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THE COMMUNITY REINVESTMENT ACT: AN ECONOMIC ANALYSIS

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INTRODUCTION

THE Community Reinvestment Act ("CRA")¹ provides, innocuously enough, that federal bank supervisors must assess how a depository institution (a bank or savings association)² serves the credit needs of its "entire community, including low- and moderate-income neighborhoods," consistent with safe and sound operation.³ The supervisors must "take such record into account" in evaluating applications to acquire deposit facilities.⁴

For many years after its adoption in 1977, the CRA was little more than a vague statement of principle without much real-world effect.⁵ In 1989, however, Congress greatly enhanced the CRA's impact as part of the comprehensive banking legislation of that year.⁶ Consequently, CRA-based challenges to bank mergers and other transactions subject to CRA scrutiny are now routine, even when the institution in question has received high marks for CRA compliance in recent examinations.⁷ Some deals are actually derailed by the stat-

¹ 12 U.S.C. §§ 2901-2907 (1988 & Supp. III 1991).

² We refer to the firms subject to the CRA as "depository institutions," although certain firms ordinarily included in the term "depository institutions," notably credit unions, are not covered.

³ 12 U.S.C. § 2903.

⁴ *Id.*

⁵ See Paul H. Schieber, A CRA Guide for Foreign Banks, *Am. Banker*, Feb. 14, 1992, at 6.

⁶ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 1212, 103 Stat. 183, 526-28 (codified as amended at 12 U.S.C. §§ 2902, 2906).

⁷ See *infra* Part VI.

ute,⁸ and the costs of consummating a transaction in the face of a CRA challenge can be substantial.⁹

The CRA is now controversial. Many bankers object that the statute imposes burdensome requirements and unfairly disadvantages depository institutions as compared with their nonbank competitors. Community activists argue that the CRA is only beginning to address problems of access to credit in low-income communities. The Bush Administration submitted a legislative proposal in 1992 designed to mitigate what it believed were some of the worst effects of the statute,¹⁰ but the legislation failed in Congress. Meanwhile President Bill Clinton made community reinvestment a centerpiece of his candidacy's economic plan, vowing to "[e]ase the credit crunch in our inner cities by passing a more progressive Community Reinvestment Act to prevent redlining, and by requiring financial institutions to invest in their communities."¹¹

This Article offers a preliminary economic analysis of the CRA in its new, post-1989 manifestation.¹² The analysis is preliminary in two

⁸ See Ellen Braitman, *Fed Is Asked to Reconsider Blocking of Merger*, *Am. Banker*, Nov. 25, 1991, at 5.

⁹ See *infra* Part V.

¹⁰ H.R. 5497, 102d Cong., 2d Sess. (1992).

¹¹ Bill Clinton & Albert Gore, *Putting People First* 12 (1992). The President and Vice President also propose to "[c]reate a nationwide network of community development banks to provide small loans to low-income entrepreneurs and homeowners in the inner cities. These banks will also provide advice and assistance to entrepreneurs, invest in affordable housing, and help mobilize private lenders." *Id.* at 11. The community development bank proposal appears to avoid some of the problems that we identify below with the Community Reinvestment Act. The present Article focuses only on the CRA and its conclusions do not necessarily carry over to community development banks.

¹² There are very few prior articles in the legal literature on the CRA. Orin L. McCluskey, *The Community Reinvestment Act: Is It Doing the Job?*, 100 *Banking L.J.* 33 (1983), focuses on the legislative history of the act and its effect on redlining. Robert C. Art, *Social Responsibility in Bank Credit Decisions: The Community Reinvestment Act One Decade Later*, 18 *Pac. L.J.* 1071 (1987), presents a laudatory picture of the act, now dated by the more recent amendments. Peter D. Schellie, *Current Developments with the Community Reinvestment Act*, 42 *Bus. Law.* 943 (1987), describes strategies available to banks for coping with CRA protests. Nancy R. Wilsker, *The Community Reinvestment Act of 1977: The Saga Continues . . .*, 46 *Bus. Law.* 1083 (1991), updates the analysis to 1991. Jonathan P. Tomes, *The "Community" in the Community Reinvestment Act: A Term in Search of a Definition*, 10 *Ann. Rev. Banking L.* 225 (1991) discusses problems in delineating the community that an institution is required to serve. Marion A. Cowell, Jr. & Monty D. Hagler, *The Community Reinvestment Act in the Decade of Bank Consolidation*, 27 *Wake Forest L. Rev.* 83 (1992) present a view of the act from the standpoint of a large bank holding company. A forthcoming study taking a critical approach to the CRA is Lawrence J. White, *The Community*

senses. First, the effects of the 1989 amendments on CRA enforcement have only begun to manifest themselves, so any evaluation of the amended statute is necessarily provisional and subject to revision in light of further evidence. Second, our study suggests a number of important, and potentially testable, predictions about the effects of the statute—for example, that CRA loans may be less profitable than other loans. Although we offer what we believe to be persuasive impressionistic evidence to support our views, statistically controlled empirical studies could lend further support to our conclusions (or, alternatively, might tend to disprove them). Thus, this study is also preliminary in the sense that its findings are subject to modification in light of future empirical work.

In brief, our conclusions are as follows: We applaud the basic goals of this legislation. The deterioration of inner-city neighborhoods, and the numerous problems that accompany it—crime, imprisonment, drug abuse, teen pregnancy, unemployment, illiteracy, broken families, gangs, discrimination, infant mortality, and AIDS—are possibly the most fundamental domestic issues facing our nation today. No program would do more good than one that addressed these terrible problems in a sensible fashion and contributed constructively to their mitigation. The revitalization of decaying neighborhoods is a fundamental challenge for American public life.

We conclude, however, that despite these positive features, the CRA in its present form does more harm than good.

Reinvestment Act: Good Intentions Headed in the Wrong Direction, 20 *Fordham Urb. L.J.* (forthcoming Fall 1992) (manuscript on file with the Virginia Law Review Association).

In a response to the present Article, Professor Peter Swire proposes a “safe harbor” reform to the CRA. Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 *Va. L. Rev.* 349 (1993). Professor Swire’s proposal would mitigate some of the uncertainties that attend the CRA as presently administered, but we believe it does not address the fundamental problems with the statute. The safe harbor, for example, would not address the problem of inefficient credit allocation, see *infra* text accompanying note 64, nor would it rectify the competitive imbalances that the CRA creates as between different types of financial institutions, see *infra* text accompanying notes 76-79. Even more fundamentally, the safe harbor would not appear to mitigate the perverse incentives that the CRA creates for capital providers to avoid the depressed urban neighborhoods that the CRA was ostensibly designed to serve. See *infra* text accompanying notes 80-81. Accordingly, although Professor Swire’s proposal would represent a significant improvement over the existing system, it does not, in our view, represent the sort of fundamental reform that is necessary in order to remedy the serious deficits of the existing regime.

The CRA, we find, is premised on a model of credit markets that was questionable at the time the statute was enacted and that has little relationship to contemporary realities, and on the normative ground that credit markets should be local in nature, despite the lack of any coherent justification for that proposition.

The CRA impairs the safety and soundness of an already overstrained banking industry: it promotes the concentration of assets in geographically nondiversified locations, encourages banks to make unprofitable and risky investment and product-line decisions, and penalizes banks that seek to reduce costs by consolidating services or closing or relocating branches. The statute, moreover, imposes a significant tax on bank mergers and deters transactions that would otherwise improve the efficiency and solvency of the nation's banking system.

The CRA subjects the banking industry to costs and burdens that are not imposed on lenders otherwise similarly situated, thus placing depository institutions at a competitive disadvantage compared with their nonbank competitors. Within the depository institution industry, the CRA discriminates against wholesale banks and other specialized institutions that are not well-adapted to community investment lending.

The CRA imposes significant compliance costs on institutions, especially smaller institutions. It induces socially unproductive expenditures on public relations and documentation that provide no benefit for local communities. Its requirements are vague and self-contradictory, and its enforcement often appears arbitrary.

The CRA has been turned to purposes that it was not intended to serve, and for which it was poorly designed. The statute encourages banks to engage in affirmative action in hiring and credit allocation. It is administered so as to encourage charitable giving by depository institutions, especially gifts that fit within certain "politically correct" categories. Regardless of the social benefits of affirmative action or charitable giving, these were not the goals of the CRA and its use to further these goals represents a distortion of its original purpose.

The CRA has become a potent political tool in the hands of activist political pressure groups. Some of these groups use the statute to magnify their political importance and to gain special favors for themselves and their leaders, either by way of obtaining funding for pet projects or garnering direct logistical or financial support for their

operations. It is possible, moreover, that the threat of a CRA challenge is sometimes used by political leaders for purposes less admirable and more self-serving. This is not to impugn the motives of activist groups, the great majority of which are reputable and public-spirited, but merely to suggest that activist groups, like the rest of society, respond to incentives in order to serve their interests.

Tragically, the CRA poorly furthers the purposes for which it was designed. It penalizes institutions that actually serve low-income and moderate-income neighborhoods, while rewarding those that do not. It drives capital away from poor neighborhoods by imposing a tax on those depository institutions foolhardy enough to do business in such communities. It discourages innovation in the provision of financial services to low-income and moderate-income neighborhoods. It might even impair the market position of existing institutions that serve local community needs.

It is not as if there are no alternatives to meet the ostensible goals of this poorly designed statute. Local organizations can work at the grass roots level to raise capital and to extend credit to community members who are known to the organization and whose credit-worthiness can be monitored. Such a process of capital formation can be driven by a healthy profit motive rather than by the goal of squeezing as much wealth as possible out of the banking industry. Financial services such as lifeline checking can be afforded to low-income and moderate-income consumers by further deregulation in the financial services industry. And if the goal of the CRA is, or has become, that of subsidizing poor or disadvantaged citizens, that goal, we believe, could more adequately be served by direct subsidy programs rather than by treating depository institutions as some form of public utility that can be assessed to serve general social needs.

Although our evaluation of the CRA is largely negative, we recognize that, like most regulatory programs, it has benefits as well as costs. The CRA does induce depository institutions to return more credit to their local communities, although why this should be considered a desideratum of sound banking is unclear to us. The Act encourages depository institutions to explore market opportunities that they might have otherwise overlooked, and thus it might offer marginal efficiency gains in specialized markets. Some of the funds that are redirected by the CRA do eventually find their way into the hands of needy persons in the form of better access to credit,

improved housing, and the like. We believe, however, that these benefits are small relative to the costs.

If we are correct in our critique of the CRA, why is it so popular? The answer, we suggest, is that the CRA benefits discrete, well-organized political interest groups. The principal beneficiaries are community activists, who enjoy great power at the local level in many jurisdictions and who are also influential in Congress. Small businesses and charitable institutions also profit from the statute. The federal banking agencies benefit from the CRA because it enhances their regulatory jurisdictions, and because it offers a powerful threat that the agencies can use in order to induce cooperation in their programs. Politicians like the CRA because it allows them to appease special interest groups through a statutory vehicle that keeps the costs of such appeasement off the explicit balance sheets of both the banks and the federal government. This political coalition is powerful enough to insulate the statute from serious attack, notwithstanding the costs that the statute imposes on the banking industry, residents of low-income and moderate-income neighborhoods, and American taxpayers.

This Article is structured as follows: Part I provides an overview of the CRA and explores the apparent purposes underlying its enactment and legislative modification. Part II examines the model of credit markets of the ideology of community reinvestment. Part III examines the act's impact on different types of institutions, both as between depository institutions and other lending institutions, and among different categories of depository institutions. Part IV considers the implications of the CRA for the safety and soundness of depository institutions. Part V addresses some of the costs of compliance. Part VI examines how the statute serves the agendas of activist pressure groups. Part VII illustrates how the CRA has been manipulated by regulators and pressure groups in order to serve goals different in some respects from those that motivated the original legislation. Part VIII evaluates the degree to which the CRA actually serves the credit needs of low-income and moderate-income communities. Part IX offers an interest-group analysis of why the CRA appears so politically popular. Part X deals with some alternatives to the CRA that may not entail the same costs.

I. THE CRA: AN OVERVIEW

We begin with an overview of the statute's legislative history, text, and administrative enforcement.

A. Legislative History

The CRA had its genesis in allegations during the 1970s that banks were engaged in "redlining" in the allocation of housing credit in their communities.¹³ The concern was that financial institutions would treat entire geographic areas—particularly decaying urban zones with significant minority populations—as being off limits for financing, and reject all applications from those areas without regard to the credit histories of individual applicants. Redlining was seen by critics as disproportionately denying credit to racial minorities,¹⁴ as contributing to the deterioration of the affected areas,¹⁵ and as aggravating the problem of financial institutions "dis-investing"—sending financial resources out of the areas in which the funds were gathered.¹⁶

Although concern about redlining is a leading theme in the legislative history,¹⁷ there is no indication that Congress perceived the proposed legislation as a means of directly prohibiting discrimination in lending. Indeed, a leading community activist objected to the bill that formed the basis of the present statute specifically on the ground that it did not "prohibit discrimination" in the terms and conditions of credit.¹⁸ Further, Congress did not envision the legislation as requiring affirmative action in lending on the basis of race, sex, ethnic background, or other categories. Nor did Congress intend the CRA to induce depository institutions to support local charities or otherwise subsidize worthy causes. The overwhelming focus of the legislative history of the CRA was on the need to preserve local communities,

¹³ See Art, *supra* note 12, at 1076.

¹⁴ See *id.* at 1077.

¹⁵ See *id.* at 1081.

¹⁶ See *id.* at 1082-83.

¹⁷ See, e.g., 123 Cong. Rec. 17,604 (1977) (statement of Sen. Proxmire) (CRA "is intended to eliminate the practice of redlining by lending institutions.").

¹⁸ See Community Credit Needs: Hearings on S.406 Before the Senate Comm. on Banking, Housing, and Urban Affairs, 95th Cong., 1st Sess. 133 (1977) [hereinafter Community Credit Needs] (statement of Gale Cincotta, Chairperson, National People's Action).

and on the argument that depository institutions could invest in their local communities and still make a profit.¹⁹

Moreover, despite the emphasis on redlining in the legislative history, the statute passed by Congress was phrased broadly to encompass depository institutions throughout the country, including institutions in suburban, rural, and wealthy urban areas as well as institutions serving decaying inner-city neighborhoods. As the title of the statute indicates, the focus of the legislation was on the problem of depository institutions shipping funds outside the areas in which the funds were obtained. The emphasis was on communities, not on race, ethnicity, gender, or other categories that dominate public policy debates in the 1990s.²⁰

B. Text and Administrative Enforcement

We turn now to the statute itself and its administrative interpretation. As we have noted, the CRA requires insured depository institutions to make efforts to meet the credit needs of their "entire communit[ies]," including low-income and moderate-income neigh-

¹⁹ See, e.g., 123 Cong. Rec. 17,631 (1977) (statement of Sen. Proxmire) ("This bill would encourage the agencies to be somewhat more vigorous in reminding lenders of their local responsibilities."); id. at 17,633 (statement of Sen. Sarbanes) ("There is nothing in this legislation that is going to require any lending institution to take any risks that are inconsistent with or contrary to the safe and sound operation of the institution.").

²⁰ Legislators both for and against the proposed statute agreed that the bill was aimed at bolstering decaying *communities*. See, e.g., id. at 17,628 (statement of Sen. Morgan) (attacking the CRA on the ground that it might require an institution "to make an unsound loan in a specific location in order to meet its quota of loans in a given locality"); id. at 17,633 (statement of Sen. Sarbanes) (asking rhetorically, in support of the proposal, "[w]hy should not a banking institution have a responsibility to meet the credit needs of the local communities in which they are located?").

This is not to say that concerns about race, ethnicity, or gender may not have been present in the minds of some members of Congress during the deliberations on the legislation. Such concerns, however, appear hardly at all in the written record, and appear at most as a subtext in the statements of certain legislators. Senator Proxmire, for example, attempted to discredit the Federal Reserve's opposition to the proposal by noting that the federal banking agencies had been unwilling to vigorously enforce the laws prohibiting discrimination in lending, and that their opposition to the CRA was "in character." Id. at 17,631 (statement of Sen. Proxmire). Senator Garn, in opposing the proposal, suggested that the CRA would duplicate efforts under the Equal Credit Opportunity Act. Id. at 17,634 (statement of Senator Garn). The legislative history, however, does not contain any persuasive indication that Congress viewed the CRA as an affirmative action measure as opposed to what the bill purported to be on its face, namely a measure designed to encourage reinvestment in local communities.

borhoods.²¹ A critical issue is the meaning of the "community" that a depository institution is supposed to serve.²² The Federal Financial Institutions Examination Council, an umbrella organization of federal bank regulators, states that "[t]he term 'local community' refers to the contiguous area surrounding each office or group of offices of an institution."²³ The delineation of the community is left, in the first instance, up to the depository institution itself, although an institution may not unreasonably exclude low-income and moderate-income areas from its community.²⁴

Depository institutions are not automatically sanctioned for failing to satisfy their CRA obligations. Rather, because most significant forms of bank expansion require applications subject to CRA scrutiny, the Act represents a meaningful threat that the responsible federal agency will deny a bank's application to expand.²⁵ Thus, any bank that contemplates establishing new branches, acquiring other banks, or merging into or being acquired by another bank must consider the possibility that its business plan will be stymied by an adverse CRA finding.²⁶

As long as CRA examination and enforcement remained confidential, the danger of an application being denied on CRA grounds was small. Congress, however, enhanced the effect of the statute in 1989²⁷

²¹ 12 U.S.C. § 2903.

²² See *Tomes*, supra note 12, at 225.

²³ Community Reinvestment: Agencies Issue Q & A on Key Factors Involved in Compliance with CRA, Banking Pol'y Rep., June 1, 1992, at 9, 9 (reprinting the Federal Financial Institutions Examination Council's answers to the 31 "most commonly asked" questions about the CRA).

²⁴ *Id.*

²⁵ 12 U.S.C. § 2903. An application to acquire a depository facility includes applications for (1) national bank or thrift institution charters; (2) deposit insurance in connection with a newly chartered depository institution; (3) the establishment of a domestic branch; (4) the relocation of a home or branch office; (5) merger or consolidation with, or the acquisition of the assets of, or the assumption of the liabilities of a depository institution; and (6) the acquisition of shares in a depository institution requiring approval under the federal Bank Holding Company Act or Savings Association Holding Company Act. *Id.* § 2902(3).

²⁶ The CRA does not by its terms apply to acquisitions by bank holding companies of nonbanking firms under § 4(c)(8) of the Bank Holding Company Act, see *The Mitsui Bank, Ltd.*, 76 Fed. Res. Bull. 381 (1990) (Order Approving Acquisition of Nonbank Company), but acquisitions of depository institutions, including savings institutions, are subject to CRA scrutiny, see *Norwest Corp.*, 76 Fed. Res. Bull. 873 (1990) (Order Approving the Acquisition of a Savings Association and Formation of a Bank Holding Company).

²⁷ Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, sec. 1212, § 807, 103 Stat. 183, 527-28. The CRA provisions were part of a floor

by requiring the examining agency to prepare a public, written evaluation of the applicant's CRA performance.²⁸ This evaluation must state the agency's conclusions regarding each of twelve assessment factors,²⁹ discuss the facts supporting such conclusions,³⁰ and contain the institution's overall CRA rating, as well as a statement describing the basis for the rating.³¹ The 1989 amendments also established a system of four CRA ratings—"outstanding," "satisfactory," "needs to improve," and "substantial noncompliance"—to replace the prior five-tiered numerical rating scale.³² Most importantly, the amendments for the first time required that the CRA ratings, and much of the examining agency's supporting discussion, be made public as of July 1, 1990.³³ By requiring the publication of ratings, the amendments subjected the supervisory agencies to political pressure from groups claiming that the agencies were not doing enough to ensure CRA compliance. The publication of an adverse CRA rating also greatly increased the chance that the institution involved would face a CRA challenge in the future (though a satisfactory rating, as we will see, is no guarantee that such a protest can be avoided).³⁴

The 1989 amendments changed the political dynamics of the CRA. Agencies apparently began to enforce the CRA more strictly.³⁵ The agencies have been willing to give the two lowest ratings of "needs to improve" and "substantial noncompliance" to a sizeable proportion of the depository institutions examined—approximately ten percent by a recent count.³⁶ This represents a significant toughening of standards; before 1989, more than ninety-seven percent of depository

amendment in the House, which had been rejected in the House Banking Committee. See 135 Cong. Rec. H2758-59 (daily ed. June 15, 1989). The amendment passed by 14 votes in the House and was then adopted, with amendments, by the House-Senate Conference Committee.

²⁸ 12 U.S.C. § 2906(a)(1).

²⁹ *Id.* § 2906(b)(1)(A). The assessment factors are published in the regulations of the Federal Financial Institutions Examination Council. See *infra* note 123.

³⁰ 12 U.S.C. § 2906(b)(1)(B).

³¹ *Id.* § 2906(b)(1)(C).

³² *Id.* § 2906(b)(2).

³³ *Id.* Certain information deemed to intrude on the privacy of named individuals or to be unsuitable for disclosure can be excised from the public section of the report. *Id.* § 2906(c).

³⁴ See *infra* notes 160-65 and accompanying text.

³⁵ See 135 Cong. Rec. H2753 (daily ed. June 15, 1989) (statement of Rep. Kennedy).

³⁶ See A "Better than Satisfactory" Grade?, *Am. Banker*, June 15, 1992, at 10.

institutions received one of the two highest CRA ratings.³⁷ The 1989 amendments have unquestionably put teeth into the CRA.

Data on CRA compliance in the wake of the 1989 amendments are still incomplete, but preliminary conclusions are possible. We have some breakdown on the relative frequency of the four CRA rating categories: The overwhelming majority of institutions—about eighty percent—receive “satisfactory” ratings; about ten percent receive “outstanding” ratings; about nine percent receive “needs to improve,” and about one percent receive “substantial noncompliance.”³⁸ As a practical matter, an institution in the “substantial noncompliance” category can assume that the banking agencies will look with disfavor at any application, even the most routine, for a depository facility.³⁹

Most dramatic is the relationship between CRA compliance and institutional size. Simply put, the larger the institution, the greater the compliance. Ironically, it is the large banks—not the so-called “community” banks—that have most significantly increased the services they offer to low-income and moderate-income customers. An American Bankers Association study found that no-frills checking accounts for low-income customers were available at eighty-five percent of banks with over one billion dollars in assets in 1991, as compared with an industry average of only sixty-one percent.⁴⁰ The size effect is pronounced for CRA ratings as well. A recent study by the Community Reinvestment Institute of San Francisco found that the average size of banks receiving the highest CRA rating was \$17.6 billion in assets.⁴¹ Banks with the second-highest rating had average assets of \$4 billion, banks with the third-highest rating had average

³⁷ For example, the FDIC in 1988 gave a composite CRA rating of “4” or “5” to only 12 of the 3060 rated institutions, or .4% of the institutions rated, and gave a rating of “3” to only 58, or 1.9% of the rated institutions. The FDIC gave a “2” rating to 2683 or 87.7% of the rated firms, and gave its highest rating of “1” to 307 or 10% of the rated institutions. See *Discrimination in Home Mortgage Lending: Hearing Before the Subcomm. on Consumer and Regulatory Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. 53 (1989)*.

³⁸ A “Better Than Satisfactory” Grade?, *supra* note 36, at 10.

³⁹ Some have argued for a return to a five-tiered scale based on a perception that the current scale leaves too many institutions with a “satisfactory” rating and fails to recognize those banks doing a better-than-satisfactory job. *Id.* So far no action has been taken. *Id.*

⁴⁰ ABA Study Shows Increasing Focus on Low-Income Consumers, Bank Letter, Aug. 12, 1991 (available in LEXIS, Banks Library, IINews File).

⁴¹ When Bigger is Better, *U.S. Banker*, July 1991, at 8.

assets of \$532 million, and banks with the fourth, and lowest, CRA rating had average assets of only \$55 million.⁴²

This size effect reflects the CRA's enforcement regime. Large institutions—particularly those that wish to expand—have more to gain from a favorable CRA rating, and more to lose from an unfavorable one, than do small institutions. A large institution is more likely to apply for a new depository facility than a small one, and it is only when applying for a depository facility that the CRA is likely to have real bite, because the agencies' principal enforcement tool is the power to deny applications. Moreover, a large institution is more vulnerable to CRA challenges by pressure groups; as in most industries, there are economies of scale in protesting, and groups specializing in CRA protests recognize that they can obtain a greater return for their efforts by protesting against larger institutions, even if smaller institutions actually have "worse" records of CRA compliance.

II. THE OUTDATED IDEOLOGY OF COMMUNITY REINVESTMENT

The CRA is grounded in an ideology of localism in banking that traces back at least to the Progressive Movement of the early decades of the twentieth century. In the CRA, this ideology was turned against the banking industry by embodying, in legal form, the proposition that depository institutions owe special obligations to their local communities.

The basic principle of localism, as the Supreme Court once observed, is that "both as a matter of history and as a matter of present commercial reality, banking and related financial activities are of profound local concern."⁴³ Underlying the principle of localism are several related propositions, each of which was stressed in one form or another in the congressional debates on the act. Although these propositions may have had some validity earlier in our history, and may even have retained some force at the time the CRA was enacted, they bear little relationship to contemporary banking realities. Localism

⁴² *Id.*

⁴³ *Lewis v. BT Investment Managers*, 447 U.S. 27, 38 (1980); see also *Northeast Bancorp v. Board of Governors of the Fed. Reserve Sys.*, 472 U.S. 159, 177 (1985) (It is a "historical fact that our country traditionally has favored widely dispersed control of banking. While many other western nations are dominated by a handful of centralized banks, we have some 15,000 commercial banks attached to a greater or lesser degree to the communities in which they are located.")

has a nostalgic ring in American folklore, but it no longer characterizes the American banking industry—especially not the larger firms that have been the principal targets of CRA scrutiny. The underlying propositions are these: (1) banking is a local industry, (2) banks drain credit out of local communities, and (3) banks owe special duties to their local communities.

A. *Banking Is a Local Industry*

A basic theme underlying the ideology of the CRA is the proposition that banks are fundamentally local institutions: they take deposits from the local community and return those funds to the community in the form of loans. Alternatively, the proposition is that banks *should be* local institutions, even if they sometimes behave as if they are not.

Proponents of the CRA adverted to this theme in debates on the statute, arguing that the bill was necessary to correct for a disturbing trend away from localism. As Senator Proxmire, the principal sponsor of the CRA, remarked, “We need to encourage bankers to get out of the office and walk around the block and find loan opportunities here at home. The law already provides that banks are chartered to meet the convenience and needs of their communities. . . . [U]nfortunately many bankers and many bank regulators have forgotten the meaning of those words.”⁴⁴

The rhetoric linking banks with their local communities has deep roots in the American imagination. The banker in American folklore is a familiar local figure, usually a pillar of the community, sometimes a villain, but always a creature of his immediate environment. The local orientation of the depository institution is even more pronounced in the case of thrift institutions, which specialize in consumer and home mortgage rather than commercial loans. One need only recall the magnetic force that Bedford Falls exercised over building and loan president George Bailey in Frank Capra’s *It’s a Wonderful Life*⁴⁵ in order to appreciate the extent to which depository institutions, especially thrift institutions, were associated with their local communities in twentieth-century American imagination.

⁴⁴ 123 Cong. Rec. 17,630 (1977) (statement of Sen. Proxmire).

⁴⁵ *It’s a Wonderful Life* (RKO Radio Pictures, Inc. 1946).

This popular image of banks as fundamentally local institutions had substantial grounding in reality earlier in the century. Banks then were local by necessity. Transportation and communications technology had not advanced to the point where it was feasible for individuals or firms to conduct their checking operations at a distance, and the only practical source of credit for most individuals and firms was a local banker. These technological constraints were reinforced, at a time when they may have just begun to break down, by legal prohibitions against geographic bank expansion. In the early decades of the century, most states adopted unit banking rules that effectively enforced the principle of localism by prohibiting a banking institution from doing business out of more than one office.⁴⁶ The result was a decentralized banking system characterized by many thousands of smaller institutions—in contrast with the centralized systems with nationwide branching that developed in other industrialized nations.⁴⁷

In recent years, however, banking has become far less local in scope. The proponents of the CRA recognized this when they decried the bankers' tendency to turn away from local communities. Senator Proxmire and others were far off the mark, however, when they portrayed the problem as simply one of bankers, abetted by indulgent regulators, forgetting their obligations to local communities and losing sight of the profit opportunities in their own back yards. This view was unrealistic even in 1977. The erosion of localism was not a matter of bankers' collective moral lapse in failing to serve their home towns; it was a product of forces over which bankers had little control and that, on balance, have served the overall economic welfare of the American people.

The evolution of the American banking system from one composed of localized unit banks to one characterized by geographically dispersed, larger institutions has taken place on a number of fronts.⁴⁸ Virtually all states now permit branch banking, and many allow state-

⁴⁶ See Jonathan R. Macey & Geoffrey P. Miller, *Banking Law and Regulation* 12-15 (1992).

⁴⁷ See *id.* at 14-15.

⁴⁸ See generally Geoffrey P. Miller, *Legal Restrictions on Bank Consolidation: An Economic Analysis*, 77 *Iowa L. Rev.* 1083 (1992) (presenting "the pros and cons of banking consolidation in light of recent economic research" and concluding that "the case for dismantling the remaining geographic restraints on bank expansion is clear-cut," *id.* at 1086).

wide branching.⁴⁹ New York has gone farther and permitted interstate branching on a reciprocal basis with other states.⁵⁰ Equally dramatic has been the growth of geographically dispersed banking through bank holding companies. Starting early in the century, banking institutions have expanded within the borders of a state by means of holding companies owning multiple subsidiary banks.⁵¹ More recently, the holding company form has allowed geographic expansion across state lines. The Supreme Court upheld regional interstate banking compacts in 1985,⁵² thereby stimulating a massive and continuing trend toward interstate banking. Today nearly all states permit interstate bank acquisitions.⁵³ Many significant interstate mergers have been consummated,⁵⁴ and more are sure to occur soon. Because the large majority of banking assets are today held by banks that themselves are part of holding companies, the raw number of banks in the country, which remains quite large (about twelve thousand by a recent count),⁵⁵ greatly overstates the actual degree of localism in the banking industry today.

Improvements in information processing and communication technology have facilitated bank expansion by other means as well. Many customers utilize bank-by-mail services, which frees them from the need to be physically near to their depository institution. Paychecks can be deposited automatically in banks located anywhere in the country through automated clearing house transactions.⁵⁶ Automatic teller machines permit withdrawals of cash, as well as other transactions, at thousands of locations. For many consumers, a trip to the bank has become a rare event. Indeed, increasing numbers of consumers are opting out of the banking system altogether, relying instead on money market funds and credit cards to perform their transaction services.⁵⁷

⁴⁹ See Macey & Miller, *supra* note 46, at 32.

⁵⁰ New York Governor Signs Branching Bill, *Am. Banker*, June 30, 1992, at 15.

⁵¹ See Macey & Miller, *supra* note 46, at 19-20, 26-28.

⁵² *Northeast Bancorp, Inc. v. Board of Governors of the Fed. Reserve Sys.*, 472 U.S. 159 (1985); see Geoffrey P. Miller, *Interstate Banking in the Court*, 1985 *Sup. Ct. Rev.* 179 (1985).

⁵³ A Look at Laws Granting Interstate Powers to Banks, *Am. Banker*, Mar. 20, 1992, at 8.

⁵⁴ Top 300 Banks in Deposits and Assets, *Am. Banker*, Mar. 26, 1992, at 28A.

⁵⁵ *Economic Report of the President* 160 (Feb. 1991).

⁵⁶ See Edward L. Rubin & Robert Cooter, *The Payment System: Cases, Materials and Issues* 736-39 (1989).

⁵⁷ See Jonathan R. Macey & Geoffrey P. Miller, *Nondeposit Deposits and the Future of Bank Regulation*, 91 *Mich. L. Rev.* 237 (1992).

These changes suggest that banking today is much less of a local industry than it was in the past. Nevertheless, the CRA might be defended on the normative ground that, regardless of whether banking *is* a local industry today, it *should be* a local industry. Yet it is difficult to justify a normative preference for localism in banking markets under any coherent conception of public policy. The movement away from localism described above has been generally beneficial for consumers. It has improved banking service, enhanced asset diversification, and allowed banks to take advantage of economies of scale.⁵⁸ At the same time, it has seriously weakened, although not entirely broken, the ties that connect banks with their immediate local communities.⁵⁹

Thus, the principle that banking is essentially a local industry is no longer generally valid as an empirical matter, nor can the proposition that banks should be local, even if they are not, be defended on persuasive normative terms.

B. Banks Drain Credit Out of Local Communities

Banks have long faced the charge that they divert funds obtained from local depositors to borrowers elsewhere, thereby hampering economic development in the localities from which the deposits are obtained.⁶⁰ Senator Proxmire voiced these concerns: "Unfortunately, we find many banks and many savings and loan [sic] which take money from the community and reinvest it elsewhere, in some cases abroad, in some cases in other parts of the country. . . . We have found many cases where these institutions have invested virtually nothing in the local community."⁶¹

⁵⁸ See Miller, *supra* note 48, at 1096-121.

⁵⁹ This is not to say that location is unimportant, especially for small consumer transactions. A recent Federal Reserve Board survey found, for example, that the large majority of individuals continue to utilize the services of a bank in their local community for checking account services. See Gregory E. Elliehausen & John D. Wolken, *Banking Markets and the Use of Financial Services by Households*, 78 Fed. Res. Bull. 169 (1992).

⁶⁰ As we note in other work, the charge that financial institutions improperly divert funds from local communities was a significant part of Progressive ideology in the early part of the century, and was an important element in the campaign to enact state securities legislation. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 Tex. L. Rev. 347 (1991).

⁶¹ 123 Cong. Rec. 17,603 (1977) (statement of Sen. Proxmire).

Senator Proxmire and other advocates of the CRA were correct that local banks often did not lend a substantial proportion of their assets within their communities. In fact, local banks have directed funds elsewhere for many years, either by means of correspondent deposits at city banks, investments in loan participations or purchases of loans originated elsewhere, purchases of bonds issued by distant firms or government entities, or otherwise.⁶² The phenomenon about which the CRA advocates were complaining was nothing new.

Despite the CRA advocates' accurate assessment of this situation, the argument for mandatory community reinvestment falls short for a number of reasons, some going to the weaknesses of reinvestment arguments generally, and some peculiar to the CRA.

First, proponents of community reinvestment have never satisfactorily explained why the mere fact that funds are obtained from a particular locality ipso facto implies that these funds should be returned to the same locality. We would never insist that corn grown in Iowa farm country be returned to Iowa farms. The corn is shipped from the farms, where it is in surplus, to other areas where there is a deficit. It is not clear why credit should be different. Like corn or any other commodity, credit is allocated through a price system that directs the good to the user who values it the most. In the case of credit, the price is the terms that the banker can obtain on loans; and if the banker can earn better terms outside the local community than within, it is difficult to see why the law should deter the transfer of the credit to the higher valued user. Moreover, the export of credit, like the export of grain or other commodities, provides benefits to the locality in which the credit is generated, in the form of local banks that can pay higher interest rates for deposits as a result of their ability to make profitable loans in distant locations. Just as Iowa farmers would be worse off if they were allowed to sell grain only to local residents, so bank depositors in a local community will be worse off if banks are restricted in their ability to export those funds to areas of capital shortage.

Community reinvestment advocates respond that profitable loans are available nearby if the banker would but look. This argument,

⁶² On the use of correspondent banks as a means of allocating credit across wide geographic areas, see Eugene N. White, *The Regulation and Reform of the American Banking System, 1900-1929*, at 65-74 (1983). On bank purchases of bonds, see Macey & Miller, *supra* note 60, at 374-76.

however, fails to explain why, if there are good profit opportunities available locally and readily identifiable at low cost, the local depository institutions are not exploiting them. Who better, after all, to identify a sound local loan customer than the local banker, with the superior access to information that experience in the local community provides? Attempting to explain this conundrum, Senator Proxmire admitted that bankers "have much better judgment because they understand their community, and have much better judgment than we have here [in Congress]," but then, with breathtaking illogic, asserted that, nevertheless, "we have to do something to nudge them, influence them, persuade them to invest in their [local] community."⁶³

If local banks do not invest locally because the most profitable loan opportunities are elsewhere, then mandatory reinvestment rules are nothing other than governmentally-imposed credit allocation that impairs the efficiency of the economy by directing credit to lower-value uses. Senator Proxmire denied that the Act would allocate credit, and noted that "[w]e already have credit allocation . . . and it is credit allocation for the Fortune Five Hundred. Whenever money gets tight, it is small business and housing and family farms that suffer, and big business that gets the scarce credit."⁶⁴ Although this rhetoric has an appealing populist ring, it overlooks the fact that the credit "allocation" to big business is the result of the operation of the price system, whereas the allocation under a mandatory community reinvestment rule is allocation by government fiat.

Quite apart from the general problem of credit allocation, there are additional lapses of logic in the argument for the CRA in particular. The CRA is a general measure, applying across the board to make it less attractive for banks and savings associations to drain credit out of their local communities. Yet, if one bank drains credit out of its local community, it is very likely to supply that credit to a borrower in some other local community. Credit is fungible: It is not as if the borrower particularly cares whether the money comes from local depositors or distant ones. Accordingly, aside from foreign loans (which were frequently criticized by CRA proponents)⁶⁵ it is difficult to see why communities in general suffer a net harm when funds are

⁶³ See 123 Cong. Rec. 17,603 (1977) (statement of Sen. Proxmire).

⁶⁴ Community Credit Needs, *supra* note 18, at 2.

⁶⁵ See 123 Cong. Rec. 17,630 (1977) (statement of Sen. Proxmire).

transferred between them (although some local communities may be net importers of credit and others net exporters).

C. Banks Owe Special Duties to Their Local Communities

A third major theme underlying the doctrine of localism is the notion that banks owe special duties to their local communities. That is, because they have been vested with valuable privileges by their communities, they have an obligation to return some of the resulting benefits in the form of credit to their localities.

This theme appears frequently in the legislative history of the CRA,⁶⁶ and indeed finds expression in the text of the statute itself. The CRA begins with the recitation that “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,”⁶⁷ and that “regulated financial institutions have [a] continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered.”⁶⁸ The clear implication is that the privilege of obtaining a bank charter carries with it responsibilities, and that one of the chief such responsibilities is the obligation to return credit to the community from which deposits are taken.

Congress is, of course, free to declare that the privilege of conducting a banking business carries with it the obligation to return credit to local communities. Congressional fiat aside, however, the argument that banks enjoy a special privilege that carries with it exceptional responsibilities to local communities, whatever its validity in 1977, is now questionable at best. Banks and savings associations no longer enjoy the effective monopoly in the deposit franchise that they did in 1977. At that time banks and saving and loans operated under a system of below-market prices for deposits—no interest for checking accounts and an administrative ceiling for time and savings accounts, with savings and loans allowed to pay a little more than banks—that can aptly be described as a cartel, administered and enforced by the federal government for the benefit of depository insti-

⁶⁶ Id. at 17,603-04, 17,629-33; see McCluskey, *supra* note 12, at 37 & n.19.

⁶⁷ 12 U.S.C. § 2901(a)(1).

⁶⁸ Id. § 2901(a)(3).

tutions.⁶⁹ That regulatory cartel has now completely broken down as banks and thrifts compete vigorously with one another for deposits.⁷⁰ As a result depository institutions have lost an enormously important government benefit that they enjoyed at the time the CRA was enacted.

Moreover, depository institutions are now facing intense and growing competition from other types of firms for the transaction business of wholesale and retail customers.⁷¹ The most significant of these nonbank competitors are mutual funds, many of which today offer extensive checking privileges. Other firms—even industrial corporations—are offering services that perform most of the same functions as the checking account at a bank.⁷² With the erosion of the monopoly that their charter once provided over transaction accounts, the argument that depository institutions should be required to return to their communities a portion of the profits flowing from their monopoly franchise loses much of its force.

Furthermore, it is not entirely clear, in the current banking environment, that a charter to operate as a depository institution confers significant benefits, even when federal deposit insurance is added to the picture. The costs of FDIC premiums have increased seven-fold over the past few years, to the point where insurance assessments constitute a significant drag on depository institution earnings.⁷³ At the same time, other regulatory taxes—including, importantly, the costs of the CRA itself—have been imposed on insured depository institutions.⁷⁴ As a result, a significant class of institutions might well make themselves better off by opting out of federal deposit insurance⁷⁵ or by dropping their bank charter altogether. Thus, the argument that

⁶⁹ See Geoffrey P. Miller, *The Future of the Dual Banking System*, 53 *Brook. L. Rev.* 1, 2-4 (1987); Kenneth E. Scott, *The Uncertain Course of Bank Deregulation*, *Reg.*, May/June 1981, at 40.

⁷⁰ See Miller, *supra* note 69, at 4-7.

⁷¹ Macey & Miller, *supra* note 57, at 245-64.

⁷² See *id.* at 260-62 (describing program of IBM credit corporation that effectively offers checking account services to investors).

⁷³ See Jonathan R. Macey & Geoffrey P. Miller, *Toward Enhanced Consumer Choice in Banking: Uninsured Deposit Facilities as Financial Intermediaries for the 1990's*, 1991 *Ann. Surv. Am. L.* 865.

⁷⁴ For a description of the greatly strengthened enforcement regime now applicable to depository institutions, officers, and institution-affiliated parties, see Macey & Miller, *supra* note 46, at 573-625.

⁷⁵ See Macey & Miller, *supra* note 73, at 884-96.

depository institutions enjoy a special and valuable privilege that entitles the chartering authority to demand some kind of return in kind has far less credibility today than it did in 1977.

In short, the ideology of community reinvestment on which the CRA was premised was questionable at the time the statute was enacted and bears little resemblance to contemporary marketplace realities. Although the CRA might be justified on other grounds, it can no longer be supported by its original ideological foundations.

III. DIFFERENTIAL IMPACT ON DEPOSITORY INSTITUTIONS

An increasingly serious difficulty with the CRA is the fact that it burdens certain types of institutions while favoring others—thus impairing the safety and soundness of those that suffer disproportionately under the act. The CRA has two main differential effects. First, it applies only to depository institutions—banks and savings associations—and not to other types of lenders. Second, it discriminates within the category of depository institutions by placing greatly disproportionate burdens on some institutions and thus giving an artificial competitive advantage to others.

A. *Depository Institutions vs. Other Lenders*

Banks and savings associations face competition from a host of other businesses with respect to their lending activities, including pension funds, life insurance companies, consumer finance firms, mortgage banks, credit unions, and many other firms. The CRA thus effectively imposes a special, discriminatory tax on banks and savings associations, which are thereby weakened relative to other financial institutions. This weakening process is already well underway, not only because of the CRA, but also for a variety of other reasons.⁷⁶ In the long run, the relative decline of banks may not be an irrevocable blow to our financial system: as banks decline, other institutions will take their place, and eventually the system will move toward equilibrium. Nevertheless, the social costs of the CRA and other regulatory taxes now being imposed on depository institutions are substantial,

⁷⁶ For discussion, see Jonathan R. Macey & Geoffrey P. Miller, *Bank Failure: The Politicization of a Social Problem*, 45 *Stan. L. Rev.* 289, 290-98 (1992); Jonathan R. Macey & Geoffrey P. Miller, *America's Banking System: The Origins and Future of the Current Crisis*, 69 *Wash. U. L.Q.* 769 (1991) [hereinafter Macey & Miller, *America's Banking System*].

because the assets tied up in these firms are reduced significantly in value when they are placed at an artificial competitive disadvantage as compared with other financial institutions.

Of course, the problem of differential impact might be solved by extending the CRA to cover other lenders.⁷⁷ Even putting to one side the economic costs of extending the reach of an inefficient statute, however, it does not seem feasible, given the existing conceptual frame of the CRA, to apply it to many nonbank lenders. Depository institutions other than banks and savings associations tend to operate across extended geographic areas.⁷⁸ They do not serve any particular "community." These lenders could be brought within the ambit of the regulation only if the ideology of community were dropped or extensively modified—to be replaced, for example, by the idea that racial minorities, women, or other groups represent "communities" that are not geographically localized, and that lending institutions of all sorts owe a duty to take affirmative steps to serve the needs of these distinct communities within the overall society. Such a statute is not impossible to imagine, although legislation of this sort appears unlikely to be enacted any time soon.⁷⁹ For the foreseeable future, it appears that banks and savings associations will continue to suffer the discriminatory tax of the CRA. This tax, coupled with other factors, will contribute further to the decline of these institutions within the American financial system.

B. Differential Impact Among Depository Institutions

In addition to imposing differentially high costs on banks and savings associations, the CRA also creates distortions within the banking

⁷⁷ Some community activists at least would favor this approach. See Robert C. Art, *supra* note 12, at 1137 n.288 (quoting a member of ACORN, the leading CRA activist organization, warning that "[i]t's just a matter of time" before nonbank lenders are covered by the statute). The banking industry also favors extending CRA to nonbank lenders. See Government Check Cashing, "Lifeline" Checking, and the Community Reinvestment Act: Hearings on S. 906, S. 907, and S. 909 Before the Subcomm. on Consumer and Regulatory Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. 99 (1989) (testimony of the American Bankers Association).

⁷⁸ See *supra* text accompanying notes 48-59.

⁷⁹ It is possible, however, that credit unions will be included in the statute, since, like banks and savings associations, these are federally-insured (usually) depository institutions. The CRA is unlikely to have much force as applied to credit unions, however, because the practice of these institutions of making loans to their own members would likely be deemed sufficient "reinvestment" to comply with the strictures of the statute.

industry because it has different effects on varying types of depository institutions. This differential effect manifests itself in a variety of ways.

Institutions Serving Depressed Communities. A particularly troubling effect of the Act is its discrimination against depository institutions serving poor neighborhoods. Because a bank's CRA rating is based on its lending practices in the area contiguous to its offices, the CRA imposes greater costs on banks in poor areas than those in wealthy areas to the extent that it causes banks to lend funds locally.⁸⁰ Banks located in wealthy areas can elect not to make loans in poor areas without risking serious CRA challenge. Banks located in poor areas, on the other hand, are effectively forced to devote a substantial proportion of their loan portfolios to their local communities. Because of these additional regulatory requirements and costs, banks seeking to expand will be less likely to establish new branches or offices in poor areas than they were prior to the promulgation of the CRA.

That the CRA would have the effect of reducing the availability of credit in impoverished areas was well understood at the time the statute was enacted. Robert R. Barnett, the Chairman of the FDIC, objected to the legislation on exactly these grounds at that time. He wrote, persuasively if inelegantly, that

the practical effect of the bill could be to discourage financial institutions from making applications for offices in neighborhoods where funds are badly needed because of the reexamination that this would entail with respect to their lending policies in service areas where they already have offices. Some institutions might even close down offices already established in certain neighborhoods if they felt that they could be publicly criticized for not meeting the credit needs of such neighborhoods when they apply for a branch in another location. The result of this would be to increase the present concentration of financial institution offices in more affluent neighborhoods.⁸¹

⁸⁰ This analysis assumes that it costs more to make loans in poor areas than in wealthy areas. Of course it may be the case that the higher costs of making loans in poor areas (which come in the form of higher rates of default and delayed collection) can be offset by charging higher interest rates—but then the institution in question would likely forfeit the CRA credit for making the loan in the first place.

⁸¹ Letter from Robert E. Barnett, Chairman, FDIC, to Senator William Proxmire (May 4, 1977), reprinted in *Community Credit Needs*, supra note 18, at 15-17.

If this counsel had been heeded in 1977, impoverished urban areas might now have better access to credit than they do with the CRA in place.

Banks Trying to Expand or Otherwise Reposition Themselves in the Market. In addition to discriminating against depository institutions serving poor neighborhoods, the CRA provides stable, well-established banks with advantages over banks that are trying to reposition themselves in the market. Although all banks are equally subject to some of the consequences of a low CRA rating, such as unfavorable media coverage, the most direct effects are on those institutions that are trying to expand by merging or establishing new branches or that are attempting to cut costs through such activities as consolidating services and closing or relocating branches.

The CRA also penalizes banks that attempt to improve their operations in a way that might be challenged by local politicians or community activists as detrimental to low-income or minority groups.⁸² For example, when Ameritrust sought approval to consolidate several branch offices in Cleveland in order to cut costs, its application was greeted with a storm of political protest. The Mayor of the city lambasted the bank for its "appalling community reinvestment performance" and joined community activists and members of the city council in resisting the bank's plans.⁸³ These protests occurred despite the fact that the bank had received, the previous month, the second-highest CRA rating from the Comptroller of the Currency.⁸⁴

Wholesale Banks. The CRA is particularly inappropriate as applied to wholesale banks. These banks have elected to serve the

⁸² The federal supervisory agencies implicitly discourage branch closings by indicating that an institution will receive CRA points for adopting "a written corporate policy concerning branch closings which contains provisions for appropriate notice, analysis of the impact of the closing on the local community, and efforts that may be made to minimize any adverse effects." Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act, 54 Fed. Reg. 13,742, 13,744 (1989). Moreover, the 1991 amendments to the CRA indicate, at least by indirection, that a depository institution will lose CRA credit if it closes or relocates a branch in a depressed area unless it pays a suitable exit fee. With its most recent amendment, the revised CRA statute now provides that an institution will earn CRA credit if it subsidizes a minority or women's bank upon closing a branch in a minority area, 12 U.S.C. § 2907; the implication is rather clear that the institution will lose CRA points if it closes a branch and fails to provide the subsidy.

⁸³ See Ellen Braitman, *Ameritrust's Branch Shutdowns Delayed by Charges of Redlining*, *Am. Banker*, Aug. 27, 1991, at 1.

⁸⁴ *Id.* at 5.

wholesale market—the market for large corporate loans and deposits—and typically carry on only a small retail banking operation, often for the convenience of wholesale customers. Although wholesale banks have to be located somewhere, and in this sense are within a community, they are not closely tied to their local communities. This is not because of any nefarious motives, but is simply a function of business strategy: because of the nature of its business, a wholesale bank draws a substantial amount of funding, and makes a substantial amount of loans, away from its local community.

Regrettably, such banks are treated, under the CRA, without much regard to their specialized business activities.⁸⁵ The Federal Reserve Board has refused to exempt wholesale banks from the statute, concluding that the Act was “intended to cover all banks that are in the business of extending credit to the public, including both *wholesale* and *retail* banks.”⁸⁶ The Board’s reasoning for sweeping wholesale banks into its general CRA regulation was perfectly conclusory: “The lending activities of these banks affect the economic health of the communities in which they are chartered.”⁸⁷

The Board has shown itself willing to penalize wholesale banks for failing in their CRA obligations. For example, in 1989 it denied what appeared to be an inconsequential application by holding companies of Continental Bank, the Chicago wholesale bank, to acquire the tiny (\$14.6 million in deposits) Grand Canyon State Bank of Scottsdale, Arizona.⁸⁸ The denial was based heavily on Continental’s alleged failure to meet its CRA obligations.⁸⁹ The Board took pains to observe that although Continental was a wholesale bank, it could still comply with the mandate of the CRA by activities such as

lending to inner-city revitalization efforts, supporting state and local governmental financing efforts, lending to small or minority-owned businesses [the Board did not explain why lending to a minority-owned business qualified for credit under a statute that mentions nothing about minority preference], lending support for low-income

⁸⁵ See Anat Bird, Community Investment Act is Fundamentally Flawed, *Am. Banker*, Dec. 18, 1990, at 4.

⁸⁶ 12 C.F.R. § 228.100 (1992).

⁸⁷ *Id.*

⁸⁸ Continental Bank Corp., 75 Fed. Res. Bull. 304 (1989) (Order Denying Acquisition of a Bank).

⁸⁹ *Id.*

multi-family rehabilitation and new construction projects, lending to or otherwise financing non-profit developers of low-income housing and small business development, or financing major upgrades and/or expansion of industrial plants that would otherwise relocate outside of the city served by the bank.⁹⁰

These may be valuable activities for financial institutions to undertake, but, with one exception, they are not ones for which a bank specializing in major commercial loans is particularly suited. The exception for loans to big businesses that threaten to leave a city is the one activity on the laundry list that a wholesale bank appears well-qualified to undertake, and, in that respect, is relatively unproblematic. It is, however, difficult to see why, in the name of preserving communities, businesses should be rewarded with favorable loan treatment by depository institutions when they threaten to leave, or why loans to big businesses are a particularly effective means for serving the credit needs of low-income and moderate-income residents. Although the Continental case presented special features, which we discuss further below,⁹¹ it clearly stands as a warning to wholesale banks that they must revamp their operations and enter lines of business for which they are not particularly qualified and in which they had previously determined, as a matter of business judgment, not to engage.

Trust Banks and Private Banks. Perhaps equally troubling is the situation of specialized banks, such as those that focus on trust services or private banking for individuals.⁹² These banks may find it difficult to advance credit to their local communities simply because they are not operated with the purpose or intent of entering that business. Under the CRA, however, they may be forced to extend their operations outward into community lending even though such activities are not consistent with their business plans and present no synergies with existing operations.

Banks with Conservative Investment Strategies. The CRA also tends to force banks into a rigid mold with respect to their asset policies. The economic forces operating on a banking institution do not dictate that it make any particular portion of its assets available in

⁹⁰ Id. at 304-05.

⁹¹ See infra notes 172-73 and accompanying text.

⁹² See Linda Corman, *Banks Struggling to Meet CRA Rules at Special Units*, Am. Banker, May 6, 1991, at 6.

lending.⁹³ A bank could purchase corporate, municipal, or national bonds instead, or could acquire other nonloan financial assets. Such a bank might be safer, and might even be more profitable, than its competitors that make a higher volume of loans. Yet it might also raise the eyebrows of the bank examiner who expects to see a suitable percentage of the bank's assets devoted to lending.

This problem beset the Cambridge State Bank of Cambridge, Minnesota, a stable and profitable institution that received a "substantial noncompliance" CRA rating. The problem, from the standpoint of the bank examiners, was that the bank simply devoted too many of its assets to investments in bonds: in the words of the report, "[m]anagement's ultraconservative lending practices appear to be discouraging applications for credit, especially in the real estate lending area."⁹⁴ It seems odd, to say the least, that a bank would be criticized by bank examiners for conservative lending practices and for not making enough funds available in real estate loans, given the severe difficulties that real estate lending has caused for banks and thrift institutions nationwide over the past five years. If Citibank had invested in government bonds, instead of making huge amounts of real estate loans during the 1980s, it could have avoided hundreds of millions of dollars in losses that it experienced as a result of the crash in the commercial real estate market.⁹⁵ But then, apparently, it would have been vulnerable to attack by CRA examiners or activists for engaging in "ultraconservative" lending practices.

IV. SAFETY AND SOUNDNESS IMPLICATIONS

We now consider the impact of the CRA on the safety and soundness of the banking industry. This section considers: First, whether CRA loans and other activities represent investments of bank capital that are as profitable as other loans on a risk-adjusted basis; second, the impact of the CRA on bank market structure; and finally, the effect of the CRA on bank portfolio diversification.

⁹³ See Macey & Miller, *supra* note 46, at 172-251 (describing legal regulation applicable to a wide range of bank investments).

⁹⁴ See Bill Atkinson, *A Bank That Won't Bend to Meet CRA Standards*, *Am. Banker*, Apr. 22, 1991, at 6.

⁹⁵ See, e.g., Fred Vogelstein & Tom Leander, *Citi Loses \$885 Million and Suspends Dividend; Chemical, Hanover Post Profits*, *Am. Banker*, Oct. 16, 1991, at 1.

A. Profitability of CRA Loans

Advocates of the CRA often claim that depository institutions should not object to their obligations under the Act because they can lend to low-income and moderate-income neighborhoods and still make a profit. The thesis is that the banking industry has failed to recognize the numerous profit opportunities available in these communities. Thus, in this view, the CRA is not inconsistent with the safety and soundness of the banking industry because a CRA loan is not an unsafe or unsound loan.⁹⁶ The premise that banks can fully comply with the CRA without sacrificing profit is implied in the statute itself, which states that depository institutions should help meet the credit needs of local communities "consistent with the safe and sound operation of such institutions."⁹⁷

There is undoubtedly truth to the argument that profitable loan opportunities exist in low-income and moderate-income neighborhoods, and that some of these loans would not be made if it were not for the CRA. Loans are illiquid assets that require extensive investigation, monitoring, and analysis.⁹⁸ In the absence of government compulsion, depository institutions will engage in costly search to find profitable lending opportunities only up to the point where the benefits of an additional unit of a search equal the costs of that search.⁹⁹ The thumb on the scales administered by the CRA causes depository institutions to engage in more search for lending opportunities in low-income and moderate-income communities, and, not surprisingly, some opportunities are being discovered.

This does not, however, mean that depository institutions were behaving uneconomically before the CRA became effective, or that heavy-handed government intervention under the CRA is plausibly going to increase the efficiency of lending by depository institutions by forcing them to take actions that would be in their own economic self-

⁹⁶ See, e.g., Marilyn F. Friedman, *Profits Await in CRA Home Loans*, *Am. Banker*, Jan. 9, 1992, at 4, 11.

⁹⁷ 12 U.S.C. § 2901(b).

⁹⁸ See Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 *J. Pol. Econ.* 401 (1983) (loans are illiquid assets); Macey & Miller, *America's Banking System*, *supra* note 76, at 774-75 (traditional bank loans require "ongoing, continuous monitoring").

⁹⁹ See George J. Stigler, *The Economics of Information*, 69 *J. Pol. Econ.* 213 (1961), *reprinted in* George J. Stigler, *The Organization of Industry* 171 (1968).

interest to take in any event. Nor does it prove that the CRA is consistent with the safety and soundness of depository institutions. The fact that there are some profitable loans to be made in low-income and moderate-income communities does not mean that greatly increasing lending in such communities is going to be a profitable activity. The existence of a few profitable loans will not make CRA activities as a whole profitable if other loans turn out to be unprofitable. An angler who casts a line outside the best fishing grounds might catch some fish, but that does not mean that such a strategy is a profitable use of the angler's time.

It is quite evident that, despite the occasional profitable CRA loan, the general effect of the CRA is to reduce depository institution safety and soundness. Regulators explicitly encourage banks to make loans on terms that would not be available to applicants from outside the pale of CRA favoritism. For example, regulators award extra CRA points to institutions that utilize "more flexible" lending criteria when making CRA loans.¹⁰⁰ Although the applicable regulation quickly recites that such "flexible" loans must be "consistent with safe and sound practices," it is difficult to imagine what "more flexible" could mean, if not more risky, or more generous with respect to terms. Similarly, the regulations encourage "high loan-to-value-ratio" mortgage loans in local communities,¹⁰¹ which means nothing other than that the depository institution should incur greater risks. Although the regulations again quickly offer the thought that such loans should be backed by private mortgage insurance, such mortgage insurance is itself neither default-free nor costless.

Depository institutions are also encouraged to earn CRA credits by cashing government checks or offering low-cost checking accounts.¹⁰² But cashing government checks is not a riskless or costless enterprise, especially in a low-income community; the depository institution bears a fraud risk if it cashes a check for a thief. Of course, a depository institution could cover this risk by charging a high check-cashing fee, or by requiring extensive documentation from persons wishing to cash checks, but if it did so it would probably forfeit the CRA credit for which it instituted the service in the first place.

¹⁰⁰ See Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act, *supra* note 82, at 13,744.

¹⁰¹ *Id.*

¹⁰² *Id.*

As regards low-cost checking, it is evident virtually from the name of the service that the enterprise is unlikely to be profitable. According to a recent American Bankers Association study, more banks are offering "lifeline" checking accounts for low-income consumers, which offer fees that are reduced or even waived.¹⁰³ In itself, this may sound like a change for the better. But the same study reported that forty percent of banks offering no-frills checking accounts operated this service at a loss, or at most broke even, in 1990-91¹⁰⁴—a dismal profit record that indicates that such services are often not in the best interest of banks in the absence of the artificial incentive of the CRA.

Whereas the CRA encourages depository institutions to devote depositor funds to low-profit or losing propositions in derogation of overall economic welfare, it discourages investment practices that until recently would have been considered paragons of prudent banking. Institutions that adhere to old-fashioned, conservative lending practices—which one might have thought would earn credit from bank examiners concerned with promoting an institution's safety and soundness—may well find themselves instead at the receiving end of the regulatory lash. Consider Farmers and Merchant's Bank of Long Beach, California. This medium-sized institution (\$1.3 billion in assets) is the best-capitalized bank of its size in California, with shareholders' equity equaling 16.5% of assets.¹⁰⁵ The bank earns a return on assets of over two percent, double what is considered excellent performance by industry standards.¹⁰⁶ A well-managed, solvent institution of this type would seem exactly the sort of depository institution that bank regulators should prize in the wake of Lincoln Savings and the other high-rolling institutions that failed in the 1980s at the cost of billions of taxpayer funds. But the bank's conservative lending strategy did not sit well with regulators, who accused it of being in "substantial noncompliance" with the CRA. In 1992 the bank was served with a cease-and-desist order by the Federal Reserve Board,

¹⁰³ See ABA Study Shows Increasing Focus on Low-Income Consumers, Bank Letter, Aug. 12, 1991 (available in LEXIS, Banks Library, Allbnk File).

¹⁰⁴ *Id.*

¹⁰⁵ Sam Zuckerman, Calif. Bank Hit in CRA Crackdown, *Am. Banker*, Apr. 2, 1992, at 1, 10.

¹⁰⁶ *Id.*

the first time such an enforcement weapon has been used against an institution for alleged CRA shortcomings.¹⁰⁷

B. Impact on Market Structure

The CRA has impeded the ability of the nation's banking system to cope with the structural weaknesses in the provision of banking services that result from an excessive number of small banking institutions.¹⁰⁸ The great majority of banking analysts agree that consolidation of banking institutions is inevitable over the coming years, and that bank mergers offer one valuable mechanism by which bank assets can be transferred to more efficient users.¹⁰⁹ A relatively unencumbered merger process has important implications for both the solvency and efficiency of the industry: If the legal system did not place undue obstacles in the path of bank mergers (including hostile acquisitions), assets of weak or badly managed depository institutions would more often be transferred to efficient management *before* a depository institution became insolvent.¹¹⁰

As presently administered, the CRA impedes this desirable process of bank mergers and acquisitions. Given the time-sensitive nature of the merger and acquisition process, a CRA-based delay to a proposed merger will often be tantamount to denying it altogether. If a CRA examination is underway or scheduled for the near future, the Federal Reserve Board is likely to defer approving a merger application until the examination is completed.¹¹¹ The Fed has not been receptive to requests that it accelerate an examination in order to facilitate a

¹⁰⁷ *Id.* at 1.

¹⁰⁸ See Miller, *supra* note 48, at 1102-05 (noting that larger banks tend to be less risky than smaller institutions).

¹⁰⁹ For a sampling, see Carter H. Golembe, Consolidation and Competition in the Financial Services Industry, 9 *Ann. Rev. Banking L.* 451 (1990); Robert A. Litan, Interstate Banking and Product-Line Freedom: Would Broader Powers Have Helped the Banks?, 9 *Yale J. Reg.* 521 (1992); Jonathan R. Macey & Geoffrey P. Miller, Bank Failures, Risk Monitoring, and the Market for Bank Control, 88 *Colum. L. Rev.* 1153, 1202-25 (1988).

¹¹⁰ See Macey & Miller, *supra* note 109, at 1212-23.

¹¹¹ Rodgin Cohen, The New Phase of Bank Consolidation: Regulatory Issues and Considerations, 27 *Wake Forest L. Rev.* 63, 81 (1992). An example is the Fed's decision to defer First Union Corporation's application to acquire Florida National Banks of Florida, Inc. until the completion of a scheduled CRA compliance examination. See Marion A. Cowell, Jr. & Monty D. Hagler, The Community Reinvestment Act in the Decade of Bank Consolidation, 27 *Wake Forest L. Rev.* 83, 97 (1992).

merger.¹¹² Moreover, if a proposed merger stimulates a CRA protest, as most mergers of any size do today, the banking agencies may also delay approval in order to conduct hearings on the CRA issues. In the recent BankAmerica/Security Pacific merger, for example, the Fed held four public hearings devoted to the CRA aspects of the proposed combination.¹¹³

Even if delay does not preclude a merger, the increased costs of the anticipated CRA protests must be considered. Responding to CRA protests is expensive, requiring extensive managerial attention and use of public relations media. Moreover, the protests will almost certainly generate adverse publicity that may harm the institution's reputation and customer base. More significant still are the costs of the uneconomic loans that are the implicit price of CRA approval. Although the recent spate of highly publicized commitments by merging banks to make billions of dollars available in community lending are largely window-dressing,¹¹⁴ the Act does induce institutions to increase their level of CRA loans in connection with proposed mergers or acquisitions. The cost of these loans is an implicit tax that the CRA imposes on the process of depository institution consolidation.

The fact that some very large mergers have taken place notwithstanding these costs does not indicate that the CRA has no effect; they indicate only that the institutions in question determined that the transaction was sufficiently desirable to warrant going forward despite the costs of the CRA. Bank managers considering whether to engage in a merger or other significant acquisition must take into account the likelihood of a CRA challenge and the attendant increased costs and adverse publicity. At the margin, some bank mergers or acquisitions that would occur in the absence of the CRA are deterred by the threat of a CRA protest and do not occur. This is not true merely as a matter of theory. There are documented cases in which depository institutions have elected not to pursue a planned acquisition because of the anticipated costs of a CRA protest. For example, Harris Bancorp, a major Chicago institution with \$13.1 billion in assets, entered an agreement to merge with First Geneva Banqueshares, a Wisconsin holding company, but abandoned the agreement upon

¹¹² See Cohen, *supra* note 111, at 81-82.

¹¹³ See BankAmerica Corp., 78 Fed. Res. Bull. 338, 339 (1992) (Order Approving the Merger of Bank Holding Companies).

¹¹⁴ See *infra* notes 150-58 and accompanying text.

learning that the Federal Reserve Board would likely deny the application because Harris' lead bank had received a "needs to improve" CRA rating in its most recent examination.¹¹⁵

C. *Portfolio Diversification*

The CRA imposes yet another risk for depository institutions: It reduces their ability to diversify their asset portfolios by making loans outside their local geographic areas, thus hedging against the chance of a significant downturn in the local economy. Just as an individual investor can improve his or her situation by obtaining a diversified investment portfolio,¹¹⁶ a depository institution can do the same by diversifying its loan portfolio (and, indeed, by diversifying its asset portfolio generally by including investments other than loans). This basic insight is reflected in a variety of existing banking regulations—for example, the regulations limiting the amount that a depository institution can lend to any one borrower are clearly designed to encourage a rough form of portfolio diversification.¹¹⁷ But the importance of portfolio diversification appears to have been forgotten when it comes to the CRA, which strongly encourages depository institutions to reduce the diversification of their portfolios by concentrating lending activity within an undiversified geographic area.

V. COMPLIANCE COSTS

The CRA might seem to impose relatively minor costs of compliance on depository institutions and their regulators. The institution must come up with a CRA plan, file a notice, maintain a file for public inspection, and stand ready to answer queries of federal bank examiners about CRA policies and procedures. The examiner must evaluate the institution's record of meeting community credit needs in connection with on-site examinations. The burden seems, though not minimal, at least bearable.

This view of the CRA, however, greatly understates the actual compliance costs. Bankers today regard the CRA as the single most

¹¹⁵ Ed Dillon, *Scuttled Deal in the West Illustrates Impact of CRA*, *Am. Banker*, Jan. 8, 1992, at 9.

¹¹⁶ See R.A. Brealey, *An Introduction to Risk and Return from Common Stocks* 102 (2d ed. 1983).

¹¹⁷ See, e.g., 12 U.S.C. § 84 (1988).

costly regulation facing them, a statement that carries weight in light of the manifold, complex, and arcane regulations governing depository institutions today.¹¹⁸ That bankers should single out the CRA among this parade of red tape is a powerful testament to the actual costs of compliance.

In this section, we consider some of these compliance costs, focusing on (1) direct costs of compliance; (2) the costs of regulatory imprecision; and (3) the costs of conducting CRA compliance by means of public relations campaigns that may be only tangentially related, at best, to matters of substance.

A. Direct Compliance Costs

The direct costs of complying with the CRA are already substantial and continue to rise. One survey of banking professionals in the Mid-Atlantic region found that, on average, banks spent fifty-nine dollars in administrative compliance costs for every one million dollars in assets in 1989, the first year of the new CRA regime, and that a majority of the institutions polled planned to more than double their CRA compliance spending in 1990.¹¹⁹ Similarly, a study compiled by the American Bankers Association in 1992 concluded that the banking industry spent \$10.7 billion complying with government regulations in 1991, and that the single most costly regulation of all was the CRA.¹²⁰

CRA exams can tie up the energies of bank personnel and bank examiners for substantial periods. A recent CRA examination of Manufacturers Hanover Trust Co. required more than five months of time for two examiners from the Federal Reserve Bank of New York, and the CRA examination of Bank of America by the Comptroller of

¹¹⁸ See *infra* text accompanying note 120. For our introduction to some of these regulations, see Macey & Miller, *supra* note 46.

¹¹⁹ John C. Foreman & J. McDuffie Brunson, *CRA: Bankers on the Defensive*, *Bank Mgmt.*, Jan. 1991, at 35.

¹²⁰ Barbara A. Rehm, *ABA: Cost of Compliance Equals 59% of Bank Profits*, *Am. Banker*, June 18, 1992, at 1, 12. These statistics should be evaluated with some care, however, because they are based on bankers' self-reports in response to a survey at a time when the American Bankers Association was preparing a campaign to challenge the high costs of government regulation. Nonetheless, it is clear that the CRA represents a substantial burden for depository institutions even relative to other forms of government regulation.

the Currency required six weeks of work by up to four examiners.¹²¹ These examinations burden not only the regulators, who may have other things to do with their time, but also the banks themselves, because they must make their facilities and personnel available to respond to the regulators' queries and feedback.

The costs of the CRA are not limited to urban banks. Smaller banks in rural areas may also be forced to undergo massive regulatory scrutiny of their community reinvestment policies. For example, one small institution in rural Nebraska, with only sixteen million dollars in assets, reportedly was subjected to a week-long CRA exam by six examiners.¹²² Although this story is somewhat anomalous, it appears clear that a CRA examination can be disruptive for institutions of all sizes.

B. Regulatory Imprecision

CRA ratings are inexact and subjective. They are based on an imprecise evaluation of twelve factors, each of them vague, that are set forth in the applicable regulations without guidance as to which are most important, which should trump in the event of conflict, and so on.¹²³ As if the first eleven of these factors were not vague enough, the twelfth sweeps in anything else that the bureaucrats might consider relevant to the institution's CRA compliance, thus guaranteeing maximum uncertainty of application. Even the Federal Financial Institutions Examination Council, the body charged with providing guidance as to the requirements of the act, admits that CRA ratings depend on a "variety of unique, complex factors," that the guidelines are "generally descriptive," that "all attributes do not apply to every institution," and, in sum, that "[a]ssessing the CRA performance [of

¹²¹ Ellen Braitman, *Hanover CRA Exam Nears Month 5: Other Banks Fear Lengthy Benchmark Will Be Set*, *Am. Banker*, Jan. 31, 1991, at 5. These appear to be on the high end of the spectrum. The Federal Reserve Board has reported that its examiners spent an average of 55 hours conducting CRA examinations on institutions with more than \$500 million in assets in 1988, and less for smaller institutions. See *Enforcement of the Community Reinvestment Act: Hearing before the Subcomm. on Consumer and Regulatory Affairs of the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. 25 (1989)*. The Office of Comptroller of the Currency spent an average of 21 work days on CRA examinations of institutions with more than \$10 billion in assets in 1988. *Id.* at 78.

¹²² "Mindless" Regulations Attacked, *Am. Banker*, July 6, 1992, at 7.

¹²³ The twelve factors are these:

an institution] is a process that does not rely on absolute standards."¹²⁴

The vagueness of these factors is compounded by the notoriously circular language that the agencies offer as purported definitions of the four CRA ratings. For banks rated "outstanding," the agencies have this to say: "An institution in this group has an outstanding record of, and is a leader in, ascertaining and helping to meet the credit needs of its entire delineated community, including low-income and moderate-income neighborhoods, in a manner consistent with its resources and capabilities."¹²⁵ Equally helpful is the definition for "satisfactory" performance: "An institution in this group has a satisfactory record of ascertaining and helping to meet the credit needs of its entire delineated community, including low-income and moderate-income neighborhoods, in a manner consistent with its resources and

(a) Activities conducted by the bank to ascertain the credit needs of its community, including the extent of the bank's efforts to communicate with members of its community regarding the credit services being provided by the bank;

(b) The extent of the bank's marketing and special credit-related programs to make members of the community aware of the credit services offered by the bank;

(c) The extent of participation by the bank's board of directors in formulating the bank's policies and reviewing its performance with respect to the purposes of the Community Reinvestment Act;

(d) Any practices intended to discourage applications for types of credit set forth in the bank's CRA statement(s);

(e) The geographic distribution of the bank's credit extensions, credit applications, and credit denials;

(f) Evidence of prohibited discriminatory or other illegal credit practices;

(g) The bank's record of opening and closing offices and providing services at offices;

(h) The bank's participation, including investments, in local community development and redevelopment projects or programs;

(i) The bank's origination of residential mortgage loans, housing rehabilitation loans, home improvement loans, and small business or small farm loans within its community, or the purchase of such loans originated in its community;

(j) The bank's participation in governmentally insured, guaranteed, or subsidized loan programs for housing, small businesses, or small farms;

(k) The bank's ability to meet various community credit needs based on its financial condition and size, and legal impediments, local economic conditions, and other factors; and

(l) Other factors that, in the Comptroller's judgment reasonably bear upon the extent to which a national bank is helping to meet the credit needs of its entire community.

Assessing the Record of Performance, 12 C.F.R. § 25.7 (1992); see Uniform Interagency Community Reinvestment Act Guidelines for Disclosure of Written Evaluations and Revisions to Assessment Rating System, 54 Fed. Reg. 52,914, 52,916 (1989).

¹²⁴ *Id.*

¹²⁵ *Id.*

capabilities.”¹²⁶ For “needs to improve,” we learn the following: “An institution in this group needs to improve its overall record of ascertaining and helping to meet the credit needs of its entire delineated community, including low- and moderate-income neighborhoods in a manner consistent with its resources and capabilities.”¹²⁷ And, to make matters perfectly clear, the category of “substantial noncompliance” is defined as follows: “An institution in this group has a substantially deficient record of ascertaining and helping to meet the credit needs of its entire delineated community, including low- and moderate-income neighborhoods, in a manner consistent with its resources and capabilities.”¹²⁸

Moreover, these ratings, although nominally uniform across agencies, may assume different interpretations depending on the rater. CRA performance is often a function of the regulator preparing the report, or even of the particular office within the regulatory agency that has primary responsibility for the examination.¹²⁹

Bankers have tended to view the CRA ratings as subjective and unsatisfactory. A recent survey of commercial bankers found a pattern of “anxiety, frustration, and uncertainty” in response to the problems of complying with the CRA.¹³⁰ Sixty-six percent of the respondents considered disclosure of CRA ratings to be potentially misleading due to the subjective nature of the evaluations, whereas only thirty-one percent detected a consensus among regulators as to how CRA activity should be measured and rated.¹³¹ In the words of one banker, “I just wish [the regulators] would figure out what they want . . . I have provided loan analyses by zip code, census track and county. They are still not satisfied and are requesting another analysis by sub-census track. This is costing a fortune.”¹³²

Even after receiving a favorable rating from the relevant agency, a depository institution has no assurance that it will not face a CRA protest. Activist groups have launched major campaigns against insti-

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ See Warren W. Traiger, *Examining Agencies Need to Fine-Tune CRA Standards*, *Am. Banker*, Oct. 28, 1991, at 8.

¹³⁰ See Foreman & Brunson, *supra* note 119, at 35.

¹³¹ *Id.* at 34.

¹³² *Id.*

tutions that had received "outstanding" or "satisfactory" CRA ratings on recent examinations.¹³³ Significantly, although the regulators could easily adopt a policy of summarily rejecting protests against institutions with high CRA ratings, they have not done so. On the contrary, the agencies specifically warn that, although a favorable CRA examination is an "important, and often controlling" factor, "[i]t is not conclusive evidence . . . in the face of significant and support [sic] allegations from a commenter."¹³⁴

The Federal Reserve Board reinforced this message by denying, on CRA grounds, an application by the \$629 million in assets First Interstate BancSystem of Montana, Inc. to acquire Commerce BancShares of Sheridan, Wyoming.¹³⁵ To all appearances the application should have been routine. The two institutions were already under common ownership, and six of First Interstate's seven subsidiary banks had received "satisfactory" ratings in their most recent CRA examination.¹³⁶ The Fed quashed the deal, however, because Colstrip, a tiny subsidiary bank with twelve million dollars in assets,¹³⁷ had allegedly failed to make loans on the Northern Cheyenne Indian Reservation in Lama Deer, Montana.¹³⁸ Thus, the allegedly deficient CRA performance of a subsidiary bank holding less than two percent of the holding company's assets, and only about one percent of the assets of the proposed postmerger firm, was deemed sufficient to derail a merger in which the remainder of the institutions had demonstrated satisfactory CRA performance.

¹³³ The recent Bank of America/Security Pacific merger is only the most prominent of many such cases. See *infra* text accompanying notes 161-65.

¹³⁴ Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act, *supra* note 82, at 13,745.

¹³⁵ First Interstate BancSystem, Inc., 77 Fed. Res. Bull. 1007, 1007 (1991) (Order Denying Merger of Bank Holding Companies); Dillon, *supra* note 115, at 9.

¹³⁶ Dillon, *supra* note 115, at 9.

¹³⁷ *Id.*

¹³⁸ *First Interstate BancSystem, Inc.*, 77 Fed. Res. Bull. at 1008-09; Dillon, *supra* note 115, at 9. The bank responded by pledging to make \$4 million in loans to reservation residents, installing an automated teller machine on the reservation, placing a tribal member on its board of directors, and hiring a reservation resident as a management trainee. See Bill Atkinson, *Montana Bank Gets Merger Nod After Lending More to Indians*, *Am. Banker*, Nov. 3, 1992, at 5.

C. Compliance as Public Relations

The agencies charged with CRA enforcement have adopted external criteria for evaluating compliance with the statute. As a practical matter, this may be the best that the regulators can do to complete their difficult mission of evaluating an institution's essentially subjective efforts to serve local communities. This reliance on external indicia of CRA compliance, however, generates pressures for depository institutions to make a showing of compliance that may, in fact, be mostly window-dressing. As a result, CRA compliance strategy is often largely public relations.

To guard against negative CRA ratings, depository institutions are well-advised to engage in elaborate "papering" of their CRA activities.¹³⁹ What matters is not so much whether the depository institution has taken actual steps to serve the credit needs of its local community, as whether it has prepared a written file that can be handed over to the examiners for their review. The better the documentation, the more likely the institution will receive a good CRA rating.¹⁴⁰ CRA evaluations are performed by professional bank examiners who, consistent with the traditions of their profession, want to see written records, thereby conforming to the bank examiner adage: "[I]f it is not documented, it does not exist."¹⁴¹ The banking agencies are explicit in their demands for documentation: They warn that "[a] poorly documented record [sic] may prolong the application process in order for the reviewing Agency to collect the information needed for its decision."¹⁴²

This focus on documentation, although understandable from the perspective of bureaucratic procedures, does not guarantee that an institution will take concrete, effective steps to change its actual practices. A recent study by the Community Reinvestment Institute—an organization devoted to community reinvestment causes—reviewed home lending records for seventy banks and thrifts in California and Massachusetts with public CRA ratings and concluded that docu-

¹³⁹ See Sam Zuckerman, Documenting Strong Program Is Key to Getting Top Rating, *Am. Banker*, Nov. 5, 1990, at 6.

¹⁴⁰ See *id.*

¹⁴¹ Francis X. Grady, CRA Success Starts with a Plan, *Am. Banker*, July 30, 1991, at 4.

¹⁴² Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act, *supra* note 82, at 13,746.

mentation, not actual performance, was the determinative factor for most CRA ratings.¹⁴³

In furtherance of a program of CRA compliance through public relations, experts advise that the depository institution's board of directors appoint a committee of the board charged with CRA evaluation, which should meet at least quarterly and keep detailed minutes of its proceedings that can be heralded during the show-and-tell of the CRA examination.¹⁴⁴ It is also advisable, according to public relations experts specializing in CRA compliance, for the depository institution to "interact" with local community groups and leaders by dispatching its officers on courtesy calls.¹⁴⁵ Town meetings are recommended.¹⁴⁶ Institutions can earn additional CRA points by distributing customer satisfaction surveys and conducting special market studies.¹⁴⁷ The institution should engage in vigorous marketing and advertising campaigns to identify itself to members of the local community.¹⁴⁸ All of this sound and fury must, of course, be elaborately documented in the bank's files.

These activities, which probably have little value in actually supplying credit to local communities, would not be especially problematic if they were not expensive. But devoting staff and resources to CRA compliance rituals is not cheap. J.P. Morgan, for example, was encouraged by its regulators to advertise the fact that it was in good compliance with the CRA—and thus spent fifty thousand dollars a year on this form of needless self-promotion.¹⁴⁹

The public relations strategies utilized by banking institutions to satisfy their regulators as to their CRA compliance have become highly sophisticated, at least for larger institutions. Recently, depository institutions have utilized the strategy of the dramatic announcement of planned loans, designed to garner maximum media attention and favorable public relations. After NCNB Corp. and C&S/Sovran Corp., two major southern bank holding companies, agreed to merge

¹⁴³ Linda Corman, Study Finds Documentation Biggest Factor in CRA Rating, *Am. Banker*, June 3, 1991, at 7.

¹⁴⁴ See, e.g., Grady, *supra* note 141, at 4.

¹⁴⁵ See, e.g., *id.*

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ Bill Atkinson, Complying with Regulations: A Costly and Growing Burden, *Am. Banker*, June 24, 1991, at 1, 10.

in 1991, they jointly pledged, with considerable fanfare, to extend ten billion dollars in "community development" loans over a ten year period.¹⁵⁰ The pledge came after political activists announced their intention to file CRA challenges to the proposed combination.¹⁵¹ BankAmerica Corp. topped this with a twelve billion dollars pledge over ten years during the course of its lobbying to obtain approval of its proposed merger with Security Pacific Corp.¹⁵² Barnett Banks, Inc. pledged in June, 1991 to lend more than two billion dollars to low-income and moderate-income families over five years, a smaller program than some of the others but a larger one relative to the size of the institution.¹⁵³

Dramatic pledges of this type often appear, on analysis, to be mostly hype. The ten billion dollar pledge by NCNB and C&S/Sovran, for example, was not backed by any binding commitments, nor did it actually represent a major expansion of community lending by the institutions, which together had extended between six hundred and eight hundred million dollars a year in CRA lending even before the announcement.¹⁵⁴ When anticipated growth and inflation is counted into the picture, a ten billion dollar loan commitment over a ten year period does not constitute a major change in corporate policy. Many observers view these CRA pledges with skepticism. Ronald Zimmerman, a Vice President at the Federal Reserve Bank of Atlanta, remarked that "[w]e look at them more as publicity, in many cases. . . . We recognize that a lot of what [they] say they're going to do, they're already doing. I guess they're hoping to avoid protests that way."¹⁵⁵

Why do banking institutions engage in these high-profile media blitzes, especially when their commitments are viewed by many, including regulators, as signifying little? A principal advantage of vague, general pledges to extend credit in the future is that they circumvent the problem of obtaining the support of many different pressure groups, each of which desires support for its own pet projects and

¹⁵⁰ Ellen Braitman & Yvette Kantrow, NCNB and C&S Make \$10 Billion CRA Pledge, *Am. Banker*, Aug. 7, 1991, at 1.

¹⁵¹ See *id.* at 1, 6.

¹⁵² Kenneth Cline, Doubts Voiced on Deal-Related Loan Pledges, *Am. Banker*, July 7, 1992, at 6.

¹⁵³ *Id.*

¹⁵⁴ Braitman & Kantrow, *supra* note 150, at 6.

¹⁵⁵ Cline, *supra* note 152, at 6.

activities. In the early days of the CRA, a depository institution wishing to consummate a transaction could neutralize a CRA protest with a suitably generous commitment to a particular protesting group.¹⁵⁶ That strategy no longer works in many cases, especially for large mergers that are likely to attract the attention of many interest groups with competing goals. The transaction costs of settling with these diverse groups become prohibitive.¹⁵⁷ Promising large amounts of money in the future tends to overcome these transaction costs while neutralizing opposition from individual groups, because no one group can know in advance how much it will obtain. As one housing activist in Atlanta remarked after learning of the NCNB-C&S/Sovran pledge, "My first response is to be optimistic [but] I'm not sure what the ten billion dollar amount is for and what will be used in our area."¹⁵⁸

In addition to overcoming the problem of negotiating with multiple protestants, the long-term pledge carries the additional advantage, from the point of view of the depository institution, of effectively preapproving the institution's subsequent activities so long as the institution meets the targets set in its initial announcement. As long as the institution meets or exceeds the terms of its pledge, it will be hard for groups that applauded the pledge at the time it was made to complain effectively about the institution's CRA performance in the future.

VI. THE INFLUENCE OF ACTIVIST GROUPS

A principal effect of the CRA has been to enhance the power of activist groups dedicated to various causes related to community development.¹⁵⁹ Many of these groups have become adept at using the CRA as a vehicle for extracting payments from depository institutions, either for their own maintenance and welfare or for their favored causes. The CRA works well for these purposes because it allows groups to bring pressure against depository institutions at a

¹⁵⁶ See Cohen, *supra* note 111, at 81.

¹⁵⁷ See *id.* ("[T]he proliferation of protests and protestants is increasingly giving rise to the situation where various commitments by the applicant will resolve some but not all of the protests.").

¹⁵⁸ See Braitman & Kantrow, *supra* note 150, at 6.

¹⁵⁹ Peter D. Schellie, *Current Developments with the Community Reinvestment Act*, 42 *Bus. Law.* 943, 946-48 (1987).

point of maximum vulnerability—when the institution has applied for permission to consummate a transaction and stands to lose both the costs of negotiating the transaction and the expected profits from the deal if the application is not approved. To avoid these losses, institutions are usually willing to remit some of their wealth to the community groups that mount the most vociferous challenges to the applicant's performance.

There appears to be little relationship between an institution's actual CRA performance and the attitude of some pressure groups. Institutions have received one of the two highest CRA ratings only to be hit with a challenge by activist groups when they subsequently applied for a depository facility. One notorious case is that of Manufacturers Hanover Trust Co. of New York. In March, 1991, Manufacturers announced that it had received a CRA rating of "outstanding" from its regulators. Less than three weeks later, Manufacturers learned that its attempt to acquire thirteen branch offices of another bank had been met by community activists who sought to block the acquisition on the ground that the bank had failed to live up to its community reinvestment responsibilities.¹⁶⁰

Consider also BankAmerica Corp.'s proposal to acquire Security Pacific Corp.¹⁶¹ All of BankAmerica's subsidiary banks had received at least a "satisfactory" CRA rating from their primary regulators, and Bank of America, which accounted for eighty-six percent of the holding company's consolidated assets, had received an "outstanding" performance rating.¹⁶² All of Security Pacific's subsidiary banks had also received "satisfactory" CRA ratings. Twenty-two subsidiary banks were involved in the merger, all of which had received CRA ratings of "satisfactory" or better from their primary regulator in the most recent examination.¹⁶³ One might think, given this record, that approval of the merger under the CRA would be a foregone conclusion. It was not. Community groups charged that the firms had failed their local communities. They claimed that the subsidiary banks had engaged in racial discrimination in advancing home mortgage

¹⁶⁰ Linda Corman, CRA Challenges Jolt Top-Rated Institutions, *Am. Banker*, Mar. 28, 1991, at 1, 8.

¹⁶¹ BankAmerica Corp., 78 Fed. Res. Bull. 338, 338 (1992).

¹⁶² *Id.* at 347.

¹⁶³ *Id.*

loans,¹⁶⁴ even though the CRA compliance examinations had found no evidence of discrimination or other illegal credit practices of any subsidiary bank of either holding company.¹⁶⁵ Although the Federal Reserve Board ultimately approved the merger, the protests and attendant unfavorable publicity were a costly distraction for this enormous transaction.

Given the threat posed by activist groups, an institution faced with a CRA challenge is often well-advised to placate the protestant by funding its pet project rather than by adopting a more even-handed approach that would promote community development generally. The federal regulators encourage this form of settlement of CRA protests, even though it may result in the funding of some projects over others without regard to their worthiness. The agencies strongly encourage "private meetings between an applicant and a protestant" in order to "resolve differences based on misunderstandings between the parties."¹⁶⁶ Although the agencies "do not . . . enforce" these settlements,¹⁶⁷ it is difficult to see why negotiations behind the scenes would be encouraged if it were not for the purpose of encouraging, and implicitly agreeing to respect, the outcomes of such deals.

These dynamics make it prudent for financial institutions that anticipate making applications for depository facilities in the future to cultivate community activists in advance of any concrete proposals. Providing support and assistance to the most effective local pressure groups and community activists is often the best way to purchase what amounts to an insurance policy against the threat of a CRA challenge by these organizations in the future. Supporting such organizations earns CRA credits with examiners to boot.

As might be expected, local community groups that benefit from a depository institution's largesse sometimes appear less likely to protest when the institution submits an application for a depository facility. When Ameritrust Corp. submitted an application to relocate two branches in Cleveland, eleven pressure groups lodged protests against the application, claiming that the bank had engaged in redlining and that the branch relocations would reduce banking services to minority

¹⁶⁴ *Id.* at 355-56.

¹⁶⁵ *Id.* at 356.

¹⁶⁶ Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act, *supra* note 82, at 13,746.

¹⁶⁷ *Id.*

communities.¹⁶⁸ Marica Nolan, the Executive Director of Neighborhood Housing Services of Cleveland, an organization that had received financial support from the bank for several years, however, did not join the protest and, indeed, expressed public surprise at the charges, praising the bank as an "active player in our community."¹⁶⁹

When Chemical Bank and Manufacturers Hanover sought approval for the largest merger in U.S. banking history, a number of community groups objected to the allegedly unfair lending practices of the applicant institutions. Conspicuously absent from the protestors, and in fact taking the uncharacteristic role of supporting the merger and praising certain aspects of the banks' community investment records, was the well-known Association of Community Organizations for Reform Now—usually referred to under the acronym ACORN—which has been among the most vocal and effective CRA interest groups in other cases.¹⁷⁰ Chemical had previously entered into a "partnership" with ACORN and other community groups "to provide credit counseling services to loan applicants who have poor credit histories, excessive debt or need assistance to qualify for a mortgage loan."¹⁷¹

When the Federal Reserve rejected, largely on CRA grounds, the application by holding companies of Continental Bank to acquire a small bank in Arizona, Gale Cincotta, one of the leaders in the initial campaign for the CRA, objected to the decision and defended Continental's CRA record.¹⁷² Cincotta's group, the National Training and Information Center, had recently received a twenty million dollar loan from Continental.¹⁷³

Groups such as Neighborhood Legal Services, ACORN, and the National Training and Information Center are well-respected and reputable organizations. Not all community activists are so upstand-

¹⁶⁸ See Ellen Braitman, *supra* note 83, *Am. Banker*, at 1, 5.

¹⁶⁹ *Id.* at 5.

¹⁷⁰ See, e.g., Claudia Cummins, *Protesters Say Columbia First Shortchanges Its Community*, *Am. Banker*, July 10, 1992, at 13; Kelley Holland, *ACORN Drops In*, *Am. Banker*, July 15, 1992, at 2; Barbara A. Rehm, *Activists Warn Banks that Campaign to Ease CRA Rules Might Backfire*, *Am. Banker*, June 29, 1992, at 1.

¹⁷¹ See Philip C. Meyer, *CRA, Not Antitrust, Is Key Regulatory Factor in Initial Megamergers*, *Banking Pol'y Rep.*, Jan. 6, 1992, at 1, 16.

¹⁷² See Lisabeth Weiner, *Community Groups Defend Continental*, *Am. Banker*, Feb. 21, 1989, at 1.

¹⁷³ See *id.* at 22.

ing, however. Political and community leaders in low-income and moderate-income areas often engage in their own business enterprises or maintain contacts with local entrepreneurs. It would hardly be surprising if some of these community leaders attempted to use their power under the CRA as a lever to obtain favorable treatment from a depository institution. When a local community activist calls on a bank lending officer to seek a below-market loan, or to vouch for the credit of an associate who is seeking such a loan, the bank might consider the application long and hard before rejecting it even if the loan would not meet normal underwriting criteria. The CRA provides a fertile potential breeding ground for such improper influence, although for obvious reasons it is difficult to document the actual incidence of such contacts.¹⁷⁴

VII. EVOLUTION OF THE ACT INTO A MEASURE SERVING SPECIAL INTEREST AGENDAS

As discussed above, the CRA was enacted as a means for ensuring reinvestment in the entire community.¹⁷⁵ Nevertheless, the CRA has evolved from a statute designed to encourage depository institution involvement in local communities into one designed to serve organized interest groups. Banking regulators, for their own political reasons, have readily acquiesced. Depository institutions that make special efforts to target particular ethnic communities are given points in CRA evaluations.¹⁷⁶ BankAmerica's successful campaign to win CRA approval for its Security Pacific takeover is a case in point: Among other factors, the applicant earned CRA credit for launching advertising campaigns specifically targeting Hispanic, Black, and Asian communities.¹⁷⁷ Loans to minority-owned businesses receive CRA points, despite the fact that the CRA says nothing about minorities and cannot easily be construed as mandating affirmative action in

¹⁷⁴ We have been informed off the record by several bankers that this kind of contact does indeed occur, although its extent is unknown.

¹⁷⁵ See *supra* notes 21-24 and accompanying text.

¹⁷⁶ See *First Union Commits \$1 Million to CRA*, ABA Banking J., Oct. 1991, at 9 (reporting that First Union Corp., as part of its CRA compliance program, had set up a program for loans, at the prime rate or below, designed specifically for women and minority business owners).

¹⁷⁷ *BankAmerica Corp.*, 78 Fed. Res. Bull. 338, 349 (1992).

lending.¹⁷⁸ Affirmative action on the basis of gender also wins CRA points with bank regulators. The Federal Reserve Board warmly praised the Bank of America for participating in a program intended to increase the supply of credit to women-owned businesses.¹⁷⁹

CRA points can also be earned by engaging in philanthropy¹⁸⁰—especially philanthropy meeting certain “politically correct” criteria, such as gifts to institutions promoting minority cultures, the condition of the homeless, or affordable housing for the poor. Even though the CRA says nothing about charity, and, indeed, by encouraging the extension of “credit” to local communities might well be seen as not extending to eleemosynary activities, bank contributions to community groups translate into CRA points with regulators. In 1992, for example, Wells Fargo & Co. donated a landmark Victorian house in downtown Sacramento, valued at one million dollars, to the La Raza/Galeria Posada, a group promoting Chicano art.¹⁸¹ An explicit purpose for the gift was to earn CRA points with the regulators.¹⁸² The gift may have been made in the finest spirit of charity, and there was nothing objectionable about the recipients of the bank’s bounty. The point, however, is that the CRA was never intended to induce banks

¹⁷⁸ The 1989 amendments to the CRA contain no explicit mention of an antidiscrimination norm, but the legislative history indicates that at least some of the members who voted on the measure, including its principal sponsor, Congressman Joe Kennedy of Massachusetts, were concerned about recent reports indicating that racial discrimination in mortgage lending was pervasive in some parts of the country. See, e.g., 135 Cong. Rec. H2753 (daily ed. June 15, 1989) (remarks of Rep. Kennedy). The amendments, however, did not deal with racial discrimination but rather required disclosure of CRA ratings—an important change, to be sure, but not one reflecting any explicit nondiscrimination norm.

The 1991 amendments added a new section awarding CRA credit to depository institutions that donate, sell on favorable terms, or make available on a rent-free basis a branch located in a minority neighborhood, but only if the recipient of the institution’s largesse is a minority depository institution or a women’s depository institution. 12 U.S.C. § 2907. Defined as “minorities” are Black-Americans, Native-Americans, Hispanic-Americans, and Asian-Americans. *Id.* § 2907(b)(3) (The 1991 amendments adopt by reference the definition of “minority” provided in Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 1204(c)(3), 103 Stat. 183, 520-21.). Thus, the statute arguably encourages affirmative action in favor of women and minorities in the award of “exit fees” that a depository institution might be required to pay in order to get out of an unprofitable branch in a decaying neighborhood.

¹⁷⁹ *BankAmerica Corp.*, 78 Fed. Res. Bull. at 349.

¹⁸⁰ See Grady, *supra* note 141, at 4.

¹⁸¹ See Teresa Carson, *Wells Takes the Cultural Route*, *Am. Banker*, Jan. 13, 1992, at 10.

¹⁸² See *id.*

to make charitable contributions that they would not otherwise have made.

Others have attempted to turn the CRA to their advantage by directing it at objects that it was not intended to serve. The NAACP for instance, has threatened CRA challenges to institutions that do not hire more African-American employees.¹⁸³ These threats are not idle. In one case in 1990, the NAACP filed a CRA challenge to the application of Southern National Corp., of Lumberton, North Carolina, to acquire NBSC Corp. of Sumter, South Carolina. The applicant responded by entering an agreement to increase its African-American work force in order to satisfy specified numerical quotas, at which point the NAACP dropped its CRA challenge.¹⁸⁴ The President of the NAACP's South Carolina State Conference remarked that it was "highly unlikely" that the applicant would have agreed to the hiring quotas had it not faced the CRA challenge.¹⁸⁵

To take another example, the Amalgamated Clothing and Textile Workers Union has actively utilized CRA protests as a means for serving the interests of the union, which may have had little to do with community reinvestment.¹⁸⁶ It has been speculated, for example, that Amalgamated's decision to protest Continental's acquisition of a small Arizona bank was in retaliation against Continental for funding the takeover of a North Carolina textile company that resulted in a loss of union jobs.¹⁸⁷

The transforming of the CRA into a mechanism for providing special benefits for defined ethnic, gender, or other groups is problematic for a number of reasons. It is not consistent with the language or

¹⁸³ Kenneth Cline, NAACP to Push for Hiring of More Blacks, *Am. Banker*, Dec. 10, 1990, at 1. This despite *National City Corp.*, 67 Fed. Res. Bull. 52, 56 n.15 (1981) (Order Approving Acquisition of Bank) (stating that the Federal Reserve Board considers employment practices to be outside scope of CRA).

¹⁸⁴ See Cline, *supra* note 183, at 6.

¹⁸⁵ *Id.*

¹⁸⁶ See Jeffrey Marshall, Amalgamated Bloodies Irksome Banks, *U.S. Banker*, Oct. 1991, at 14.

¹⁸⁷ *Id.* at 16 (citing an unidentified source "close to Continental"). In early 1989, the Federal Reserve Board agreed with Amalgamated that Continental's reinvestment record was deficient under the CRA and denied approval of the Arizona merger. *Id.* In another such action, in late 1990 Amalgamated filed a CRA protest over Norwest Corp.'s proposed acquisition of First National Bank of Anoka, a \$250-million-asset Minnesota bank. This protest was allegedly motivated by Norwest's refusal to recommit a loan to a children's clothing manufacturer with 4000 union employees. *Id.* at 19. The Fed approved the deal. *Id.*

legislative history of the statute. Quite apart from whether it is desirable, as a matter of policy, for private institutions to engage in charitable giving, affirmative action in credit allocation, or granting favors to special interest groups, it seems problematic under the system of separation of powers for banking agencies to exercise a form of *cy pres* power to reform a statute in order to serve other goals.¹⁸⁸

VIII. IMPACT ON LOW-INCOME COMMUNITIES

Perhaps the most problematic feature of the CRA is its impact on the communities it was principally designed to serve—low-income, deteriorating urban communities. As noted above,¹⁸⁹ it requires little imagination to see that a depository institution not presently serving such a community would be cautious about entering that market, even if it believed that there might be opportunities for profit in performing depository services there. Serving such communities means including the area in the institution's community, and therefore being subject to the CRA's requirement of making loans within the neighborhood that might be significantly more extensive than the institution would want to make as a matter of its own business judgment. As a result, the CRA probably harms the very areas that it was ostensibly designed to serve by actually reducing the amount of credit that would be available in those areas as compared with what would be the situation in the absence of the CRA.¹⁹⁰

The CRA poses a distinct risk to local communities in another respect as well. By threatening depository institutions with severe penalties if they do not advance credit to meet the needs of African-Americans and other minorities, the CRA has greatly increased the competitive pressures facing minority-owned institutions that have

¹⁸⁸ This is not to suggest that racial discrimination in credit allocation is not a problem requiring careful attention from policymakers and government officials. Preliminary studies indicate that mortgage denials are significantly higher for African-Americans and Hispanics than for whites at similar income levels. See Glenn B. Canner & Dolores S. Smith, Home Mortgage Disclosure Act: Expanded Data on Residential Lending, 77 Fed. Res. Bull. 859, 868 (1991). More recent data continue to show a higher rate of mortgage denials for African-American and Hispanic applicants than for white applicants. See, e.g., Claudia Cummins, Fed Reports Little Change In Loan Bias, Am. Banker, Oct. 28, 1992, at 1, 14.

¹⁸⁹ See *supra* notes 80-81 and accompanying text.

¹⁹⁰ See Ray G. Huffaker, Market-Based Policies to Increase Home Mortgage Credit in Declining Urban Neighborhoods, 106 Banking L.J. 538, 541-46 (1989).

traditionally served this market segment.¹⁹¹ Minority-owned institutions feeling this competitive pressure have charged that their competitors are making below-market loans in their core communities.¹⁹² They have responded by lobbying for changes to the CRA that would allow a depository institution to earn CRA points by investing in a minority-owned bank, or in a loan participation arranged by such a bank, rather than by direct investment in local communities.¹⁹³ This legislation was not enacted, but in 1991 Congress did encourage depository institutions to subsidize minority and women's banks when closing branches in minority neighborhoods,¹⁹⁴ and in 1992, it amended the CRA further to clarify that regulators may give CRA credit for community lending projects undertaken by nonminority-owned or nonwoman-owned financial institutions in "partnership" with minority-owned or woman-owned institutions if these projects meet the credit needs of the community.¹⁹⁵

IX. THE CRA IN INTEREST GROUP THEORY

The preceding sections have demonstrated what we believe to be convincing reasons to be skeptical about the CRA. Nevertheless, the statute appears to be politically popular. Indeed, Congress has enhanced its effectiveness over the years.¹⁹⁶ If the CRA is such questionable public policy, why does it appear to be so popular?

The answer, we believe, is that the CRA benefits organized political interest groups. Principal beneficiaries are community activists, who enjoy great power at the local level in many jurisdictions and who are also influential in Congress. As we have seen, some activist organizations have utilized the CRA to enhance their own political power, to gain financial support for their favored projects, and to obtain logisti-

¹⁹¹ Minority-owned depository institutions already operate at thinner profit margins than their white-owned peers. The median return on assets for minority firms with between \$50 million dollars and \$300 million dollars in assets was 30 basis points, compared with 80 basis points for white-owned peer institutions, according to one source. Nanine Alexander, *Tough CRA Rules Hurting Minority Banks*, U.S. Banker, Sept. 1991, at 70.

¹⁹² *Id.* (citing statement of Bruce Gamble, executive director of The National Bankers Association, minority bankers industry organization with a membership of 60 banks).

¹⁹³ *Id.* at 71.

¹⁹⁴ 12 U.S.C. § 2907.

¹⁹⁵ Housing and Community Development Act of 1992, Pub. L. No. 102-550, 106 Stat. 3672.

¹⁹⁶ See *supra* notes 27-37 and accompanying text.

cal and other assistance for their activities.¹⁹⁷ The CRA has been a bonanza for activist groups, and although the benefits of the statute are now somewhat dissipated by competition among different groups, it still represents a major source of funding and power that these groups will fight to sustain and enhance.

Small businesses and small farms also profit from the statute. Loans to these groups qualify for CRA credit, and they may perceive that, faced with a choice between gaining CRA credit with a loan to a small business or family farm or a loan to a borrower in a depressed urban neighborhood, a depository institution might opt for the former as representing the safer investment. These groups—especially small businesses—are powerful both at the local and the national political levels.

The other major beneficiaries of the CRA, ironically enough, are the banking agencies themselves. The CRA provides a useful mechanism that regulatory agencies can use to increase their authority over institutions under their jurisdiction. The criteria for evaluating a bank's CRA performance are so vague that an agency can almost always plausibly determine to deny an application for a depository facility on CRA grounds.¹⁹⁸ The chance that a bank could successfully challenge such a denial in court is vanishingly slight, given the wide discretion ordinarily accorded to administrative agencies in the implementation of generalized regulatory mandates. Banks understand this and know that an agency that is dissatisfied with them for any reason can use the CRA to exact retribution. Armed with this weapon, the federal banking agencies can exercise ever-increasing administrative guidance over the banks under their jurisdiction without actually having to cite chapter and verse from the statute books to justify their demands.¹⁹⁹

It is partly in this light that we understand the decision by the Board of Governors, referred to earlier, denying on CRA grounds Continental's application to acquire a small Arizona bank.²⁰⁰ Continental made this application at a time when it was still operating

¹⁹⁷ See *supra* notes 159-74 and accompanying text.

¹⁹⁸ On the vagueness of the criteria, see *supra* notes 123-37 and accompanying text.

¹⁹⁹ See David G. Litt, Jonathan R. Macey, Geoffrey P. Miller & Edward L. Rubin, *Politics, Bureaucracies, and Financial Markets: Bank Entry into Commercial Paper Underwriting in the United States and Japan*, 139 U. Pa. L. Rev. 369, 385-89 (1990).

²⁰⁰ See *supra* note 187 and accompanying text.

under the terms of the government bail-out that followed its failure in 1984.²⁰¹ Its application was not well-received by several Fed Governors, who viewed it as an abuse of the terms of the bail-out program.²⁰² The Board's order itself contained thinly veiled criticisms of Continental; it noted that the application "raises important public policy concerns with regard to the potential for distortion of competition due to continued use of government provided capital in competition with private capital."²⁰³ Reading between the lines, it is plausible to see the Board using its CRA powers in this case as a means of reprimanding Continental for its perceived misbehavior in the use of government-provided funds.²⁰⁴

The CRA is popular among many members of Congress because it represents a means for satisfying the demands of important and organized constituent groups without increasing the budget deficit or establishing new federal agencies. Although CRA enforcement is vested in regulatory agencies, the Act did not establish any new agencies or offices. Moreover, the on-budget costs of CRA are very small, and to the extent they are more than de minimis, they are incorporated into the general agency budgets. This is not to say that the CRA is not funded by a tax—it is—but the tax comes in the form of a regulatory burden placed on banks that is not included (except indirectly) in the federal budget. The costs are hidden from public view.

Although the CRA benefits powerful interests, it does harm depository institutions. The American banking industry, however, was politically prostrate at the time the CRA was equipped with teeth, in the thrift bail-out legislation of 1989. Given the vast sums that were being expended to rescue the thrift industry, it hardly seemed excessive to ask depository institutions to pay a little back in the form of lending to their local communities. If depository institutions were to

²⁰¹ See *Continental Bank Corp.*, 75 Fed. Res. Bull. 304, 306 (1989).

²⁰² See Barbara A. Rehm, *Behind the Scenes: How Angell Blocked Continental Acquisition*, *Am. Banker*, Feb. 23, 1989, at 1, 22.

²⁰³ See *Continental Bank Corp.*, 75 Fed. Res. Bull. at 306.

²⁰⁴ Noteworthy, in this regard, is the fact that the Board rejected the application even though the institution had made significant steps toward "improving" its CRA performance in the future, a fact deemed significant by the two dissenting Governors. See *id.* at 306 (Heller and LaWare, dissenting). In another case, the Board could easily have taken Continental's actions as evidence of substantial improvement and approved the application notwithstanding the deficiency of the bank's prior performance.

accept the subsidy of federal deposit insurance, they could jolly well pay a little back in the form of aid to their local communities.

Thus, the political science of the CRA seems to reduce to this: Supporting the statute is a broad coalition of powerful groups including activist community groups, small businesses, small farms, and the bank regulators themselves; opposing it is only a banking industry that has been relatively politically impotent. Others harmed by the statute—the general public, and, arguably, the residents of the deteriorating urban neighborhoods whom the Act was ostensibly designed to serve—are not politically organized and play no part in the calculus. Given this permutation of forces, the statute appears quite secure, and we see little chance for fundamental reform, although smaller banks might be able to obtain some relief from the most onerous requirements of the law.

X. TOWARD BETTER ALTERNATIVES

As we mentioned at the outset, the CRA addresses problems of enormous importance to American life. Although the CRA itself may be flawed or even counter-productive, there might be alternative mechanisms available to realize some of the statute's admirable goals. In the following pages we discuss a few intriguing suggestions, although we emphasize that none of these ideas is without flaw and that the problems of revitalizing decaying communities are so profound and intractable that no government program may be efficacious at resolving them.

One interesting model of community credit generation draws on a device that has proven successful in the Korean-American community. Korean-Americans have developed a mechanism for raising capital solely within the community, which effectively harnesses the profit motive for the development of productive investments. They operate lending clubs, known as "kehs," into which each member makes a monthly contribution. When the pool gets sufficiently large, the club meets and votes to make a loan to the member with the best business idea.²⁰⁵ Among the advantages of the keh system is that the members of the club are all informed about the qualifications of the applicant, and are positioned to monitor the borrower's performance

²⁰⁵ See Elyssa Getreu, *Taking a Lesson From Korea for Lending in the Inner City*, *Am. Banker*, June 29, 1992, at 7.

on an ongoing basis. The members of the keh possess a variety of nonlegal community sanctions to bring pressure against members who have failed to repay a loan. Thus, even though the keh loans are unsecured, they probably present a low default risk. Further, the keh system enlists the participants' profit motive in order to ensure that the loans are made to the most efficient user of the funds. The keh system, in short, is true, grass-roots community reinvestment, and is accomplished without costly government intervention, regulation, or supervision. A more Americanized variant on the keh system is found in the substantial growth in Asian community banks, which have sprouted up to serve Asian-American populations in a number of cities, and which have prospered by serving this population group.²⁰⁶

At least one banking industry analyst believes that a variant on the keh system might work more generally as a means for improving the supply of credit to inner-city neighborhoods. Michael R. Cunningham, a Washington consultant, envisages a bank offering pooled accounts in which members of inner-city neighborhoods can contribute each month until the pool reaches a sufficient size.²⁰⁷ The bank would then lend money to one of the members, using the pool as collateral for the loan. Because the funds of each member of the pool would stand behind the loan, there would be a good incentive for the members to monitor each other. The bank, meanwhile, would be able to sell the loans in a secondary market if a third party guarantee could be provided.²⁰⁸

Although this idea has appeal, it suffers from the fact that the bank would be the one to make the loan decision. It would appear more sensible for the members of the pool themselves to decide who should receive the loan, given the fact that their money is on the line if the recipient defaults. Further, the members of the pool, rather than the bank, are the ones with the best knowledge of the applicant's reliability. The bank should be placed in the role of administering the loan pool for a fee, rather than making the loan itself. This quibble aside, however, Mr. Cunningham's idea has considerable promise as a

²⁰⁶ See James R. Kraus, *Asian Community Banks Booming in U.S.*, *Am. Banker*, May 11, 1992, at 1.

²⁰⁷ See Getreu, *supra* note 205, at 7.

²⁰⁸ *Id.*

means of promoting savings and economic self-reliance and self-determination in depressed urban areas.

Other programs that deserve serious consideration, and that are already in place in some cities, include credit unions at which persons living in low-income areas pool their funds and determine jointly how to allocate credit. The Lower East Side People's Federal Credit Union, in a depressed neighborhood of New York City, has 2,600 mostly Hispanic, low-income members.²⁰⁹ It makes loans of between one hundred and five thousand dollars to members who would have difficulty obtaining financing elsewhere. This institution is not a precise model for a viable grass-roots economic development program for depressed areas, both because loans are often made for day-to-day living expenses rather than for capital improvement, and because the credit union would not be an economically viable entity without transfer payments from a major commercial bank that withdrew from the neighborhood several years ago.²¹⁰ The basic model of a grass-roots organization in which members of the community pool their savings and make loans to one another remains attractive, however.

Professor Edward Rubin has proposed an interesting version of "lifeline" banking for low-income citizens under which grocery stores and other retailers would be authorized to offer deposit services to customers.²¹¹ This proposal offers a mix of deregulation and increased competition tied to enhanced benefits for low-income consumers, although there appears to be no reason why retailers could not perform payment services for persons of average or even substantial means as well. Although Rubin concludes that lifeline transaction accounts would need to be insured by the federal government,²¹² this does not seem to be an essential part of the proposal; the funds held on account could easily be backed by collateral, and the expansion of federal deposit insurance hardly seems like a sensible idea given the catastrophes that have occurred recently to the existing federal deposit insurance systems. The general idea of authorizing gro-

²⁰⁹ See Bill Atkinson, *Institution Filling a Void on NY's Lower East Side*, *Am. Banker*, Nov. 13, 1990, at 8. The People's Federal Credit Union is one of more than 300 "lower-income" credit unions that serve people in areas in which it has historically been difficult to obtain credit. *Id.*

²¹⁰ *Id.*

²¹¹ Edward L. Rubin, *The Lifeline Banking Controversy: Putting Deregulation to Work for the Low-Income Consumer*, 67 *Ind. L.J.* 213, 234, 247 (1992).

²¹² *Id.* at 235, 247.

cery stores and other retailers to perform payments functions, however, appears to hold promise as a means of bringing basic banking services to low-income consumers through market mechanisms as opposed to unwieldy, expensive, and inefficient government programs.

This is just a sampling of the creative ideas that have been advanced to deal with the problem of providing financial services to areas blighted by urban decay. Although none is a panacea, the problems of the inner cities are not ones for which panaceas are to be expected. If the imagination of policymakers can be directed toward new solutions, and away from costly programs such as the CRA, the result might be the development of innovative, market-driven initiatives that better serve the national welfare as well as the interests of residents of deteriorating urban neighborhoods.

CONCLUSION

In conclusion, we emphasize what we said at the outset: We have no quarrel with, and in fact applaud, the goals of the CRA. The economic revitalization of America's inner cities is in everyone's enlightened interest. Nor do we question the motives or good faith of groups that benefit from the statute. Many socially conscious and altruistic people have utilized the statute to advance what they reasonably believe to be worthwhile causes.

Further, we recognize that the CRA has benefited some people in inner-city neighborhoods, as well as some small businesspeople, small farmers, and the like. Depository institutions, especially the larger institutions that have the most reason to fear CRA challenges, have unquestionably attempted to increase the supply of credit to these and other groups in order to receive CRA credit. And the CRA has no doubt contributed to the empowerment of community groups, as well as to individuals and offices within depository institutions and their federal regulators, which are rightly sensitive to the problems facing low-income communities today.

Our argument against the CRA is not that it has no good effects, but that, on balance, the bad effects outweigh the good. Based on an outdated ideology of community reinvestment, this statute allocates credit inefficiently, impairs the safety and soundness of depository institutions, imposes significant (and steadily increasing) compliance costs, selectively taxes depository institutions over competing firms, and, most tragically, harms the very group—residents of low-income

urban areas—that it was ostensibly designed to serve. Politically popular though it is, the CRA should be comprehensively re-examined by persons who are truly concerned about improving the plight of our nation's inner cities.