Expanding the CRA to All Financial Institutions

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The Community Reinvestment Act (CRA) was enacted in response to the fact that minority and low-income communities were not being fairly and adequately served by banks which have been beneficiaries of the U.S. government's safety net since the Great Depression. The federal government, by expanding its safety net in 2008 to include investment banks, broker-dealers, and other financial institutions, took the steps necessary to stabilize the global financial markets. The central premise of this article is that in return for access to the Federal Reserve's Discount Window, investment banks, broker-dealers,[1] and other financial institutions should be required to comply with an updated CRA. Fair access for all Americans to the full range of financial services is essential to restore our faith in the U.S. financial system and the health of our economy.

When the CRA was enacted in 1977 the fundamental principle of the legislation was that banks should provide loans and services to the communities from which they obtain deposits. Despite great progress, large segments of the United States population continue to be underserved by the financial services industry and do not have access to the full range of products and services. This is illustrated by the subprime mortgage crisis, which has affected people of every ethnicity and income level, but has been particularly damaging in low-income and minority communities.

According to an analysis of loans reported under the Home Mortgage Disclosure Act, African Americans were 2.3 times more likely and Hispanics were twice as likely as whites to get high-cost loans after adjusting for loan amounts and the income of the borrowers. High-cost, subprime mortgages are often characterized as loans made to people with low credit scores, and therefore blemished credit, or little experience with debt. Scant attention has been paid to the concentration of these loans in neighborhoods that are largely African American, Hispanic, or both. This pattern of disparate lending holds true even when comparing white middle-class or upper-income neighborhoods with similar minority communities.[2]

A recent article in *The New York Times* highlighted this phenomenon in an analysis of two neighboring communities in the Detroit metropolitan area:

> One, located in the working-class suburb of Plymouth, is 97 percent white with a median income of $51,000 in 2000. To the east, a census tract in Detroit just inside Eight Mile Road has a very similar median income, $49,000, but the population there is 97 percent black.
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> Last year, about 70 percent of the loans made in the Detroit neighborhood carried a high interest rate — defined as three percentage points more than the yield on a comparable Treasury note — while in Plymouth just 17 percent did.

It is hard to prove why there is such a disparity between economically similar neighborhoods, but as the article suggests, a good place to start is the "history of banks' avoiding minority neighborhoods, the practice known as 'redlining.'"[3]

The Changing Financial Services Business

In 1977, financial services in the United States were delivered very differently. There were geographic limitations on where banks and thrifts could operate. Consistent with the Glass-Stegall Act, there were restrictions on the kinds of business that commercial banks could

1 *Broker-dealers trade securities for their own account and for their customers.*

2 *Braunstein, Saundra F., Director, Division of Consumer and Community Affairs, Testimony before the Committee on Financial Services, U.S. House of Representatives, " The Community Reinvestment Act", February 13, 2008.*

3 *Vikas Bajaj and Ford Fessenden, "What's Behind the Race Gap?" The New York Times, November 4, 2007.*

conduct versus investment banks, broker-dealers, and thrifts. Commercial banks took deposits to make personal and commercial loans. Thrifts took deposits and primarily lent people money to purchase homes. Broker-dealers accepted people's money to buy stocks and bonds. Investment banks accepted investors' money to raise debt and equity for businesses. Financial services were a bricks-and-mortar operation where individuals and businesses visited their local bank to deposit a paycheck, establish a savings account, or get a loan. Individuals also went to their local brokerage to invest and to the local office of the investment bank to raise debt and equity to buy or expand their business. The secondary market was relatively undeveloped. It existed primarily in the mortgage market where Ginnie Mae bought Federal Housing Administration (FHA) and Veterans Administration (VA) insured mortgages, packaged them into pools and sold them to mortgage bond investors. Fannie Mae and Freddie Mac were agencies of the federal government that did the same with conventional first mortgages.

Over the last 30 years, we have seen the expansion, privatization, and subsequent renationalization of Fannie and Freddie and unprecedented consolidation in the financial services industry. The local bank has become a branch of a larger, national bank, and the local banker hardly exists anymore. The distinctions that existed in the types of products and services that the various types of financial institutions can offer have disappeared. The Glass-Steagall Act has been virtually repealed, allowing for the creation of the financial supermarket where one institution can make loans, underwrite debt and equity, and sell stocks and bonds. Technological advances such as direct deposit for payroll and Internet banking have made bricks and mortar less important to large segments of more sophisticated customers. According to a 2004 *Michigan Law Review* article by Michael Barr, banks and thrifts' share of financial assets has declined dramatically since the end of World War II from 60 percent to about 25 percent.[4]

Other developments include the advent of 401(k) accounts, which has allowed more individual investors to be responsible for managing their own retirement accounts. And home loans have become increasingly complex financial instruments that are bought and sold in highly developed secondary markets, severing the connection between lender and borrower.

Access to the Federal Safety Net

During the Great Depression, the federal government responded to the crisis of confidence experienced by depositors with a series of measures including providing insurance for individual accounts with deposits up to $100,000 (now $250,000) and the creation of the Discount Window to provide liquidity to commercial banks. To ensure that federally insured deposits were lent in a prudent manner, commercial banks fell under the regulatory oversight of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) and the Federal Reserve. Today, what has brought many financial institutions to the brink of disaster, was a combination of poor quality loans and insufficient equity capital. The capital markets' increased liquidity and a voracious appetite for return allowed financial institutions to operate with highly leveraged capital structures. When the capital markets broke down, these institutions were forced to hold assets on their balance sheets. They became vulnerable to failure because they did not have the equity to support the assets they were forced to hold.

Bear Stearns, for example, represents a modern day equivalent of a run on a bank. The run was fueled by rumors in the markets that there was a liquidity crisis at Bear Stearns. The rescue of Bear Stearns was the first instance of the Federal Reserve providing access to the Discount Window to a non-commercial bank. JPMorgan Chase's subsequent acquisition of Bear Sterns (facilitated by a federal guaranty), IndyMac's failure and takeover by the FDIC, and Bank of America's acquisition of Merrill Lynch were precipitated by the market's loss of confidence.

In another example, Countrywide was a standalone mortgage bank, which was thinly capitalized and had assets of questionable quality. When faced with mounting losses and limited access to liquidity from the capital markets, Countrywide ran out of cash and was unable to operate independently as a going concern. This led to its sale to Bank of America. To stave off a similar fate, American Express, Goldman Sachs, Morgan

4 *Barr, Michael S. (2004). "Credit Where it Counts: The Community Reinvestment Act and Its Critics" Paper 411, University of Michigan Law Review*

Stanley and GMAC (among others) have all pursued bank holding company status to gain access to the Discount Window and the liquidity safety net it provides.

This phenomenon, where financial institutions of all stripes are looking for government backing, is not uniquely American. At the October, 2008 G8 Conference, European policy makers decided to guaranty the performance of their banks and convinced U.S. policy makers to do the same. These extraordinary actions by the Federal Reserve and by central banks around the world were necessary to prevent the collapse of the global financial system. In other words, the current global financial crisis has precipitated a dramatic expansion of government-backed safety nets.

The Opportunities Created by Extending the CRA to New Financial Institutions

Including investment banks and broker-dealers in the CRA should not be seen as a burden. Rather, these institutions could comply with the act in ways that continue to focus on their core competencies, while simultaneously increasing access to financial expertise and capital for low-income, minority, and underserved communities. This would certainly be in keeping with the amendments made to the CRA in 2005 that expanded its scope to disaster areas and underserved rural areas. In the Detroit neighborhood mentioned earlier, the financial supermarkets could provide multiple choices for people looking for home loans. Investment banks could create funds for and provide direct investment in businesses owned by low-income individuals and minorities or businesses located in low-income and minority communities. Broker-dealers could sell shares in these funds or the actual debt and equity securities issued. Investment banks and broker-dealers could provide training and technical assistance for individuals, entrepreneurs and small businesses. They could locate facilities in underserved areas, or provide sponsorship for charter schools for underserved populations. Causes such as rebuilding New Orleans after Hurricane Katrina and greater homeownership for low- and moderate-income people would be greatly aided by the participation of the investment banking community. The possibilities for new financial products offered to low-income individuals are only limited by the investment banks and broker-dealers' creativity, ingenuity, and entrepreneurial spirit.

It is important to note that most of the loans made by depository institutions examined under the CRA have not been higher-priced loans, and studies show that the CRA has increased the volume of responsible lending to low- and moderate-income households.[5] It is also significant that 50 percent of subprime loans were made by mortgage service companies not subject to comprehensive federal supervision including the CRA and another 30 percent were made by affiliates of banks or thrifts which are not subject to routine supervision or examinations.[6] For those who believe that in exchange for the safety net comes the responsibility to provide fair product and service access consistent with safety and soundness, then compliance with a proven mechanism like the CRA should prevent some of the abuses that we have witnessed in the subprime crisis from reoccurring.

The genius of the CRA is the flexibility it gives banks in how they can comply. In addition, there are meaningful penalties for noncompliance, such as the inability to complete mergers and acquisitions among financial institutions with less than Satisfactory ratings, and that banks' CRA examinations are made public. Given the consolidation in the financial services industry, the penalties for noncompliance with the CRA should be revised. One possibility is charging non-compliant institutions penalty rates on loans from the Discount Window. Another is charging significant fines as a penalty for non-compliant institutions.

Research has shown that the CRA has been successful in its original goal of providing fair access to financial services by expanding access to credit for low-income, moderate-income, and minority households at a reasonable cost. It has offered a better alternative than any other similar legislation or government subsidy, and compares favorably with alternative forms of regulation.[7] In the recent financial crisis, financial institutions covered by the CRA have increased the volume

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5 *Yellen, Janet L. president and CEO, Federal Reserve Bank of San Francisco Opening Remarks to the 2008 National Interagency Community Reinvestment Conference, March 31, 2008. See also, Traiger & Hinckley LLP, The Community Reinvestment Act: A Welcome Anomaly in the Foreclosure Crisis, Indications that the CRA Deterred Irresponsible Lending in the 15 Most Populous U.S. Metropolitan Areas, January 7, 2008.*

6 *Barr , Michael S., testimony before the U.S. House of Representatives Committee on Financial Services, "The Community Reinvestment Act: Thirty Years of Accomplishments, But Challenges Remain," February 13, 2008.*

7 *Barr, "Credit Where It Counts."*

of responsible lending to low- and moderate-income households. Three decades after enactment of the CRA, it remains flexible with respect to compliance. The break down of the capital markets has caused regulated and non-regulated financial institutions to pursue bank holding company status in search of the safety and the liquidity provided by the Discount Window. The decision to expand the Federal Reserve's safety net to include investment banks, broker-dealers, and other financial institutions has preserved the American financial system. With financial institutions like Morgan Stanley and Goldman Sachs pursuing bank holding company status comes the opportunity to make good on the commitment to provide Americans equal access to the full range of financial services that the CRA originally promised. These institutions that use their creativity and intellectual capital to develop the newest, most innovative products for a select few would now, through compliance with the CRA, also be required to develop products and services for the low-income, minority, and underserved markets. Extending the CRA to the same institutions that benefit from the safety net would result in the fair access for all Americans to the full range of financial services that is essential to restoring our faith in the U.S. financial system and the health of our economy. ■

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