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The Effectiveness of the Community Reinvestment Act

Updated January 31, 2017

Congressional Research Service
https://crsreports.congress.gov
R43661

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

The Community Reinvestment Act (CRA; P.L. 95-128, 12 U.S.C. §§2901-2908) addresses how banking institutions meet credit needs in low- and moderate-income (LMI) neighborhoods. The federal banking regulatory agencies—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)—currently implement the CRA. The regulators conduct examinations to evaluate how banks are fulfilling the objectives of the CRA and issue performance ratings. Having a satisfactory or better CRA rating is desirable when banks request to merge with other banking institutions.

The CRA, which was enacted in 1977, was subsequently revised in 1989 to require public disclosure of bank CRA ratings and for the CRA examination to have a four-tiered system of descriptive performance levels (i.e., Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance). In 1995, the CRA examination was customized to account for differences in bank sizes and business models. In 2005, the bank size definitions were revised and indexed to the Consumer Price Index. The definition of community development was also modified to expand CRA opportunities for public welfare investments. In addition, the CRA has evolved to include consumer and business lending, community investments, and low-cost services that would benefit LMI areas and entities.

Congressional concerns regarding the CRA stem from various perceptions of its effectiveness. Some contend that the CRA creates incentives for banks to make loans to unqualified borrowers likely to have repayment problems, which can translate into losses for lenders. Others are concerned that the CRA is not generating sufficient incentives to increase credit availability to qualified LMI borrowers, which may impede economic recovery for some following the 2007-2009 recession.

This report informs the congressional debate concerning the CRA's effectiveness in incentivizing bank lending and investment activity to LMI borrowers. After a discussion of the CRA's origins, it presents the CRA's examination process and bank activities that are eligible for consideration of CRA credits. Next, it discusses the difficulty of determining the CRA's influence on bank behavior. For example, some have argued that, by encouraging lending in LMI neighborhoods, the CRA may also encourage the issuance of higher-risk loans (to the extent that the two are correlated). Regulators, however, generally do not award CRA credits for payday and most subprime (nontraditional mortgage) loans, even if these loans were originated in LMI areas. This regulatory practice suggests the CRA has little or no influence on higher-risk lending. In addition, banks face a variety of financial incentives (e.g., capital requirements, the current interest rate environment, consumer credit demand, and consumer credit history) that influence how much (or how little) they lend to LMI borrowers. Because financial and CRA incentives concurrently exist, it is difficult to separate how much influence should be attributed solely to the CRA. Furthermore, compliance with CRA does not require adherence to lending quotas or benchmarks. In the absence of benchmarks, determining the extent to which CRA incentives have influenced LMI credit availability relative to other factors is not straightforward.

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CRA Background and Objectives

Congress passed the Community Reinvestment Act of 1977 (CRA; P.L. 95-128, 12 U.S.C. §§2901-2908) in response to concerns that federally insured banking institutions were not making sufficient credit available in the local areas in which they were chartered and acquiring deposits. According to some in Congress, the granting of a public bank charter should translate into a continuing obligation for that bank to serve the credit needs of the public where it was chartered.[1] Consequently, the CRA was enacted to "re-affirm the obligation of federally chartered or insured financial institutions to serve the convenience and needs of their service areas" and "to help meet the credit needs of the localities in which they are chartered, consistent with the prudent operation of the institution." The CRA requires federal banking regulators to conduct examinations to regularly assess the records of banks in terms of meeting local credit needs and requires those records to be taken into account when institutions apply for charters, branches, mergers, acquisitions, and other applications that require regulatory approval.

Congress became concerned with the geographical mismatch of deposit-taking and lending activities for a variety of reasons.[2] Deposits serve as a primary source of borrowed funds that banks may use to facilitate their lending. Hence, there was concern that deposits collected from local neighborhoods were being used to fund out-of-state as well as various international lending activities at the expense of addressing the local area's housing, agricultural, and small business credit needs.[3] Another motivation for congressional action was to discourage *redlining* practices. One type of redlining can be defined as the refusal of a bank to make credit available to all of the neighborhoods in its immediate locality, including certain low- and moderate-income (LMI) neighborhoods where deposits may have been collected. A second type of redlining is the practice of denying a creditworthy applicant a loan for housing located in a certain neighborhood even though the applicant may qualify for a similar loan in another neighborhood. This type of

[1] See U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Community Credit Needs*, S. 406, 95th Cong., 1st sess., March 23-25, 1977, pp. 1-429.

[2] U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Housing and Community Development Act of 1977*, committee print, prepared by Report to accompany S. 1523, 95th Cong., 1st sess., May 16, 1977, Report No. 95 175 (Washington: GPO, 1977), pp. 33-35.

[3] During the 20th century, U.S. banks began to expand their operations across designated geographical boundaries. For example, large regional banks in the 1960s and 1970s expanded their lending operations internationally and, in some cases, established foreign branches. The U.S. banking system was also transitioning from a system characterized primarily by unit banking, in which a small, independent bank operated solely in one state with no branches, to interstate banking. Interstate banking and branching allows a bank to conduct activities (e.g., accepting deposits, lending) across geographical (state) boundaries, forgoing the need to establish separate subsidiaries for each locality in which it operates and, therefore, having to duplicate the operating costs and capital requirements in each subsidiary. See James V. Houpt, "International Activities of U.S. Banks and in U.S. Banking Markets," *Federal Reserve Bulletin*, September 1999, pp. 599-615, at http://www.federalreserve.gov/pubs/bulletin/1999/0999lead.pdf; Frederick R. Dahl, "International Operations of U.S. Banks: Growth and Public Policy Implications," *Law and Contemporary Problems*, Winter 1967, pp. 100-130; and David L. Mengle, *The Case for Interstate Branch Banking*, Federal Reserve Bank of Richmond, Economic Review, Richmond, VA, November 1990, at http://www.richmondfed.org/publications/research/economic_review/1990/pdf/er760601.pdf. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328, 108 Stat. 2338) overrode long-standing state prohibitions against nationwide banking. See Susan McLaughlin, *The Impact of Interstate Banking and Branching Reform: Evidence from the States*, Federal Reserve Bank of New York, Current Issues in Economics and Finance, New York, NY, May 1995, at http://www.ny.frb.org/research/current_issues/ci1-2.pdf.

redlining pertains to circumstances in which a bank refuses to serve all of the residents in an area, perhaps for reasons that may involve discrimination.[4]

The CRA applies to banking institutions with deposits insured by the Federal Deposit Insurance Corporation (FDIC), such as national banks, savings associations, and state-chartered commercial and savings banks.[5] The CRA does not apply to credit unions, insurance companies, securities companies, and other nonbank institutions given the differences in their financial business models.[6] The Office of the Comptroller of the Currency (OCC), the Federal Reserve System, and the FDIC administer the CRA, which is implemented via Regulation BB.[7] The CRA requires federal banking regulatory agencies to evaluate the extent to which regulated institutions are effectively meeting the credit needs within their designated *assessment areas* (where institutions have local deposit-taking operations), including LMI neighborhoods, in a manner consistent with the federal prudential regulations for *safety and soundness*.[8]

The CRA's impact on lending activity has been publicly debated. Some observers are concerned that the CRA may induce banks to forgo more profitable lending opportunities in nontargeted neighborhoods by encouraging a disproportionate amount of lending in LMI communities.[9] Furthermore, some argue that CRA compels banks to make loans to higher-risk borrowers that are more likely to have repayment problems, which may subsequently compromise the financial stability of the banking system.[10] For example, some researchers have attributed the increase in risky lending prior to the 2007-2009 recession to banks attempting to comply with CRA objectives.[11] Others are concerned that enforcement of CRA objectives has not been stringent enough to compel banks to increase financial services in LMI areas.[12] Almost all banks receive *Satisfactory* or better performance ratings (discussed in more detail below) on their CRA examinations, which some may consider indicative of weak enforcement.

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[4] For a description of the Fair Housing Act (Title VIII of the Civil Rights Act of 1968, P.L. 90-284, 42 U.S.C. 3601 et seq.), see http://www.federalreserve.gov/boarddocs/supmanual/cch/fair_lend_fhact.pdf.

[5] See Office of the Comptroller of the Currency (OCC), *Community Reinvestment Act*, Fact Sheet, March 2014, at http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cra-reinvestment-act.pdf.

[6] Credit unions have membership restrictions, meaning these institutions may only lend to their members. A credit union may get permission to lend outside of its membership if it wants to operate in an underserved area. See CRS Report R43167, *Policy Issues Related to Credit Union Lending*, by Darryl E. Getter. Insurance and securities companies typically do not hold federally insured deposits and are not obligated by the CRA.

[7] The OCC is the primary regulator for national banks. The Federal Reserve System is the primary regulator for bank holding companies and some state banks. The FDIC is the primary regulator for state banks not under the Federal Reserve. Several states also have separate community reinvestment laws applicable to banking institutions under their supervision.

[8] Safety and soundness regulation refers to banks maintaining prudent loan underwriting standards and sufficient regulatory capital to buffer against default risks and prudently underwrite CRA-qualified loans.

[9] For example, see Yaron Brook, "The Government Did It," *Forbes*, July 18, 2008, at http://www.forbes.com/2008/07/18/fannie-freddie-regulation-oped-cx_yb_0718brook.html.

[10] See Michael V. Berry, *Historical Perspectives on the Community Reinvestment Act of 1977*, Federal Reserve Bank of Chicago, ProfitWise News and Views, Chicago, IL, December 2013, at http://www.chicagofed.org/digital_assets/publications/profitwise_news_and_views/2013/PNVDec2013_FINAL_web.pdf.

[11] See Sumit Agarwal, Efraim Benmelech, and Nattai Bergman, et al., *Did the Community Reinvestment Act (CRA) Lead to Risky Lending?*, National Bureau of Economic Research, NBER Working Paper 18609, Cambridge, MA, December 2012, at http://www.nber.org/papers/w18609.pdf.

[12] For example, see Roberto Quercia, Janneke Ratcliffe, and Michael A. Stegman, "The CRA: Outstanding, and Needs to Improve," in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, Federal Reserve Banks of Boston and San Francisco, February 2009, pp. 47-58, at http://www.frbsf.org/community-development/files/revisiting_cra.pdf.

This report informs the congressional debate concerning the CRA's effectiveness in incentivizing bank lending and investment activity to LMI customers. It describes the three tests (i.e., lending, investment, and service) that collectively make up the CRA examination, as well as how bank CRA ratings are calculated. Next, it presents the difficulty of attributing bank lending decisions to CRA incentives. For example, it identifies subjectivity issues associated with CRA compliance costs and examination standards that vary by banking institution. Banks are unlikely to get credit for all the loans they make to LMI customers. Specifically, most higher-risk subprime and payday loans are not eligible for CRA consideration and, therefore, cannot be attributed to CRA incentives. In addition, greater mobility of lending and deposit-taking activity across regional boundaries due to the growth of nationwide banking and nonbank competitors in the financial markets has complicated the ability to geographically link various financial activities.[13] Hence, it is possible that many bank investment activities occurring in a designated assessment area that are eligible for CRA consideration may simply be profitable, meaning they may have occurred without the CRA. In short, attributing the composition of bank loan portfolios to either too strong or too weak enforcement of the CRA is difficult.

CRA Examinations and Qualifying Activities

The CRA does not impose lending quotas or benchmarks. Instead, banks have a wide variety of options to serve the needs of assessment areas. These include mortgage, consumer, and business lending; community investments; and low-cost services that would benefit LMI areas and entities.[14] For example, banks may receive CRA credits for such activities as

- investing in special purpose community development entities (CDEs), which facilitate capital investments in LMI communities (discussed below);
- providing support (e.g., consulting, detailing an employee, processing transactions for free or at a discounted rate, and providing office facilities) to minority- and women-owned financial institutions and low-income credit unions (MWLIs), thereby enhancing their ability to serve LMI customers;
- serving as a joint lender for a loan originated by MWLIs;[15]
- facilitating financial literacy education to LMI communities, including any support of efforts of MWLIs and CDEs to provide financial literacy education;
- opening or maintaining bank branches and other transactions facilities in LMI communities and designated disaster areas;

[13] See Robert B. Avery, Marsha J. Courchane, and Peter Zorn, "The CRA Within A Changing Financial Landscape," Federal Reserve Banks of Boston and San Francisco, in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, February 2009, pp. 30-47, at http://www.frbsf.org/community-development/files/revisiting_cra.pdf.

[14] See OCC, *CRA: Community Development Loans, Investments, and Services*, Fact Sheet, March 2014, at http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cra-loans.pdf.

[15] P.L. 102-233, the Resolution Trust Corporation, Refinancing, Restructuring, and Improvement Act of 1991, as amended by P.L. 102-550, the Housing and Community Development Act of 1992, gives positive CRA credit to losses resulting from branches transferred to minority- and women-owned institutions. P.L. 102-550 allows cooperation with minority- and female-owned institutions to receive such credit. For examples of various qualified community investments and technical assistance that can receive consideration for CRA credit, see OCC, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation (FDIC), "Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment; Notice," 78 *Federal Register* 69671-69680, November 20, 2013.

- providing low-cost education loans to low-income borrowers;[16] and
- offering international remittance services in LMI communities.[17]

The examples listed above are not comprehensive, but they illustrate several ways banks may obtain consideration for CRA credits.[18] CRA credits or points, which are awarded if the eligible activities occur within an assigned assessment area, are then used to compute a bank's overall composite CRA rating, discussed in more detail below.

The CRA Examination

Regulators apply up to three tests, which are known as the *lending*, *investment*, and *service* tests, respectively. The *lending* test evaluates the number, amount, and distribution across income and geographic classifications of mortgage, small business, small farm, and consumer loans. The *investment* test grades community development investments in the assessment area. The *service* test examines retail service delivery, such as the availability of branches and low-cost checking in the assessment area. The point system for bank performance under the lending, investment, and service tests is illustrated in **Table 1**.[19] The lending test is generally regarded as the most important of the three tests, awarding banks the most points (CRA credits) in all rating categories.

Table 1. Points Assigned for CRA Performance Under the Individual Lending, Investment, and Service Tests

Rating	Lending	Investment	Service
Outstanding	12	6	6
High Satisfactory	9	4	4
Low Satisfactory	6	3	3
Needs to Improve	3	1	1
Substantial Noncompliance	0	0	0

Source: Federal Financial Institutions Examination Council.

Federal banking regulators evaluate financial institutions based upon their capacity, constraints, and business strategies; demographic and economic data; lending, investment, and service opportunities; and benchmark against competitors and peers. Given that all of these factors vary across banks, the CRA examination was customized in 1995 to account for differences in bank

[16] On September 29, 2010, federal banking regulators implemented P.L. 110-315, 122 Stat.3078, which allows CRA consideration to be given to banks that make low-cost education loans to LMI borrowers. See Board of Governors of the Federal Reserve System, FDIC, OCC, Office of Thrift Supervision, "Agencies Issue Final Community Reinvestment Act Rule to Implement Provision of Higher Education Opportunity Act," press release, September 29, 2010, at http://www.gpo.gov/fdsys/pkg/FR-2010-10-04/pdf/2010-24737.pdf.

[17] For more information on remittances and recent regulatory developments, see CRS Report R43217, *Remittances: Background and Issues for Congress*, by Martin A. Weiss.

[18] A more extensive list of activities eligible for CRA credit consideration can be found at FDIC, Board of Governors of the Federal Reserve System, OCC, "Agencies Release Final Revisions to Interagency Questions and Answers Regarding Community Reinvestment," press release, November 15, 2013, at http://www.federalreserve.gov/newsevents/press/bcreg/20131115a.htm.

[19] The point system is illustrated at Federal Financial Institutions Examination Council, "Community Reinvestment Act: Interagency Questions and Answers Regarding Community Reinvestment," 66 *Federal Register* 36639, July 12, 2001, pp. 33639-33640.

sizes and business models.[20] In 2005, the bank size definitions were revised to include "small," "intermediate small," and "large" banks. The asset size thresholds were also indexed to inflation using the Consumer Price Index. Effective January 1, 2017, a "small bank" is defined as having less than $1.226 billion in assets as of December 31 of either of the prior two calendar years; an "intermediate small bank" has at least $307 million as of December 31 of both of the prior two calendar years but less than $1.226 billion as of December 31 of either of the prior two calendar years.[21] Consequently, a "large bank" would have $1.216 billion or more in assets.

Small banks are evaluated only under the lending test. Regulators review (1) loan-to-deposit ratios; (2) percentage of loans in an assessment area; (3) lending to borrowers of different incomes and in different amounts; (4) geographical distribution of loans; and (5) actions on complaints about performance. Intermediate small banks are subject to both the lending and investment tests. Large banks are subject to all three tests.

As shown in **Table 1**, banks receive fewer credits for making CRA-qualified investments than for providing direct loans to individuals under the lending test. CRA-eligible investments may not be simultaneously considered for both the lending and service tests.[22] For example, a bank may receive CRA consideration under the lending test for making a loan to LMI individuals that is guaranteed by a federal agency, such as the Federal Home Administration (FHA).[23] If, however, a bank purchases securities backed by pools of FHA-guaranteed mortgage originations, this activity receives credit under the investment test. Thus, the bank receives less CRA credit than it would for making a direct loan even though it would still be facilitating lending to LMI borrowers.

The CRA was revised in 1989 to require descriptive CRA composite performance ratings that must be disclosed to the public.[24] The composite ratings illustrated in **Table 2** are tabulated using the points assigned from the individual tests (shown in **Table 1** above). The CRA ratings also appearing in **Table 2** are assigned based upon the composite ratings. Grades of *Outstanding* and *Satisfactory* are acceptable; *Satisfactory* ratings in both community development and retail lending are necessary for a composite *Satisfactory*.[25] Large banks must receive a sufficient amount of points from the investment and service tests to receive a composite *Outstanding* rating.

[20] See OCC, Federal Reserve System, FDIC, Office of Thrift Supervision, "Community Reinvestment Act Regulations and Home Mortgage Disclosure; Final Rules," 60 *Federal Register* 22156-22223, May 4, 1995.

[21] See OCC, Treasury; Board of Governors of the Federal Reserve System, FDIC, "Agencies Release Annual CRA Asset-Size Threshold Adjustments for Small and Intermediate Small Institutions," press release, December 29, 2016, at https://www.federalreserve.gov/newsevents/press/bcreg/20161229a.htm.

[22] See Federal Reserve Bank of Minneapolis, *CRA Qualified Investments in the Federal Reserve's Ninth District*, Minneapolis, MN, May 2001, at https://www.minneapolisfed.org/community_education/community/cra/QualInvestReport.pdf.

[23] See Derek Hyra, William Reeves, and Barry Wides, et al., "The SBA's 7(a) Loan Program: A Flexible Tool for Commercial Lenders," *Community Developments Insights*, September 2008; and William Reeves, "FHA 203(k) Mortgage Insurance Program: Helping Banks and Borrowers Revitalize Homes and Neighborhoods," *Community Developments Insights*, May 2013.

[24] U.S. Congress, House Committee on Financial Services, *The Community Reinvestment Act*, Testimony by Sandra F. Braunstein, Director, Division of Consumer and Community Affairs, 110th Cong., 2nd sess., February 13, 2008, at http://www.federalreserve.gov/newsevents/testimony/braunstein20080213a.htm.

[25] The text of this joint ruling is available at http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050719/attachment.pdf.

Table 2. CRA Composite Rating Point Requirements

CRA Composite Rating	Total Point Requirements (for Large Banks)
Outstanding	20 or more
Satisfactory	11-19
Needs to Improve	5-10
Substantial Noncompliance	0-4

Source: Federal Financial Institutions Examinations Council.

Regulators include CRA ratings as a factor when lenders request permission to engage in certain activities, such as moving offices or buying another institution. Denying requests, particularly applications for mergers and acquisitions, is a mechanism that may be applied against banking organizations with ratings below *Satisfactory*. Applicants with poor ratings may resubmit their applications after making the necessary improvements. In 2005, the banking regulators ruled that any evidence of discrimination or credit practices that violate an applicable law, rule, or regulation by any affiliate would adversely affect an agency's evaluation of a bank's CRA performance.[26] Covered institutions must post a CRA notice in their main offices and make publicly available a record of their composite CRA performance.[27]

Community Investments Eligible for CRA Consideration

As mentioned previously, direct lending to borrowers, taking place in what is referred to as *primary lending markets*, is eligible for CRA credit under the lending test. Alternatively, investments taking place in *secondary lending markets*, in which investors purchase loans that have already been originated (such that little or no direct interaction occurs between investors and borrowers), are eligible for CRA credit under the investment test. Secondary market investors may assume the default risks of borrowers after purchasing their loans. Alternatively, they can form pools consisting of numerous loans and then issue financial securities to a multitude of investors, thereby sharing the risks. Originating loans directly to borrowers or purchasing debt securities, therefore, are simply alternative methods to facilitate lending.[28]

The activities that are eligible for CRA credit have been expanded to encourage banks to make public welfare investments. More specifically, eligible activities include

- a *public welfare investment* (PWI) that promotes the public welfare by providing housing, services, or jobs that primarily benefit LMI individuals;[29] and
- a *community development investment* (CDI), *economic development investment,* or project that meets the PWI requirements.[30] Examples of CDI activities include

[26] See OCC, Board of Governors of the Federal Reserve System, and FDIC, "Community Reinvestment Act Regulations," at http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050719/attachment.pdf.

[27] See Federal Reserve Bank of Atlanta, *Community Reinvestment: Does Your Bank Measure Up?*, at http://www.frbatlanta.org/pubs/cra/community_reinvestment_does_your_bank_measure_up_printable.cfm.

[28] See CRS Report R43087, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets*, by Edward V. Murphy.

[29] For a more detailed definition of a PWI, see OCC, *Public Welfare Investments*, Fact Sheet, July 2011, at http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-public-welfare-investments.pdf and 12 C.F.R §§24.2, 24.3, and 24.6 at http://www.gpo.gov/fdsys/pkg/CFR-2013-title12-vol1/pdf/CFR-2013-title12-vol1-part24.pdf.

[30] *Community development* includes "activities that promote economic development by [the] financing [of] business or

promoting affordable housing, financing small businesses and farms, and conducting activities that revitalize LMI areas.

The PWI authority allows banks to engage in activities that typically would not be permitted as long as these activities promote the public welfare and do not expose institutions to unlimited liability.[31] For example, banks are not allowed to make direct purchases of the preferred or common equity shares of other banking firms. They may, however, purchase equity shares of institutions with a primary mission of community development (discussed in more detail in the **Appendix**) up to the allowable CDI limit. The Financial Services Regulatory Relief Act of 2006 (P.L. 109-351) increased the CDI limits of national banking associations and state banks (that are members of the Federal Reserve System) from 10% to 15% of a bank's unimpaired capital and unimpaired surplus for investments made to a single institution.[32]

CDIs that benefit a bank's designated assessment area are eligible to receive consideration for CRA credit. Thus, the revised PWI and CDI definitions made more banking activities eligible for CRA credits. For CRA purposes, the definition of CDI was expanded in 2005 to include "underserved and distressed" rural areas[33] and "designated disaster areas"[34] to aid the regional rebuilding from severe hurricanes, flooding, earthquakes, tornados, and other disasters.[35] The disaster area provision allows banks anywhere in America to receive consideration for CRA credit if they facilitate making credit available to a distressed location or geographic area outside of their own assessment areas.

CDI loans that banks made directly in their assessment areas would receive full CRA consideration under the lending test, but credits awarded under the investment test may be prorated when institutions provide indirect funding. For example, a bank would not receive CRA credits for investing in an entity that decides not to provide credit in LMI communities within the bank's assessment area. Regulators, therefore, prorate CRA credits for indirect investments to ensure they were applied to low-income community developments.[36] The **Appendix** provides

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farms that meet the size eligibility standards consistent with Small Business Administration's size limitations for Development Company and Small Business Investment Company programs." See Definition of Community Development, Federal Reserve—12 C.F.R. §228.12, at http://www.phil.frb.org/community-development/events/development-financing-in-rural-pa/presentations/cca_rural-111606_definitions.pdf.

[31] See OCC, *Activities Permissible for a National Bank, Cumulative*, April 2012, at http://www.occ.gov/publications/publications-by-type/other-publications-reports/bankact.pdf.

[32] Supervised banks are restricted as to how much they are allowed to lend to a single borrower. The lending limit applies to the banks' unimpaired capital and unimpaired surplus, and higher amounts may be permitted for different types of loans. Generally speaking, unimpaired capital and unimpaired surplus refer to a bank's Tier 1 and Tier 2 capital, which includes its allowance for loan and lease losses, minus any nonmarketable intangible assets. For the legal definitions of unimpaired capital and surplus, see Part 215—Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (Regulation O), 59 *Federal Register* 8837, February 24, 1994, at http://www.fdic.gov/regulations/laws/rules/7500-1300.html.

[33] These areas are available from the Federal Financial Institutions Examination Council. For example, see the 2012 List of Distressed or Underserved Nonmetropolitan Middle-Income Geographies at https://www.ffiec.gov/cra/pdf/2012distressedorunderservedtracts.pdf.

[34] Federal disaster declarations listing affected counties are available from the Federal Emergency Management Agency website at http://www.fema.gov/news/disasters.fema.

[35] See Board of Governors of the Federal Reserve System, FDIC, OCC, "Banking Agencies Issue Final community Reinvestment Act Rules," press release, July 19, 2005, at http://www.federalreserve.gov/BoardDocs/press/bcreg/2005/20050719/default.htm.

[36] In 2007, a set of questions and answers used to explain how regulators would allocate CRA credits gave some institutions the impression that CRA credits associated with low-income housing tax credit (LIHTC) investments would be prorated if they made qualifying investments in their assessment areas. The regulators, however, had not changed

examples of CDI activities that would qualify for CRA consideration under the investment test. Any awarded CRA credits could be prorated given that investing banks typically would have less control over when and where the funds are loaned.

Difficulties Determining CRA Effectiveness

Given that the CRA is not a federal assistance program and that several regulators implement it separately, no single federal agency is responsible for evaluating its overall effectiveness. In 2000, Congress directed the Federal Reserve to study the CRA's effectiveness.[37] The Federal Reserve's study reported that lending to LMI families had increased since the CRA's enactment but found that it was not possible to directly attribute all of that increase to the CRA. For example, advancements in underwriting over the last several decades have enabled lenders to better predict and price borrower default risk, thus making credit available to borrowers that might have been rejected prior to such technological advances.[38] Some academic studies report similar findings.[39] Although lending to LMI borrowers by CRA-covered institutions has increased during the act's existence, other financial developments make it difficult to attribute this outcome solely to the CRA.[40] This section examines the difficulty of linking lending outcomes directly to the CRA.

Subjectivity Issues

CRA examinations have an element of subjectivity in terms of both the quality and quantity of CRA compliance. Regulators determine the "innovativeness or complexity of qualified investments" as well as whether the bank has undertaken a sufficient amount of CRA activities to be in compliance. Generally speaking, the number of points some CRA-eligible investments receive relative to others is up to the regulator's judgment given that no formal definition of "innovativeness" or "complexity" has been established (although regulators provide a variety of examples as guidelines for banks to follow).[41] In addition, there is no official quota indicating when banks have done enough CRA-qualified activities to receive a particular rating. Without specific definitions of the criteria or quotas, CRA examination performance may be considered subjective.

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the methodology for allocating CRA credits.

[37] Board of Governors of the Federal Reserve System, *The Performance and Profitability of CRA-Related Lending*, at http://www.federalreserve.gov/boarddocs/surveys/craloansurvey/cratext.pdf.

[38] See Robert B. Avery, Raphael W. Bostic, and Paul S. Calem, et al., "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, vol. 82, no. 7 (July 1996), pp. 621-648; and Susan Wharton Gates, Vanessa Gail Perry, and Peter M. Zorn, "Automated Underwriting in Mortgage Lending: Good News for the Underserved?," *Housing Policy Debate*, vol. 13, no. 2 (2002), pp. 369-391.

[39] For examples, see Michael S. Barr, "Credit Where It Counts: The Community Reinvestment Act and Its Critics," *New York University Law Review*, vol. 80, no. 2 (2005), pp. 513-652; and John Taylor and Josh Silver, "A Framework for Revisiting the CRA," in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, Federal Reserve Banks of Boston and San Francisco, February 2009, pp. 2-7, at http://www.frbsf.org/community-development/files/cra_30_years_wealth_building.pdf.

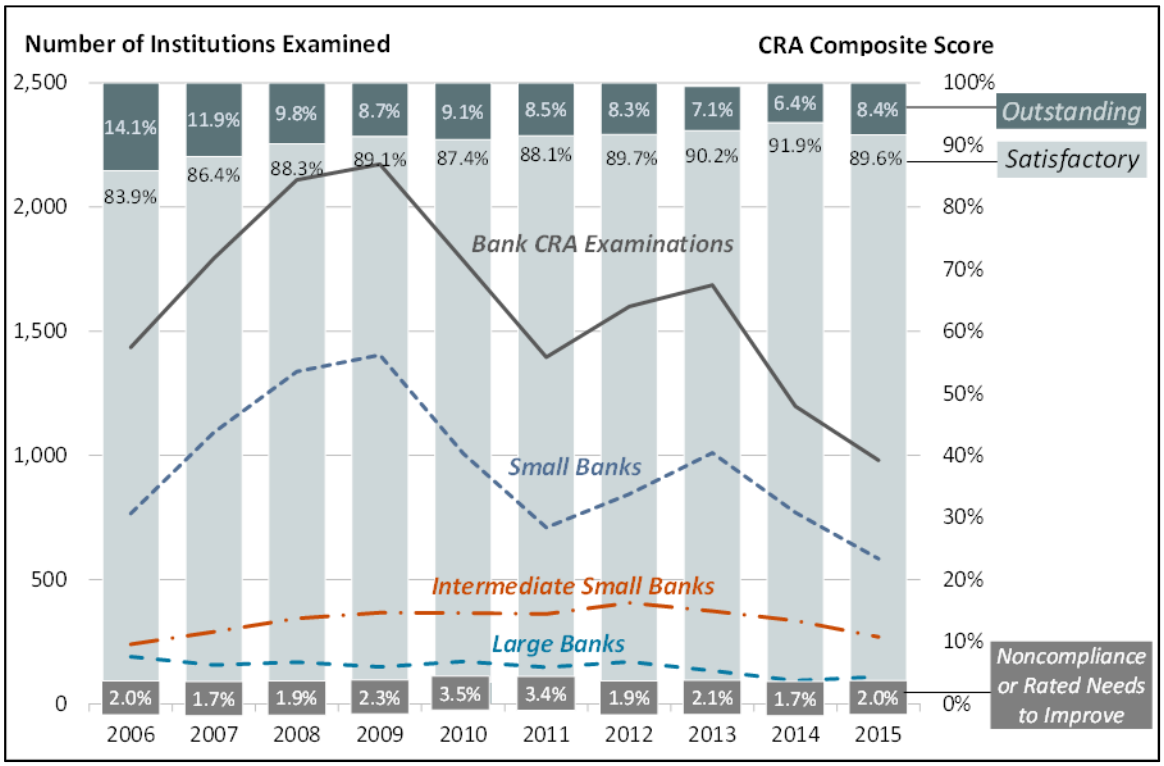
[40] For example, see William C. Apgar and Mark Duda, *The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges*, Federal Reserve Bank of New York, Economic Policy Review, New York, NY, June 2003, at http://www.newyorkfed.org/research/epr/03v09n2/0306apga.pdf.

[41] See Federal Reserve Bank of Minneapolis, *CRA Qualified Investments in the Federal Reserve's Ninth District*, Community Affairs, Minneapolis, MN, May 2001, at https://www.minneapolisfed.org/community_education/community/cra/QualInvestReport.pdf.

Almost all banks pass their CRA examinations. **Figure 1** shows the average annual composite scores of banks that received CRA examinations as well as the annual number of bank examinations by size. In 2015, for example, there were 981 CRA examinations—584 for small banks, 269 for intermediate small banks, and 109 for large banks.[42] Generally, most banks receive a composite *Satisfactory* or better rating regardless of the number of banks examined in a year. For all years, approximately 97% or more of banks examined received ratings of *Satisfactory* or *Outstanding*. It is difficult to know whether the consistently high ratings reflect the CRA's influence on bank behavior or if the CRA examination procedures need improvement.

Figure 1. Summary of Annual CRA Examinations: Number of Banks Examined and Average Composite Ratings

2006-2015



Source: Data provided by the Federal Financial Institutions Examination Council CRA Rating Search, at http://www.ffiec.gov/craratings/default.aspx.

Determining the costs associated with CRA compliance is also arguably subjective. For example, the CRA has been described by some bankers as burdensome, particularly in terms of the amount of documentation and paperwork required to demonstrate CRA eligibility. The law, P.L. 95-128, requires documentation and generates costs associated with reporting CRA-qualifying activities.[43]

[42] The 19 remaining institutions received CRA examinations that were different from the conventional small bank, intermediate small bank, and large bank examinations.

[43] A 1993 study estimated the ongoing operating cost of complying with the law averaged $69,579 per financial institution. See Marrinan Barefoot & Associates, Inc., Anjan V. Thakor, and Jess C. Beltz, *Common Ground: Increasing Consumer Benefits and Reducing Regulatory Costs in Banking*, Madison Wisc.: Herbert V. Prochnow Education Foundation, 1993; and Grant Thornton, "Regulatory Burden: The Cost to Community Banks," Study Prepared for the Independent Bankers Association of America, January 1993, p. 15.

The collecting and processing of statistics constitutes most of the burden, which arguably weighs disproportionately on community banks with smaller staffs.[44] These costs, however, would still be incurred given that these institutions must comply with other regulatory mandates, such as the Home Mortgage Disclosure, Equal Credit Opportunity, and Fair Housing Acts. The 2005 rules simplified the CRA compliance requirements for smaller banks. The Financial Services Regulatory Relief Act of 2006 also reduced the frequency of on-site CRA examinations for smaller banking institutions.[45]

Do Higher-Risk Loans Receive CRA Consideration?

As previously stated, innovations, such as the adoption of automatic underwriting, which allows lenders to better identify riskier borrowers, have contributed to making more credit available to more people since passage of the CRA. Borrowers with weaker credit histories can be charged higher interest rates and fees than those with better credit histories to compensate lenders for taking on greater amounts of credit or default risk.[46] Nontraditional (e.g., interest-only, initially low interest rates) loan products allow borrowers to obtain lower regular payments during the early stages of the loan, perhaps under the expectation that their financial circumstances may improve in the later stages as payments adjust to reflect the true costs. The ability to charge higher prices or offer such nontraditional loan products may result in greater higher-risk lending.

Meanwhile, federal banking regulators appear less willing to award banks CRA credit for originating most higher-risk loans, most likely because of the difficulty in determining whether the higher-risk loan was made for CRA purposes or resulted from discriminatory or predatory lending practices.[47] For example, the actual costs of a loan may have been hidden or simply not transparent to borrowers when they entered into the lending transaction.[48] It is difficult for regulators to monitor how well borrowers understood the disclosures regarding loan costs and features or whether any discriminatory or predatory behavior occurred at the time of loan origination.[49] Regulators would not want to award CRA credits and later discover evidence of improper consumer disclosure or discrimination practices. In addition, regulators that focus primarily on the safety and soundness of the banking system are unlikely to support lending practices that could result in large concentrations of high-risk loans on bank balance sheets.[50]

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[44] See Grant Thornton, *The High Cost of Community Bank CRA Compliance*, prepared for the Independent Community Bankers of America, at http://www.icba.org/files/pdfs/crareport.pdf.

[45] P.L. 109-351.

[46] See Wendy M. Edelberg, *Risk-based Pricing of Interest Rates in Household Loan Markets*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2003-62, Washington, DC, December 5, 2003, at http://www.federalreserve.gov/pubs/feds/2003/200362/200362pap.pdf; and Darryl Getter, "Consumer Credit Risk and Pricing," *Journal of Consumer Affairs*, vol. 40, no. 1 (Summer 2006), pp. 41-63.

[47] See OCC, FDIC, Federal Reserve Board, Office of Thrift Supervision, National Credit Union Administration, *Interagency Fair Lending Examination Procedures*, Federal Financial Institutions Examination Council, August 2009, at http://www.ffiec.gov/pdf/fairlend.pdf; and http://www.occ.gov/topics/consumer-protection/fair-lending/index-fair-lending.html. Also, banks may be awarded CRA credit for making higher risk loans insured by federal agencies, such as the Federal Housing Administration (FHA) or the Small Business Administration (SBA).

[48] For more information on consumer disclosures, particularly for those shopping for mortgages, see CRS Report R41980, *Revisiting Mortgage Loan Disclosures Under the Consumer Financial Protection Bureau*, by Darryl E. Getter and Sean M. Hoskins.

[49] See U.S. General Accounting Office, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending*, GAO-04-280, January 2004, at http://www.gao.gov/assets/160/157511.pdf.

[50] Asset quality is one of the components of the CAMELS rating system used when examining the financial health of U.S. banks and credit unions. For more information, see the FDIC's Risk Management Manual of Examination

Consequently, banks are unlikely to receive CRA consideration for higher-risk lending, particularly if regulators explicitly discourage certain practices (discussed below), arguably weakening the linkage between higher-risk lending and the CRA.

Subprime Mortgages and the Qualified Mortgage Rule

Although no consensus definition has emerged for subprime lending, this practice may generally be described as lending to borrowers with weak credit at higher costs relative to borrowers of higher credit quality.[51] In September 2006, the banking regulatory agencies issued guidance on subprime lending that was restrictive in tone.[52] The guidance warned banks of the risk posed by nontraditional mortgage loans, including interest-only and payment-option adjustable-rate mortgages. The agencies expressed concern about these loans because of the lack of principal amortization and the potential for negative amortization. Consequently, a study of 2006 Home Mortgage Disclosure Act data reported that banks subject to the CRA and their affiliates originated or purchased only 6% of the reported high-cost loans made to lower-income borrowers within their CRA assessment areas.[53] Banks, therefore, received little or no CRA credit for subprime mortgage lending. Instead, federal regulators offered CRA consideration to banks that helped mitigate the effects of distressed subprime mortgages.[54] On April 17, 2007, federal regulators provided examples of various arrangements that financial firms could provide to LMI borrowers to help them transition into affordable mortgages and avoid foreclosure. The various workout arrangements were eligible for favorable CRA consideration.[55]

Banks are unlikely to receive CRA consideration for originating subprime mortgages going forward. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203) requires lenders to consider consumers' ability to repay before extending them mortgage credit, and one way for lenders to comply is to originate *qualified mortgages* (QMs) that satisfy various underwriting and product-feature requirements.[56] For example, QMs may not have any negative amortization features, interest-only payments, or points and fees that exceed

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Policies, at http://www.fdic.gov/regulations/safety/manual/.

[51] See Rajdeep Sengupta and William R. Emmons, "What is Subprime Lending?" *Economic Synopses, Federal Reserve Bank of St. Louis*, vol. 13 (2007), at https://research.stlouisfed.org/publications/es/07/ES0713.pdf.

[52] See the joint press release, Federal Reserve Board, *Federal Financial Regulatory Agencies Issue Final Guidance on Nontraditional Mortgage Product Risks*, September 29, 2006 at http://www.federalreserve.gov/boarddocs/press/bcreg/2006/20060929/defaul.htm.

[53] See Neil Bhutta and Glenn B. Canner, *Did the CRA Cause the Mortgage Market Meltdown*, Federal Reserve Bank of Minneapolis, Community Dividend, Minneapolis, MN, March 1, 2009, at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4136&; U.S. Congress, House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy, *Bank Mergers, Community Reinvestment Act Enforcement, Subprime Mortgage Lending, and Foreclosures*, Testimony of Sandra Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve System, 110th Cong., 1st sess., May 21, 2007, at http://www.federalreserve.gov/newsevents/testimony/braunstein20070521a.htm; and OCC, "Comptroller Dugan Says CRA not Responsible for Subprime Lending Abuses," OCC press release, November 19, 2008, at http://www.occ.gov/news-issuances/news-releases/2008/nr-occ-2008-136.html.

[54] Board of Governors of the Federal Reserve System, U.S. Department of Housing and Urban Development, FDIC, National Credit Union Administration, OCC, Office of Thrift Supervision, "Federal Regulators Encourage Institutions to Work with Mortgage Borrowers Who Are Unable to Make Their Payments," press release, April 17, 2007, at http://www.occ.gov/news-issuances/news-releases/2007/nr-ia-2007-41.html.

[55] These workout arrangements presumably would receive CRA consideration under the lending test given that new, modified loans would be provided directly to borrowers.

[56] See CRS Report R43081, *The Ability-to-Repay Rule: Possible Effects of the Qualified Mortgage Definition on Credit Availability and Other Selected Issues*, by Sean M. Hoskins.

specified caps of the total loan amount; in most cases, borrowers' debt-to-income ratios shall not exceed 43%. QM originations will give lenders legal protections if the required income verification and other proper underwriting procedures were followed. Given the legal protections afforded to QMs, some banks might show greater reluctance toward making non-QM loans. With this in mind, the federal banking regulators announced that banks choosing to make only or predominately QM loans should not expect to see an adverse effect on their CRA evaluations; however, the regulators did not indicate that CRA consideration would be given for non-QMs.[57] Arguably, the federal banking regulators appear less inclined to use the CRA to encourage lending that could be subject to greater legal risks.

Payday Lending

The willingness of banks to provide financial services in LMI communities suggests the existence of profit opportunities. For example, banks have demonstrated interest in providing financial services, such as payday loans (small dollar cash advances) in the form of products, such as subprime credit cards, overdraft protection services, and direct deposit advances. Legislation, such as the Credit Card Accountability Responsibility and Disclosure Act of 2009 (P.L. 111-24, which restricts subprime credit card lending), federal banking regulators, and the Consumer Financial Protection Bureau (CFPB), however, discourage banks from engaging in payday lending.[58] Payday and similar loans have been criticized for their often triple-digit annual percentage rates and the frequency with which cash-constrained borrowers roll over or take out successive loans rather than repay the original principal amount in full when due.[59] When regulations require "cooling off" periods between successive loans, banks arguably must offer financial products that payday borrowers are unlikely to find useful.[60]

In response, the FDIC conducted a small-dollar loan pilot program from February 2008 to December 2009 in which 28 banking firms voluntarily participated.[61] The FDIC provided a template for small-dollar banking products designed to compete with more traditional payday loan products. Under these guidelines, all fees and interest associated with these loans must total less than 36% per year. In addition, the template required mandatory savings and financial education. Banks were also instructed to monitor excessive consumer usage of overdrafts (which are equivalent to rollovers). The FDIC reported that small-dollar loans were a useful business strategy for banks because they facilitated banks' ability to build or retain profitable, long-term relationships with their customers and obtain favorable CRA consideration.[62] The profitability of this lending was contingent upon the ability of banks to generate higher transaction volumes,

[57] See Board of Governors of the Federal Reserve System, FDIC, National Credit Union Administration, OCC, "Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans," press release, December 13, 2013, http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131213a1.pdf.

[58] For more on banking products that provide equivalent payday lending services and recent regulatory developments, see CRS Report R43364, *Recent Trends in Consumer Retail Payment Services Delivered by Depository Institutions*, by Darryl E. Getter.

[59] See Susanna Montezemolo, *Payday Lending Abuses and Predatory Practices*, Center for Responsible Lending, The State of Lending in America & its Impact on U.S. Households, Durham, NC, September 10, 2013, at http://www.responsiblelending.org/state-of-lending/payday-loans/.

[60] See Joe Adler, "Banks: Deposit Advance Guidelines Will Help Payday Lenders, Hurt Consumers," *American Banker*, November 21, 2013.

[61] See FDIC, "FDIC Board Approves Small-Dollar Loan Pilot Project," press release, June 19, 2007, at http://www.fdic.gov/news/news/press/2007/pr07051.html; and http://www.fdic.gov/smalldollarloans/.

[62] See "A Template for Success: The FDIC's Small-Dollar Loan Pilot Program," *FDIC Quarterly*, vol. 4, no. 2 (2012), at http://www.fdic.gov/bank/analytical/quarterly/2010_vol4_2/FDIC_Quarterly_Vol4No2_SmallDollar.pdf.

cover the underwriting and servicing costs, and cross-sell additional financial products to the borrowers.[63] Nevertheless, higher-priced loan products with features similar to the template loan introduced in this pilot program could possibly receive CRA credit.

Competitive Advantages for Nonbank Lenders

Generally speaking, regulatory guidance that discourages banks from making higher-risk loans may result in customers migrating to nonbank financial service providers (including payday lenders), thus weakening the effectiveness of the CRA. During the 1980s and 1990s, LMI communities experienced an increase in the supply of (subprime) mortgage products by nonbanking institutions not covered by the CRA as well as an increase in the use of alternative financial service providers, such as check cashers and payday lenders.[64] Furthermore, some banks saw declines in deposits during the 1997-2007 period.[65] Shrinking customer deposit bases make it more difficult to meet CRA objectives (i.e., geographically match deposit-taking with lending activity), particularly for small and intermediate small community banks that are only evaluated under the direct lending component of the CRA test. Larger banks, which are subject to the CRA service test and thus get consideration for providing transaction services in LMI communities, also face challenges when they lose the short-term cash advance market segment to nonbanks and payday lenders.[66] Hence, limitations on bank product offerings for consumer protection purposes may encourage migration to financial service providers not covered by the CRA, possibly one of many factors contributing to the growth of the shadow-banking sector.[67]

Concurrent Investment Incentives

As discussed earlier, activities that receive consideration under the investment test are awarded fewer CRA credits relative to the lending test. Despite the lower CRA incentive, banks make sizeable CRA-qualified investments because these activities are expected to be profitable. Consequently, it is difficult to determine whether banks are motivated to make these investments because of CRA incentives, profit incentives, or both.

During recessions, banks tend to reduce direct (or primary market) lending and increase their holdings of securities because both the demand and the supply of direct loan originations often decline during economic slowdowns and early recovery periods.[68] Following the 2007-2009

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[63] See Mark Pearce, "Small-Dollar Loan Pilot Produced Valuable Insights, Profits," *American Banker*, June 21, 2012.

[64] See William C. Apgar, Jr. and Christopher E. Herbert, *Subprime Lending and Alternative Financial Service Providers: A Literature Review and Empirical Analysis*, U.S. Department of Housing and Urban Development, February 2006, at http://www.huduser.org/Publications/pdf/sublending.pdf; and Joint Center for Housing Studies, *The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System*, March 20, 2002.

[65] See James Harvey and Kenneth Spong, *The Decline in Core Deposits: What Can Banks Do?*, Federal Reserve Bank of Kansas City, Financial Industry Perspectives, Kansas City, MO, 2001, at http://www.kansascityfed.org/PUBLICAT/FIP/prs01-4.pdf.

[66] See Mark Willis, "It's the Rating, Stupid: A Banker's Perspective on the CRA," in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, Federal Reserve Bank of San Francisco, San Francisco, CA, February 2009, at http://www.frbsf.org/community-development/files/its_rating_stupid1.pdf and Michael S. Barr, "Community Reinvestment Emerging from the Housing Crisis," in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, sponsored by the Federal Reserve Bank of San Francisco, February 2009, at http://www.frbsf.org/community-development/files/community_reinvestment_emerging_from_housing_crisis.pdf.

[67] See CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy.

[68] See William R. Keeton, *Causes of the Recent Increase In Bank Security Holdings*, Federal Reserve Bank of Kansas City, Economic Review, Kansas City, MO, 1994, at http://www.kansascityfed.org/PUBLICAT/EconRev/

recession, U.S. interest rates dropped to historically low levels for an abnormally long period of time. The household and business sectors reduced their demand for credit, and borrowing activity declined substantially.[69] Low-yielding interest rate environments squeeze banking profits and encourage banks to search for higher-yielding lending opportunities, which might be found in the secondary markets and possibly even be eligible for CRA consideration. For example, banks receive CRA consideration under the investment test when purchasing state and local municipal bonds that fund public and community development projects in their designated assessment areas. Even if they do not receive CRA consideration, banks may still have an incentive to purchase municipal bonds given the current interest rate environment as well as the lower risk-weighting treatment relative to other asset holdings.[70]

Figure 2 presents the yields and rates of growth of portfolio holdings for mortgage loans and municipal bonds between 2000 and 2014. Mortgage yields have been steadily declining from more than 8% in 2000 to less than 4% in 2011, and yields have been slightly above 4% over the previous year. Mortgage yields are currently similar to those for municipal bonds. Although the growth rate of the residential mortgage loan share in bank portfolios was generally positive until about 2006, it has since been negative. Meanwhile, the growth rate of the share of bank municipal bond holdings has generally been rising since 2006.[71] Given that capital requirements for holding municipal bonds are lower and fewer borrowers may qualify for mortgages, a positive growth rate of bank investments in municipal securities appears to occur simultaneously with a negative growth rate in mortgage investments holdings. The rising share of municipal bond holdings, however, may be more related to normal profit incentives than to CRA-related incentives, and benefits to designated assessment areas may be coincidental.

EconRevArchive/1994/2Q94KEET.pdf.

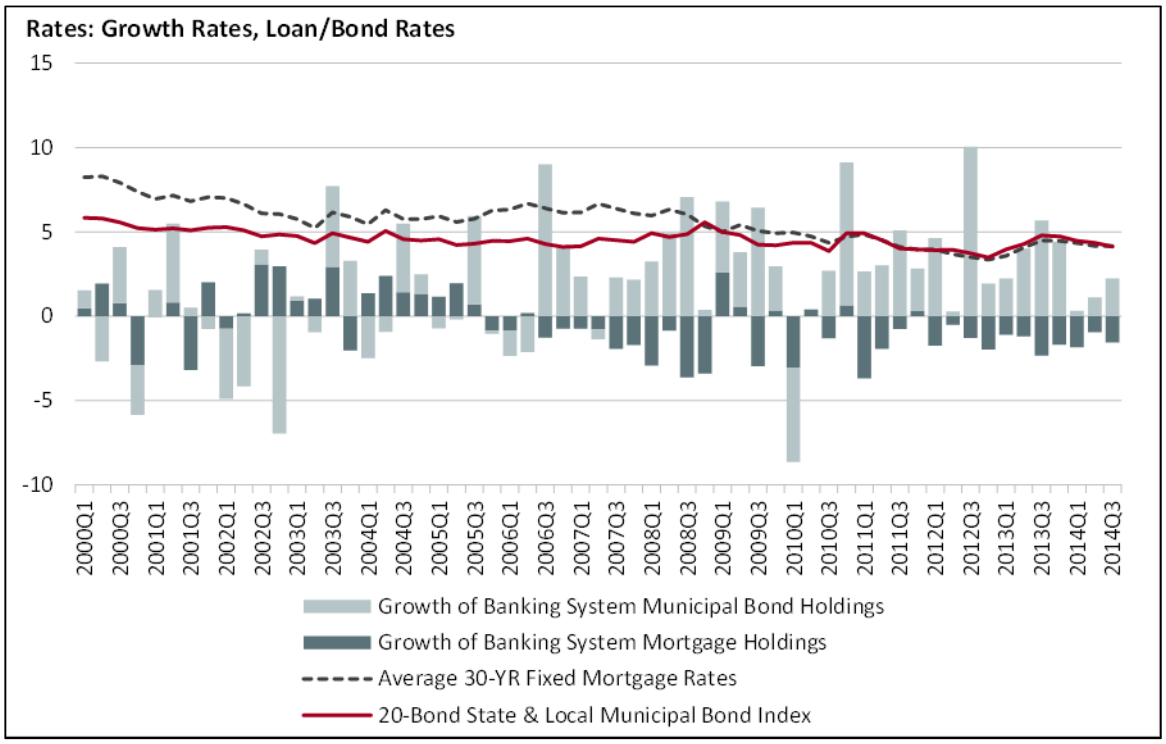
[69] See CRS Report R41623, *U.S. Household Debt Reduction*, by Darryl E. Getter; and Ann Marie Wiersch and Scott Shane, Why Small Business Lending Isn't What It Used To Be, Federal Reserve Bank of Cleveland, Economic Commentary, August 14, 2013, at https://www.clevelandfed.org/research/commentary/2013/2013-10.cfm.

[70] For more information on the risk-weighting and capital charges of bank assets, see CRS Report R42744, *U.S. Implementation of the Basel Capital Regulatory Framework*, by Darryl E. Getter.

[71] See Gary S. Corner, Emily Dai, and Daigo Gubo, *Could Rising Municipal Securities Holdings Increase Community Banks' Risk Profiles?*, Federal Reserve Bank of St. Louis, Central Banker, St. Louis, MO, 2013, at http://www.stlouisfed.org/publications/cb/articles/?id=2447.

Figure 2. Comparison of Bank Share of Investments in Mortgages and Municipal Bonds

2000-2014 3rd Quarter



Source: Federal Deposit Insurance Corporation and Federal Reserve Bank of St. Louis Federal Reserve Economic Data (FRED).

Note: CRS computations.

Bank investments in Small Business Investment Corporations (SBICs, defined in the **Appendix**) may also serve as an example of concurrent incentives. Banks typically provide *senior* debt rather than *subordinate* debt to businesses in need of financing. Senior lenders have first claims to the assets of the business in case of failure. Subordinate financiers tend to provide funds in the form of mezzanine capital or equity; they require a higher return given that they agree to take on more risk in the event of a failure.[72] In a low-interest-rate environment, banks may have a greater incentive to provide higher-yielding, higher-risk mezzanine investment financing to a SBIC than to rely almost exclusively on lower-yielding senior financing.[73] An increase in SBIC financing activities, as with any bank investment portfolio shifts, may reflect responses to normal profit incentives rather than to CRA-related incentives.

[72] Mezzanine financing is a hybrid of debt and equity financing and is typically used to finance the expansion of an existing business. It provides the lender the right to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders, such as banks and venture capital companies.

[73] See Shane Kite, "SBIC Revival: Why Interest From Banks Is Way Up, As The Volcker Rule Looms," *American Banker*, July 23, 2014, at http://www.americanbanker.com/magazine/124_04/sbic-revival-why-interest-from-banks-is-way-up-as-the-volcker-rule-looms-1066822-1.html.

Finally, because lenders' CRA status is a factor in merger approvals, banks interested in mergers may be encouraged to engage in CRA-eligible activities.[74] In recent years, the pace of bank mergers has slowed for several reasons. For example, the banking system is still accumulating sufficient capital reserves to cover current loan delinquencies.[75] These higher capital requirements stem from implementation of the Basel III Capital Accords and the passage of the Dodd-Frank Act, and additional regulatory requirements increase with bank size.[76] However, there may be incentives to merge if cost advantages associated with larger scales of operation exist. Rising merger activity among small and medium sized banks reflects an industry consolidation trend over the past several decades in which banking assets have increased even as the number of banking institutions has declined. Small banks lack benefits associated with economies of scale (volume of transactions) and economies of scope (array of financial services). Given fewer sources of revenue, smaller banks may be more vulnerable to revenue interruptions stemming from economic downturns or increasing compliance costs. Some banking firms hoping to capitalize on strategic merger opportunities that could potentially lower their operating costs and increase market share may consider CRA credits valuable. Consequently, the CRA's influence varies by bank size and current business strategies.

[74] See William Lenney and Paul Matteo, *Bank Mergers and Acquisitions Continue at a Slow Pace*, Federal Reserve Bank of Philadelphia, SRC Insights, Philadelphia, PA, 2009, at http://www.phil.frb.org/bank-resources/publications/src-insights/2009/third-quarter/q3si5_09.cfm.

[75] See CRS Report R43002, *Financial Condition of Depository Banks*, by Darryl E. Getter.

[76] See CRS Report R42744, *U.S. Implementation of the Basel Capital Regulatory Framework*, by Darryl E. Getter; and CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte.

Appendix. CRA Investment Options

Community development investments (CDIs) that meet public welfare investment (PWI) requirements are those that promote the public welfare, primarily resulting in economic benefits for low- and moderate-income (LMI) individuals. This appendix provides examples of CDI activities that would qualify for consideration under the CRA investment test. In many cases, covered banks are more likely to take advantage of these optional vehicles to obtain CRA credits if they perceive the underlying investment opportunities to have profit potential.

Loan Participations

Banks and credit unions often use *participation (syndicated) loans* to jointly provide credit. When a financial firm (e.g., bank, credit union) originates a loan for a customer, it may decide to structure loan participation arrangements with other institutions.[77] The loan originator often retains a larger portion of the loan and sells smaller portions to other financial institutions willing to participate. Suppose a financial firm originates a business or mortgage loan in a LMI neighborhood. A bank may receive CRA investment credit consideration by purchasing a participation, thus becoming a joint lender to the LMI borrower. An advantage of loan participations is that the default risk is divided and shared among the participating banks (as opposed to one financial firm retaining all of the risk). CRA consideration is possible if the activity occurs within the designated assessment area. For all participating banks to receive credit, some overlap in their designated assessment areas must exist. An exception is made for participations made to benefit designated disaster areas, in which all participating banks would receive CRA consideration regardless of location.

State and Local Government Bonds

State and local governments issue municipal bonds, and the proceeds are used to fund public projects, community development activities, and other qualifying activities.[78] The interest that nonbank municipal bondholders receive is exempt from federal income taxes to encourage investment in hospitals, schools, infrastructure, and community development projects that require state and local funding. Legislative actions during the 1980s eliminated the tax-exempt status of interest earned from holdings of municipal bonds for banks.[79] Although banks no longer have a tax incentive to purchase municipal bonds, they still consider the profitability of holding these loans, as they do with all lending opportunities. Furthermore, banks receive CRA investment consideration when purchasing state and local municipal bonds that fund public and community development projects in their designated assessment areas.

[77] This activity should not be confused with a securitization given that loan portions are sold to specific entities rather than restructured into new public offerings.

[78] See CRS Report R40523, *Tax Credit Bonds: Overview and Analysis*, by Steven Maguire.

[79] The 1982 Tax Equity and Fiscal Responsibility Act limited the interest deduction from holding municipals for banks to 85%; the 1984 Deficit Reduction Act further reduced the deduction to 80%. The 1986 Tax Act completely eliminated the interest deduction for holding municipals for banks. See Peter Fortune, *The Municipal Bank Market, Part I: Politics, Taxes, and Yields*, Federal Reserve Bank of Boston, New England Economic Review, Boston, MA, 1991, at http://www.bostonfed.org/economic/neer/neer1991/neer591b.pdf.

CRA-Targeted Secondary Market Instruments

Secondary market financial products have been developed to facilitate the ability of banks to participate in lending activities eligible for CRA consideration, such as purchasing mortgage-backed securities (MBSs) or shares of real estate investment trusts (REITs). A MBS is a pool of mortgage loans secured by residential properties; a multifamily MBS is a pool of mortgage loans secured by multifamily properties, consisting of structures designed for five or more residential units, such as apartment buildings, hospitals, nursing homes, and manufactured homes. CRA-MBSs are MBSs consisting of loans that originated in specific geographic assessment areas, thereby allowing bank purchases into these pools to be eligible for CRA consideration under the investment test.[80] Similarly, REITs may also pool mortgages, mortgage MBSs, and real estate investments (e.g., real property, apartments, office buildings, shopping malls, hotels). Investors purchase shares in REIT pools and defer the taxes.[81] Banks may only invest in mortgage REITs and MBS REITs. Similar to the CRA-MBSs, the REITs must consist of mortgages and MBSs that would be eligible for CRA consideration. The Community Development Trust REIT is an example of a REIT that serves as a CRA-qualified investment for banks.[82]

Community Development Financial Institutions and Equity Equivalent Investments

The Community Development Financial Institutions (CDFI) Fund was created by the Riegle Community Development Regulatory Improvement Act of 1994 (the Riegle Act; P.L. 103-325).[83] The CDFI Fund was established to promote economic development for distressed urban and rural communities. The CDFI Fund, currently located within the U.S. Department of the Treasury, is authorized to certify banks, credit unions, nonprofit loan funds, and (for-profit and nonprofit) venture capital funds as designated CDFIs.[84] In other words, a bank may satisfy the requirements to become a CDFI, but not all CDFIs are banks. The primary focus of institutions with CDFI certification is to serve the financial needs of economically distressed people and places. The designation also makes these institutions eligible to receive financial awards and other assistance from the CDFI Fund.[85]

In contrast to non-CDFI banks, some CDFI banks have greater difficulty borrowing funds and then transforming them into loans for riskier, economically distressed consumers.[86] The lack of

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[80] For example, see Fannie Mae, *CRA-Targeted Fannie Mae MBS*, at http://www.fanniemae.com/portal/jsp/mbs/data/mbs/cratargeted.html.

[81] To qualify as a REIT, most of a company's assets and income must be connected to real estate investments and at least 90% of its taxable income must be distributed to shareholders annually in the form of dividends. For more information, see http://www.sec.gov/answers/reits.htm.

[82] See Judd Levy, "The Community Development REIT," *Community Investments*, vol. 14, no. 1 (March 2002), pp. 7-9.

[83] See U.S. Department of the Treasury, *Community Development Financial Institutions Fund*, at http://www.cdfifund.gov/who_we_are/about_us.asp; and CRS Report R42770, *Community Development Financial Institutions (CDFI) Fund: Programs and Policy Issues*, by Sean Lowry.

[84] Native American CDFIs are established to serve Native American, Alaska native, and native Hawaiian communities.

[85] OCC, *CDFI Certification for National Banks and Federal Savings Associations*, Fact Sheet, March 2014, at http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cdfi-certification.pdf.

[86] For more information on how CDFIs typically fund loans, see Michael Swack, Jack Northrup, and Eric Hangen, *CDFI Industry Analysis: Summary Report*, University of New Hampshire Carsey Institute, May 2, 2012, http://carseyinstitute.unh.edu/sites/carseyinstitute.unh.edu/files/publications/Report-Swack-CDFI-Industry-Analysis.pdf. For comparison, an explanation of how traditional banks fund their loans may be found at CRS Report

loan level data for most CDFI banks causes creditors to hesitate in making low-cost, short-term loans to these institutions. Specifically, the lack of information on loan defaults and prepayment rates on CDFI banking assets is likely to result in limited ability to sell these loan originations to secondary loan markets. Consequently, the retention of higher-risk loans, combined with limited access to low-cost, short-term funding, makes CDFI banks more vulnerable to liquidity shortages.[87] Hence, CDFIs rely primarily on funding their loans (assets) with *net assets*, which are proceeds analogous to the equity of a traditional bank or net worth of a credit union. CDFI net assets are often acquired in the form of awards or grants from the CDFI Fund or for-profit banks. Funding assets with net assets is less expensive for CDFIs than funding with longer-term borrowings.

Banks may obtain CRA investment credit consideration by making investments to CDFIs, which provides CDFIs with net assets (equity). Under PWI authority, banks are allowed to make equity investments in specialized financial institutions, such as CDFIs, as long as they are considered by their safety and soundness regulator to be at least *adequately capitalized*.[88] Furthermore, the final Basel III notification of proposed regulation (NPR)[89] allows for preferential capital treatment for equity investments made under PWI authority, meaning equity investments to designated CDFIs may receive more favorable capital treatment.[90] Consequently, banks often provide funds to CDFIs through *equity equivalent investments* (EQ2s), which are debt instruments issued by CDFIs with a continuous rolling (indeterminate) maturity. EQ2s, from a bank's perspective, are analogous to holding convertible preferred stock with a regularly scheduled repayment.[91] Hence, banks may view EQ2s as a potentially profitable opportunity to invest in other specialized financial institutions and receive CRA consideration, particularly when the funds are subsequently used by CDFIs to originate loans in the banks' assessment areas.[92]

R43002, *Financial Condition of Depository Banks*, by Darryl E. Getter.

[87] See Mark Pinsky, *Growing Opportunities in Bank/CDFI Partnerships*, OCC, Community Developments, Washington, DC, 2002, at http://www.occ.gov/static/community-affairs/community-developments-newsletter/Summer-01.pdf.

[88] For information on the five prompt corrective action capital categories (well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized) for banks insured by the FDIC, see FDIC, *Risk Management Manual of Examination Policies: Part II - CAMELS, 2.1 Capital*, at http://www.fdic.gov/regulations/safety/manual/section2-1.pdf and CRS Report R41718, *Federal Deposit Insurance for Banks and Credit Unions*, by Darryl E. Getter.

[89] The Board of Governors of the Federal Reserve System and the OCC adopted the final rule implementing the Basel III capital regulatory framework for banking institutions on July 2, 2013; the FDIC adopted the final rule on July 9, 2013. See "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule," at http://www.federalreserve.gov/bcreg20130702a.pdf.

[90] Community development investments will generally receive a risk weight of 100% (in comparison with other equity exposures that could receive a 400% risk weight) as well as a capital charge of 8%. See Thomas J. Curry, Remarks at National Community Investment Fund Annual Development Banking Conference, Chicago, IL, November 13, 2013, at http://www.occ.gov/news-issuances/speeches/2013/pub-speech-2013-175.pdf. For more information on risk-weighting and capital charges, see CRS Report R42744, *U.S. Implementation of the Basel Capital Regulatory Framework*, by Darryl E. Getter.

[91] When the company is profitable, preferred stockholders receive a dividend at regular intervals. If a publicly traded company is liquidated, its creditors are paid first, followed by its preferred stockholders, and the common stockholders of the firm are paid last with whatever proceeds are left over. Preferred stockholders, therefore, provide *subordinate* or *mezzanine* financing, discussed in footnote 72 above. For specific legal attributes of this financial instrument, see Beth Lipson, "Equity Equivalent Investments," *Community Investments*, vol. 14, no. 1 (March 2002), pp. 10-12.

[92] The CDFI Fund may also induce banks, via cash awards through its Bank Enterprise Award program, to make EQ2 investments. For more information, see U.S. Department of the Treasury, *Community Development Financial*

Small Business Investment Companies

The Small Business Administration (SBA) was established in 1953 by the Small Business Act of 1953 (P.L. 83-163) to support small businesses' access to capital in a variety of ways.[93] Although issuing loan guarantees for small businesses is a significant component of its operations, the SBA also has the authority to facilitate the equity financing of small business ventures through its Small Business Investment Company (SBIC) program, which was established by the Small Business Investment Act of 1958 (P.L. 85-699).[94] SBICs that are licensed and regulated by the SBA may provide debt and equity financing and, although not a program requirement, educational (management consulting) resources for businesses that meet certain SBA size requirements.[95]

Banks may act as limited partners if they choose to provide funds to SBICs, which act as general partners.[96] Banks may establish their own SBICs, jointly establish SBICs (with other banks), or provide funds to existing SBICs. SBICs subsequently use bank funding to invest in the long-term debt and equity securities of small, independent (SBA-eligible) businesses, and banks may receive CRA investment consideration if the activities benefit their assessment areas.[97] Community banks invest in SBICs because of the profit potential as well as the opportunity to establish long-term relationships with business clients during their infancy stages. Banks that are considered by their regulators to be adequately capitalized are allowed to invest in these specialized financial institutions under PWI authority, but the investments still receive risk-based capital treatment.[98] SBIC assets, similar to CDFIs, are illiquid given the difficulty to obtain credit ratings for SBIC investments; thus, they cannot be sold in secondary markets.[99] Because banks risk losing the principal of their equity investments, they are required to perform the proper due diligence associated with prudent underwriting.[100]

Institutions Fund, at http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=1.

[93] The Small Business Act provides the SBA authority to establish size standards, both for specific programs and for specific industries, to determine which for-profit businesses qualify as small. See CRS Report RL33243, *Small Business Administration: A Primer on Programs and Funding*, by Robert Jay Dilger and Sean Lowry; and CRS Report R40860, *Small Business Size Standards: A Historical Analysis of Contemporary Issues*, by Robert Jay Dilger.

[94] See CRS Report R41456, *SBA Small Business Investment Company Program*, by Robert Jay Dilger.

[95] See Lawrence S. Mondschein, "Small Business Investment Companies," *Community Investments*, vol. 14, no. 1 (March 2002), pp. 14-16.

[96] See OCC, *Small Business Investment Companies: An Investment Option for Banks*, Community Developments Insights, September 2012, at http://www.occ.gov/topics/community-affairs/publications/insights/insights-sbic.pdf.

[97] See Sarah Bennett, "SBICs: More than an Equity Investment," in *Community Investments*, vol. 9, no. 4 (Fall 1997), at http://www.frbsf.org/community-development/files/Bennett_SBICs.pdf.

[98] SBIC investments are subject to a 400% risk weight for non-publicly traded equity exposures. In cases in which the equity exposure is considered nonsignificant, it may be possible to receive a risk weight of 100%.

[99] Businesses that need funding pay rating agencies for their credit ratings, and small LMI business start-ups seeking funding from SBICs would be unlikely to bear such expenses. For more information about firms paying for credit ratings of their security issuances, see CRS Report R40613, *Credit Rating Agencies and Their Regulation*, by Gary Shorter and Michael V. Seitzinger.

[100] See OCC, *SBA's Small Business Investment Company Program*, Fact Sheet, January 2014, at http://www.occ.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-sbic.pdf.

Tax Credits

The *low-income housing tax credit* (LIHTC) program was created by the Tax Reform Act of 1986 (P.L. 99-514) to encourage the development and rehabilitation of affordable rental housing.[101] Generally speaking, government (federal or state) issued tax credits may be bought and, in many cases, sold like any other financial asset (e.g., stocks and bonds). Owners of tax credits may reduce their tax liabilities either by the amount of the credits or by using the formulas specified on those credits, assuming the owners have participated in the specified activities that the government wants to encourage. For LIHTCs, banks may use a formula to reduce their federal tax liabilities when they provide either credit or equity contributions (grants) for the construction and rehabilitation of affordable housing. If a bank also owns a LIHTC, then a percentage of the equity grant may be tax deductible if the CDFI uses the funds from the grant to finance affordable rental housing. Furthermore, banks may receive consideration for CRA-qualified investment credits.

After a domestic corporation or partnership receives designation as a Community Development Entity (CDE) from the CFDI Fund, it may apply for *New Markets Tax Credits* (NMTCs). Encouraging capital investments in LMI communities is the primary mission of CDEs, and CDFIs and SBICs automatically qualify as CDEs.[102] Only CDEs are eligible to compete for NMTCs, which are allocated by the CDFI Fund via a competitive process. Once awarded an allocation of NMTCs, the CDE must obtain equity investments in exchange for the credits. Then, the equity proceeds raised must either be used to provide loans or technical assistance or deployed in eligible community investment activities. Only for-profit CDEs, however, may provide NMTCs to their investors in exchange for equity investments.[103] Investors making for-profit CDE equity investments can use the NMTCs to reduce their tax liabilities by a certain amount over a period of years. As previously discussed, a bank may receive CRA credit for making equity investments in nonprofit CDEs and for-profit subsidiaries, particularly if the investment occurs within the bank's assessment area. Furthermore, banks may be able to reduce their tax liabilities if they can obtain NMTCs from the CDEs in which their investments were made.

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[101] See CRS Report RS22389, *An Introduction to the Low-Income Housing Tax Credit*, by Mark P. Keightley and Jeffrey M. Stupak.

[102] In addition, a nonprofit CDE may have a for-profit subsidiary to conduct specific business activities. For example, a college located in a LMI community may receive a nonprofit CDE designation, but it may become necessary to establish a for-profit subsidiary for ancillary activities, such as a highly profitable athletic program, which could threaten the college's tax-exempt status. A nonprofit hospital located in a LMI may have a for-profit subsidiary used to conduct the profitable gift shop and parking activities.

[103] The NMTC was established as part of the Community Renewal Tax Relieve Act of 2000 (P.L. 106-554). For information about the application requirements to become a CDE and obtain NMTCs, see https://www.novoco.com/new_markets/resource_files/cde/CDE_Q_A_0705.pdf.

Acknowledgments

The author acknowledges the contributions made by Nils Bjorksten, Robert Dilger, Sean Hoskins, Sean Lowry, Edward Murphy, and Jared Nagel.

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