, a bank receiving an outstanding rating under the lending test can all but ignore the requirements of the other two. On the other hand, if the bank does not receive at least a "low satisfactory" rating on the lending test, it cannot be saved by an "outstanding" or "satisfactory" rating. 12 C.F.R. § 25.28(b)(3).

In fact, that these elements are mentioned under the ratings labeled "needs to improve" and "substantial non-compliance" may be most important as this indicates that a failure to provide these types of services will result in a low rating. Therefore, a bank must provide some level of these services to be rated in compliance.

The rating systems for the service test and especially the investment test are even more beneficial to CDFIs. All three of the listed considerations for a high compliance rating under the investment test support innovative investment practices on flexible terms for community development.²³⁹ The service test rating system is vague on what it actually requires, but, as has been discussed before, has a great deal of potential through the innovative provisions of financial services and opportunities for bankers to lend their expertise to CDFIs to serve both these institutions and the low-income people and families served by the CDFI.²⁴⁰

²³⁹ Under 12 C.F.R. Part 228 app. A (b)(2)(i), the "outstanding" rating for the Investment Test qualifications reads as follows:

The Board rates a bank's investment performance "outstanding" if, in general, it demonstrates:

- (A) An excellent level of qualified investments, particularly those that are routinely provided by private investors, often in a leadership position;
- (B) Extensive use of innovative or complex qualified investments;
- and
- (C) Excellent responsiveness to credit and community development needs .

12 C.F.R. Part 228 app. A(b)(2)(i).

²⁴⁰ The service test ratings requirements are found under 12 C.F.R. Part 228 app. A (b)(3)(i).

The Board rates a bank's service performance "outstanding" if, in general, the bank demonstrates:

- (A) Its service delivery systems are readily accessible to geographies and individuals of different income levels in its assessment area(s);
- (B) To the extent changes have been made, its record of opening and closing branches has improved the accessibility of its delivery systems, particularly in low- or moderate-income geographies or to low- or moderate-income individuals;
- (C) Its services (including, where appropriate, business hours) are tailored to the convenience and needs of its assessment area(s),

Again, as with the lending test ratings, it is more significant that the lower ratings emphasize the need for a bank to undertake innovative approaches to community finance in order to avoid a poor rating.

The rating requirements under the wholesale and limited purpose bank test are similar to the regular bank ratings under the investment test in that they emphasize the provision of innovative investments and community development activities.²⁴¹ For small bank evaluations, the only real item of interest apart from what has already been discussed involves the requirement that regulators also evaluate written public complaints regarding the bank's compliance performance.²⁴² This provides more community leverage for impacting the way banks choose to comply with their CRA requirements and has potential benefit for CDFIs which may be starting up or are already existing in the community.

The strategic plan evaluations examine simply how well the bank reaches the goals which it sets for itself, in conjunction with the community. Of course, the bank must exceed its designated goals for "satisfactory" compliance in order to achieve the "outstanding" rating.²⁴³

2. *Impact of CRA Performance on Applications*

The effect of CRA performance on applications²⁴⁴ is only significant to this article because of the requirement that the regulator "takes into account any views expressed by interested parties."²⁴⁵ This is primarily important because it provides a

particularly low- or moderate-income geographies or low- or moderate-income individuals; and

(D) It is a leader in providing community development services.

12 C.F.R. Part 228 app. A(b)(3)(i).

²⁴¹ 12 C.F.R. § 228(c) app. A.

²⁴² 12 C.F.R. § 228(d)(1)(iv) app. A.

²⁴³ 12 C.F.R. § 228(e) app. A.

²⁴⁴ 12 C.F.R. § 229(b).

²⁴⁵ 12 C.F.R. § 228.29(b). All written comments must be submitted to the regulators in a pre-determined format. 12 C.F.R. § 262.2. For example, comments submitted to the Board of Governors of the Federal Reserve must be

forum for the community to file complaints against a bank and to use this avenue, or even the threat of using it, to leverage a broad range of investment and community lending support which can be beneficial for supporting CDFIs. Many regulators have been "front loading" public comments prior to conducting CRA exams.²⁴⁶

3. *Assessment Area Delineation*

Assessment Area Delineation may be a more relevant area to community development institutions than it initially appears and has some possible, though indirect, consequences depending on how strictly a bank's service area or community is drawn.²⁴⁷ The importance for CDFIs depends upon the location of the actual community institution and the locations of others with which it is working. A bank's delineated service community is specifically drawn and may not always fit the community served by a particular CDFI. In fact, a CDFI which serves a portion of a community served by a bank may not actually fall within the bank's delineated community, even though the areas served may overlap. Banks may be unwilling to provide support for a CDFI outside of its assessment area, although it is more likely that they will receive CRA credit if that CDFI is providing services within the bank's community. This is especially true for wholesale and limited purpose banks.²⁴⁸ This may be mitigated by the requirement that "whole geographies" be included, encompassing an entire geographical

done in a manner which conforms to specifications set out under the regulations of the Board. *Id.*

²⁴⁶ See Seiberg, *supra* note 50, at 3.

²⁴⁷ 12 C.F.R. § 228.41. The delineation of the primary service community, also referred to as the assessment area, is performed by the bank with regulatory approval under 12 C.F.R. §§ 228.41(a), (g). Delineating assessment areas is determined pursuant to the existence of Municipal Statistical Areas ("MSAs") based on census data or a political subdivision, such as a county or town, as well as the area from 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." 12 C.F.R. § 228.41(c).

²⁴⁸ 12 C.F.R. § 228.25(e).

community as opposed to simply that portion of the community served by the bank.²⁴⁹

The lending test is fairly specific in that only loans inside of the assessment area will be evaluated.²⁵⁰ However, there is an exception where the test deals with “community development loans,” which states that such a loan may benefit “the bank’s assessment area(s) or a broader statewide or regional area that includes the bank’s assessment area(s).”²⁵¹ It is probable that regulators will work with this broader interpretation and provide CRA credit to banks which invest in a CDFI outside of their service communities, as long as a portion of the benefit goes back to that community. This provides a benefit not only to individual CDFIs, but to broader networks of CDFIs which may evolve in conjunction with other community-based service organizations and strengthen an overall community financial infrastructure.

Both the investment and service tests are broader than the lending test, stating clearly that investments made by banks and services provided by banks may be in an area larger than the delineated community, so long as the “home” community is included.²⁵² The same is true of the test for wholesale and limited purpose banks,²⁵³ but not of the test for small banks or the strategic plan, though the community development loan exception is included.²⁵⁴

4. *Data Collection and the Public File*

The data collection and public file regulations²⁵⁵ list the kinds of data which banks are required to supply to regulators which

²⁴⁹ 12 C.F.R. § 228.41(e)(1).

²⁵⁰ See § 228.22(a)(1), (b).

²⁵¹ 12 C.F.R. § 228.12(i)(2)(ii). See also 12 C.F.R. § 228.22(a)(1) (including community development loans in the lending test criteria).

²⁵² See § 228.23(a) (investment test); § 228.24(b) (service test).

²⁵³ 12 C.F.R. § 228.25(e)(1).

²⁵⁴ The Small Bank Test repeatedly includes the phrase “of its assessment area(s)” in its criteria. 12 C.F.R. § 228.26(a). See also 12 C.F.R. §§ 228.27(a), (c) (setting forth relevant provisions of the strategic test).

²⁵⁵ 12 C.F.R. §§ 228.42 (data collection), 228.43 (public file).

allow them to have the necessary tools with which to examine the financial institution.²⁵⁶ These materials are available for public scrutiny at the bank.²⁵⁷ This is relevant to CDFIs only to the extent that the data and public information can be used to help influence the way a bank lends and invests in the community.

CONCLUSION

After several decades of government-sponsored urban and rural revitalization programs, which have been abandoned or failed to produce the hoped for results, the lesson for low-income communities may be that if their life and energy are going to be restored, they must do it largely through their own innovation. Still, even the most clever and industrious local entrepreneurs cannot make water flow from a stone. If funding does not come from the government, the next logical source is from the banking and finance industry. In promoting this partnership, the federal and state governments have utilized the most prominent of the fair-lending laws, the Community Reinvestment Act, to stimulate broad and innovative relationships between banks and their primary service communities. CDFIs represent one of the most progressive means for community revitalization entrepreneurs to have a long-lasting impact on their neighborhoods through their grass roots knowledge of local lending

²⁵⁶ While mortgage lending data has long been available since the passage of the original HMDA in 1975, comprehensive data on small business and small farm lending was not collected by the regulators prior to the adoption of the new CRA rules. While the data is new and has only been analyzed for 1996, it shows that the number and dollar amount of small business loans originated and purchased by banks reflect the distribution of small businesses across the nation. Small farm loans are distributed more or less in proportion to the distribution of small farms across the United States. The distribution of small business loans for low-income communities has been in rough proportion to the number of small businesses located in such communities, unlike the distribution of home purchase loans. See Raphael W. Bostic & Glenn B. Canner, *New Information on Lending to Small Businesses and Small Farms: The 1996 CRA Data*, 84 FED. RESERVE BULL. 1, 13-14 (1998).

²⁵⁷ 12 C.F.R. § 228.42 (data collection and reporting); 12 C.F.R. § 228.43 (content and availability of the public file).

and investing markets.²⁵⁸ These local organizations require financing and some training to make more effective use of the finances, all of which can be supplied by the banking industry. Banks, in turn, can benefit by supporting these small, locally-oriented financial institutions in a number of ways, including the satisfaction of their social responsibilities under CRA. The new CRA regulations promulgated by the federal banking regulators not only greatly reduce the traditional conflict between banks and community activists, but take great steps forward in promoting the partnership between banks and CDFIs.

This new approach to community development should serve as a model for a variety of other potential solutions to policy problems in the nation, particularly in an era when the public is less enamored, both financially and politically, with big government programs and heavy public spending. True empowerment comes when the members of a community are able to help themselves, being given basic tools such as financing to reach their goals. With more such government-facilitated but private-sector based partnerships, society can more expediently find some lasting solutions to a myriad of economic and social problems, bringing about a brighter future.

²⁵⁸ Ironically, progressives have largely ignored banking as a vital tool for social change, instead focusing on "sexier" social issues. See Anthony D. Taibi, *Race Consciousness, Communitarianism, and Banking Regulation*, 1992 U. ILL. L. REV. 1103 (1992).

