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THE COMMUNITY REINVESTMENT ACT: GOOD INTENTIONS HEADED IN THE WRONG DIRECTION

*Lawrence J. White**

I. Introduction

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

Although reality is otherwise, the populist rhetoric and imagery dominate policy. The shackles are widespread: commercial banks' activities in the securities and investment banking area are severely limited by the Glass-Steagall Act;¹ the ability of banks to own and operate businesses beyond a narrow range of financial services is restricted by the Bank Holding Company Acts of 1956 and 1970;² the ability of banks to operate freely on an interstate basis (i.e., to establish full-fledged local branches) is restricted by the McFadden Act of 1927 and the Douglas Amendment to the Bank Holding Company Act of 1956;³ some states still place limitations on the ability of banks to branch within their states; and many states impose limitations on the fees that banks can charge for various services.

The major vehicle for extracting tribute is the Community Reinvestment Act of 1977⁴ ("CRA" or "the Act"). The Act places an obligation on commercial banks and on savings and loan associations ("S&Ls") and savings banks (S&Ls and savings banks are frequently described as "thrifts") to "meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions." The Act offers no greater precision for these phrases, and the task of fleshing them out and enforcing them has been left to the bank and thrift regulatory agencies. The

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1. The Glass-Steagall Act is the popular name for sections 16, 20, 21, and 32 of the Banking Act of 1933, 12 U.S.C. § 24 (1988).

2. 12 U.S.C. §§ 1841, 1843, 1849 (1988); 31 U.S.C. §§ 5111-5112 (1988).

3. 12 U.S.C. § 36 (1988); 12 U.S.C. § 1842(d) (1988).

4. 12 U.S.C. §§ 2901-2907 (1988 & Supp. III 1991).

vagueness of the term "credit needs" easily lends itself to an open-ended "wish list" approach by community organizations that lobby regulators. Richard Marsico's accompanying Article in this journal⁵ exemplifies this "wish list" approach.

The CRA approach is fundamentally flawed; it rests on a rapidly crumbling foundation. In essence, either it is redundant, because serving the local community is profitable anyway; or it requires cross-subsidy, with above-normal profits from other services subsidizing the losses from the unprofitable service to the local community. In this latter case, the fresh winds of financial services competition are increasingly erasing any above-normal profits that might be earned on other services. Consequently, the basis for the cross-subsidy is rapidly disappearing, and banks will either shirk their CRA obligations or will incur overall losses — a result that conflicts with the CRA language, "consistent with the safe and sound operation of such institutions." Further, in the long run, the CRA obligations will cause banks to try to exit unprofitable communities completely, rather than to remain and offer a limited range of potentially profitable services; and banks will tend to avoid entering any such communities. Finally, in a world of increasingly global markets for financial services, the CRA's emphasis on localism is anachronistic and ultimately self-defeating for the reasons just stated.

A major theme will pervade this Essay: the rising pressures of competition in financial services. This increased competition is surely beneficial for consumers generally and for the health of the U.S. economy. It provides a widening array of financial services at lower costs and higher yields. But this increased competition also severely undermines regulatory efforts, such as the CRA, that try to channel banks' activities in specific directions or areas. Because these competitive pressures will not disappear and are likely to continue to grow stronger, sound public policy should recognize the limitations that they impose on such regulatory efforts. More suitable alternatives should be devised for achieving the goals that motivate the CRA. Indeed, the reduction of the remaining regulatory barriers to greater financial services competition should be part of a new approach.

The remainder of this Essay will expand on these ideas. Part II

5. Richard Marsico, *A Guide to Enforcing the Community Reinvestment Act*, 20 FORDHAM URB. L.J. 165 (1993); see also Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement is Needed*, 20 FORDHAM URB. L.J. 293 (1993); Wendy Pelle, *Housing Activist Groups Continuing to Push CRA*, NAT'L MORTGAGE NEWS, Nov. 30, 1992, at 15; Ted Cornwell, *Housing Activist Groups Continuing to Push CRA But CRA Is 'Not Enough'*, NAT'L MORTGAGE NEWS, Nov. 30, 1992, at 15.

provides the main argument that the CRA is ill-advised. Part III asks why the political system remains so attached to the “shackle them and exact tribute from them” approach to banks. And Part IV offers a conclusion, including some sensible alternatives to the CRA.

II. The Basic Argument: The CRA is Ill-Advised

In the 1970s banks in some communities were perceived to be reluctant to provide loans or other financial services to specific neighborhoods or areas — almost always low-income central city neighborhoods, with a high proportion of black or other minority residents and low or declining property values. Bank managers were said to have literally or figuratively drawn red lines on maps around neighborhoods in which they would not lend.⁶ It was this perception that led to the enactment in 1977 of the CRA, which obligated banks to meet the credit needs of their communities.

It is clear that for most banks in most communities the CRA is redundant. They serve their communities well, or at least adequately, as is evidenced by a relative absence of CRA complaints from the affected communities. They do so because they find this service profitable. But the CRA still means extra costly paperwork for banks. Additionally, bank executives must always operate in fear that some organization or group of customers will claim that their “needs” are not being adequately met. Community groups’ notions of “needs” can become quite elastic, with little acknowledgement of the roles of prices and costs; again, Professor Marsico’s Article provides a good example of this elasticity.

Still, it is communities that claim that they are not being adequately served — that they are being redlined — where the CRA is supposed to have its impact. An immediate question then arises: Why are banks not providing the desired services to these communities?

There are a number of possible answers. First, banks may be practicing conscious or unconscious discrimination against one or more minority groups that are heavily represented among the residents of the community and whose members would in fact be profitable customers.⁷ If this is so, the problem is one of racial or ethnic discrimi-

6. A number of studies making these claims are summarized in GEORGE J. BENSTON ET AL., *AN EMPIRICAL STUDY OF MORTGAGE REDLINING* (1978).

7. Discrimination against minority groups in home mortgage lending has become an issue of great concern in the early 1990s. A recent, careful study by the Federal Reserve Bank of Boston shows that, even after the important credit characteristics of loan applicants are taken into account, lenders’ rejection rates for black and Hispanic loan applicants are significantly higher than for white applicants. See Alicia H. Munnell et al.,

nation, and it is best solved directly through more vigorous enforcement of anti-discrimination laws.

Second, banks may simply be neglecting profitable opportunities — perhaps because of ignorance, carelessness, or laziness. If this were true, then CRA might be giving banks a push in the direction that their self-interest should be taking them anyway. Perhaps in 1977, when banks enjoyed more legal and economic protection from competitors, bank managers were more prone to a quiet life and to forgoing profitable opportunities. This relaxed style of banking seems much less likely to occur in the more competitive 1990s. In any event, the real solution to this phenomenon (if it is important) is a set of policies to encourage *more* competition in financial services — not the shackling and extracting policies, of which the CRA is a prominent part, that can ultimately reduce competition.

Third, banks located in a community that they perceive to be in decline may be reluctant to make mortgage loans to homebuyers or commercial loans to businesses in that community, for fear that borrowers will not be able to repay their loans fully and that the bank consequently will suffer losses. However, there may be an externality or spillover effect at work here. In an urban area, the decline or lack of upkeep of one property (e.g., a home, an apartment building, or a commercial facility) can have negative effects on the values of neighboring properties; conversely, an improvement in one property can benefit the others. But individual parties who focus on their private benefit-cost calculations will tend to ignore such spillover effects on others. Accordingly, owners may neglect maintenance or upkeep of properties based on their private benefit-cost calculations, even though the aggregate *community* benefits of their actions could exceed those private costs.

This proposition applies not only to the owners of properties but also to lenders on those properties: each bank's decision concerning the making of a loan on a property (e.g., to finance improvements) will be based on its private calculation as to the likelihood that the loan will be repaid and will ignore the effects on neighboring properties. Consequently, each bank's reluctance to lend to individual parties in a community that it perceives to be in decline will reinforce other banks' reluctance to lend and thus will increase the probability that the community will indeed decline.⁸

Mortgage Lending in Boston: Interpreting HMDA Data, Working Paper No. 92-7, Federal Reserve Bank of Boston (Oct. 1992).

8. This point is addressed in JACK M. GUTTENTAG AND SUSAN M. WACHTER, REDLINING AND PUBLIC POLICY (1980), and in Michael Lamb, *The Deregulation of*

If, instead, the banks could coordinate their lending decisions, they might find that their joint lending could arrest the community's decline and make their loans jointly profitable;⁹ in essence, each bank would benefit from the lending decisions of the other banks. The necessary vehicle here is a coordinating agency — either governmental or private — that can reassure each bank that the other banks are part of the community lending program. Without this coordinating agency the CRA is unlikely to be sufficient; and with this agency the CRA is largely unnecessary.

Fourth, banks may simply find the service to be unprofitable¹⁰ because its costs and/or risks are too high. In such cases (in the absence of the three phenomena mentioned above) banks cannot meet their CRA obligations to provide such services unless they are able to earn above-normal profits on their operations elsewhere, thereby making up for the losses in the CRA-induced area. In essence, banks must be able to cross-subsidize internally the CRA-induced services; otherwise the banks will incur overall losses or earn inadequate profits.

In this respect it is important to note that, so long as the CRA-induced services are otherwise unprofitable, banks will always want to shirk their CRA obligations. Even if excess profits elsewhere were available for internal cross-subsidy, banks would be better off if they did not incur the losses on the CRA-induced services.

Even more important, in the increasingly competitive financial services world of the 1990s, the areas in which banks can hope to earn above-normal profits are rapidly disappearing. Changes in state and federal laws are reducing the protections against competition among themselves that banks used to enjoy. Further, rapid improvements in the basic technologies of financial services — data processing and telecommunications — have allowed banks to extend the geographic and product scope of their services, again increasing competition among themselves. These same improvements have allowed non-banks to develop loan and investment products that compete with banks' core loan and deposit services. Consequently, commercial banks now face competition in one or more of their services from S&Ls, savings

Banking?, in *THE DEREGULATION OF BANKING AND SECURITIES INDUSTRIES* (Lawrence G. Goldberg and Lawrence J. White eds., 1979).

9. Of course, this turnaround may not always be possible. The community's decline may be occurring for fundamental reasons, and the correction of the externality among lenders may not be sufficient to offset these factors. In this case even joint lending will be unprofitable.

10. The bank need not incur losses for the service to be unprofitable; it is sufficient for the bank to earn less than a normal, competitive return on the capital invested in the activity.

banks, credit unions, mortgage banking firms,¹¹ consumer credit companies, industrial credit companies, insurance companies, pension funds, mutual funds, investment banking firms,¹² and non-financial companies (e.g., AT&T, Sears, General Electric, General Motors, Ford) that have entered the credit card market. Table 1¹³ provides a clear picture of the diminished role of banks in supplying the primary financial service — the granting of credit — that is the focus of the CRA. As the table indicates, commercial banks now account for less than a quarter of all credit extended and outstanding to the rest of the U.S. economy, and banks and thrifts together (the only two classes of lenders covered by CRA) account for less than a third of the total. If equity investments as a substitute for debt were included in the totals, the banks' share would be less than a sixth, and the combined banks' and thrifts' shares would be well below a quarter.

There are, of course, some communities where banks are relatively important. And there are some categories of loan services, such as loans to small business borrowers, in which banks face relatively less competition from other lenders. Accordingly, in local markets where banks are relatively few, existing banks may be able to earn above-competitive profits on these types of loans.¹⁴ Nevertheless, the general picture is one of increasing competition and thus of a reduced possibility of excess profits "elsewhere" to cross-subsidize unprofitable CRA-induced services.

An example from another regulatory area may help clarify this point. In response to regulatory pressures, AT&T practiced cross-subsidy in its pricing of telephone services from the 1930s through the 1970s. Large profits were earned in heavily used long-distance city-pair markets, which were used to make up for deficient or non-existent profits on lightly used long-distance city-pairs and on local service.¹⁵ So long as AT&T had a monopoly over long-distance service, this cross-subsidy was feasible. When competitive entry by MCI, Sprint, and other new long-distance carriers eroded the profit margins in the heavily used city-pair markets, this pattern of internal cross-

11. Mortgage banking firms are companies that originate mortgages and quickly sell them in the secondary market.

12. Investment banking firms, by helping corporations sell their securities directly to investors, thereby encourage these corporations to bypass banks as sources of finance.

13. See *infra* at 292.

14. There is thus a valid continuing role for antitrust scrutiny of bank mergers.

15. See William A. Brock and David S. Evans, *Creamskimming*, in *BREAKING UP BELL: ESSAYS ON INDUSTRIAL ORGANIZATION AND REGULATION* (David S. Evans ed., 1983); ROBERT W. CRANDALL, *AFTER THE BREAKUP: U.S. TELECOMMUNICATIONS IN A MORE COMPETITIVE ERA* (1991).

subsidy became increasingly difficult to maintain. It finally ceased with the antitrust separation of AT&T's long distance services from the local Bell operating companies in 1984.

Similarly, the rising competition among banks and between banks and non-bank providers of financial services is eroding the above-normal profits that banks may have previously earned in their protected market niches and must doom any scheme that relies on internal cross-subsidy.

Further, as banks and thrifts consider the possibilities of entry and exit over time, they will surely avoid entering areas where they fear that CRA obligations will be onerous, and they will try to exit these types of areas whenever possible. On the former point, it is worth noting that when Freedom National Bank, headquartered in Harlem, New York City, became insolvent in 1990 and was seized by the Federal Deposit Insurance Corporation ("FDIC"), the FDIC could find no other bank or thrift that was willing to take over Freedom's operations, even when the FDIC promised to cover the losses on Freedom's bad loans. Consequently, Freedom was permanently closed and liquidated, and residents of Harlem and Bedford-Stuyvesant (where Freedom had a branch) subsequently have had fewer banking services available to them. When Goldome Bank failed in 1991, the FDIC was able to attract only one bank to take over its Harlem branches. It seems likely that a contributing factor in the reluctance of other institutions to take over Freedom's and Goldome's banking operations were their fears of CRA obligations.

In sum, rapid improvements in data processing and telecommunications are widening the markets for many financial services to regional, national, or even international boundaries. The CRA's emphasis on localism is increasingly anachronistic, ultimately futile, and even counter-productive. The U.S. economy is not well served by the CRA.

III. Why Are Banks Treated So Differently?

Few other enterprises in the U.S. economy are saddled with a legal *obligation* to serve their local communities. Indeed, even among the many types of providers of financial services mentioned in Part II, only banks and thrifts are burdened with a CRA obligation. All other financial services providers can choose to offer services in a community as they see fit. Why are banks treated so differently?

There seem to be a number of reasons. First, banks have historically wielded a great deal of economic power. Early in the nineteenth

century commercial banks were virtually the only sources of finance;¹⁶ as late as 1900 they still accounted for over 50% of the assets of all financial intermediaries, and the combination of commercial banks, savings institutions, and trust companies accounted for over 75% of the total. Though commercial banks' share of overall lending has steadily declined throughout the twentieth century to less than a quarter of all credit extended in today's economy,¹⁷ memories linger. Furthermore, banks remain the largest identifiable group of lenders in an increasingly diverse financial system.

Second, banks are among the few types of firms in the marketplace that do not automatically respond "yes, how many do you want?" when a potential customer expresses interest in their product.¹⁸ A bank's primary revenue-generating product is a loan, which must be repaid with interest in order for the bank to earn a profit. For this reason the bank's loan officers must exercise judgment as to the probabilities of repayment when deciding on the size and terms of a loan and to whom it will be made.¹⁹ This exercise of judgment appears to give the bank a great deal of power.

In the nineteenth century, when banks were the predominant lending institutions and when the limits of data processing and telecommunications meant that financial markets were geographically circumscribed, a local bank was more likely to have a monopoly and actually to be able to exercise market power.²⁰ In the 1990s, a local bank is much less likely to have market power, and a competitive

16. These data are found in ROBERT LITAN, *WHAT SHOULD BANKS DO?* (1987).

17. See Table 1, *infra* at 292.

18. Insurance companies are the other major category of enterprises that exercise judgment in the sale of their services.

19. A bank is considerably less finicky about its deposit customers, unless it fears that a checking account customer might overdraw his or her account (which would either place the bank in a loan relationship with the customer or generate extra costs for the bank to avoid doing so).

20. Paradoxically, many states' nineteenth century shackling efforts, by restricting bank branching, increased many local banks' market power, since those banks did not have to fear that other banks would branch into their communities. One explanation for this paradox is reminiscent of late twentieth century CRA efforts. By preventing banks from branching, the community hoped that it was thereby confining the bank to doing business in the community, in bad times as well as good ones. In essence, branching restrictions were seen as an insurance policy for the community, and the consequent market power and monopoly rents for the local bank were the insurance "premiums" that the local community paid for the policy. (The community might then try to reduce those premiums through usury ceilings or other limitations on the bank's behavior.) For an expansion of this argument, see Charles W. Calomiris, *Regulation, Industrial Structure, and Instability in U.S. Banking: An Historical Perspective*, in *STRUCTURAL CHANGE IN BANKING* (Michael Klausner and Lawrence J. White eds., 1993).

marketplace will discipline lenders' foolish judgments.²¹ But the individual judgments of loan officers, even of competitive banks, continue to appear to convey great power; and this appearance feeds the rhetoric of shackling and extracting.

Third, banks have always been perceived as special because of the special nature of their liabilities: *deposits*. From the beginning of the republic in the late eighteenth century, government regulation of banks has had as one of its primary goals the preservation of the safety and soundness of banks through, for example, limitations on banks' activities and investments. The purposes of this regulatory effort have been to protect the *depositors* in those banks, to prevent *depositor* runs on banks, and generally to protect the payments mechanism of the economy, which involves the movement of *deposits* among banks. Since 1933 federal *deposit* insurance has added an extra element of "specialness" to banks. Though this special nature (which applies equally to thrifts and credit unions) is based on banks' liabilities, the aura of specialness has carried over to their lending and, again, has fed the rhetoric of shackling and extracting.

Fourth, as the numbers of failed commercial banks, S&Ls, and savings banks have mounted in the 1980s and early 1990s²² the media have continually used the terms "bailout" and "rescue" to describe the regulators' actions in seizing the insolvent institutions, liquidating them or finding acquirers for them, and absorbing their losses as part of the deposit insurance process. The general public now believes that taxpayer moneys are being used to "bail out the banks and the S&Ls" and that local communities deserve something in return from "the banks and the S&Ls." In actuality, the moneys are being used to satisfy the federal government's deposit insurance obligations to the *depositors* in the *insolvent* institutions;²³ and the remaining healthy institutions are not the beneficiaries.²⁴ Nevertheless, the rhetoric of

21. But a predilection by virtually all lenders to discriminate against some types of borrowers — as apparently is the case in mortgage lending — will not be cured by competition. See *supra* note 7.

22. The total number of such failures now exceeds 2,000.

23. For a more complete discussion, see LAWRENCE J. WHITE, *THE S&L DEBACLE: PUBLIC POLICY LESSONS FOR BANK AND THRIFT REGULATION* (1991).

24. Banks and thrifts pay deposit insurance premiums, which in 1992 were 23 cents per \$100 of deposits; in 1993 they will vary between 23 cents and 31 cents, depending on the FDIC's assessment of the riskiness of the institution. Arguably, in the past these premiums were too low, especially for high-risk S&Ls, since the accumulated premiums paid were woefully inadequate to cover the asset shortfalls of the (subsequently) insolvent S&Ls. However, the primary beneficiaries were the owners of the high-risk S&Ls and their customers. A good case could be made that the current premiums are too high for adequately capitalized, conservatively managed banks and thrifts. See, e.g., Barbara A. Rehm, *FDIC May Widen Premium Range After Trial Run of Risk-Based Plan*, AM.

“bailout” persists, and the notion that communities deserve something in return follows close behind.

In sum, a set of largely false images and impressions continues to characterize banks. In this light, the public policy insistence that banks serve “the needs” of their local communities is understandable. The reality of banks’ current position in the U.S. economy, however, argues strongly for a different approach.

IV. Conclusion

If the CRA is the wrong direction for public policy, are there viable alternatives? I believe that the answer is “yes” and that these alternatives would provide a more direct approach to the problems that the CRA and its current proponents try to address.

First, to the extent that racial or other types of *personal* discrimination in lending is perceived to be the problem, more vigorous enforcement of antidiscrimination laws — notably the Equal Opportunity Credit Act of 1975²⁵ — is the best solution. This approach has the double advantage of being more direct than the CRA and of covering all lenders, not just the banks and thrifts. Tougher enforcement should be combined with increased education and training of lenders’ line personnel. The use of matched pair “testers” (individuals who pose as potential customers) is likely to be a valuable tool of enforcement, to support the investigation of individual complaints and the use of statistical analysis to detect discrimination.²⁶

Second, to the extent that the neighborhood externality or spillover effects discussed in Part II are the problem, governments at all levels should encourage the formation of public or private organizations that can serve as coordinators and re-assurers of individual banks in their lending functions. The banks themselves should be encouraged to form consortia or syndicates to deal with these neighborhood externalities, although a proper concern for antitrust issues should also be present.

Third, if there are transferable lessons to be learned from successful lending efforts in low income communities,²⁷ these lessons should be disseminated as effectively as possible — for example, through semi-

BANKER, Dec. 16, 1992, at 1 (quoting George French, Associate Director of FDIC’s research division); see also T.W. Epps et al., *New Rules Penalize Prudently Managed Banks*, AM. BANKER, Jan. 19, 1993, at 4.

25. 15 U.S.C. §§ 1691-1691f (1988).

26. See Claudia Cummins, *Sound Off*, AM. BANKER, Nov. 30, 1992.

27. For example, the South Shore Bank of Chicago has apparently been successful in making profitable loans to low income inner-city communities.

nars sponsored by bank and thrift regulators. Further, policies to encourage *greater* competition in the provision of financial services — for example, by making interstate branching easier — should decrease the likelihood that lazy, incompetent, or inefficient bankers are forgoing the opportunity to provide profitable service in these communities.

Finally, to the extent that there is a public purpose to be served in the provision of financial services to communities that banks (or any other lender) do not find profitable, this argument should be made directly, and public moneys — i.e., direct government subsidies — should be used to ensure the provision of these services.²⁸ Though government policy in the U.S. has a long and not very honorable tradition of trying to avoid open and direct subsidies by trying instead to force regulated firms to provide the same transfers through internal cross-subsidy,²⁹ policies that are more open and transparent are surely a superior form of government.

Requiring a largely competitive banking system to provide these unprofitable financial services through internal cross-subsidy is inappropriate, inefficient, and ultimately a recipe for frustration and futility. There are better ways.

28. This need not mean direct government provision of the services. Instead, selective subsidies to private financial services providers can effectively “leverage” a smaller amount of public funds to achieve a larger flow of services. Or government subsidies could provide the “seed money” capital for specialized community development banks.

29. In addition to the telecommunications example discussed in Part II, transportation (e.g., rail, truck, air, bus) is another area where government efforts at cross-subsidy have been prevalent.

Table 1: The Sources of Credit Market and Trade Credit Debt Outstanding to the Domestic Nonfinancial Sectors of the U.S. Economy, Yearend 1991^a

Source	Amount (billions)	Share of Lending Total
Commercial banks	\$ 2,851	23.4%
S&Ls and savings banks	1,013	8.3
Credit unions	175	1.4
Insurance companies	1,623 ^b	13.3
Pension and retirement funds	951	7.8
Other financial sector lenders	1,991	16.4
Nonfinancial sector lenders	3,554 ^c	29.2
Total	\$12,158	100.0%

^aSource: Federal Reserve System, *Flow of Funds Accounts*.

^bIncludes \$52 billion in trade credit.

^cIncludes \$910 billion in trade credit.