

EXPANDING SME ACCESS TO CAPITAL THROUGH THE COMMUNITY REINVESTMENT ACT (CRA)

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ABSTRACT

The Community Reinvestment Act (CRA) of 1977 aims to equalize opportunities for small business credit regardless of community income. CRA regulation and bank reporting attracts debate from the banking industry, community activists, and economists and is an appropriate concern for entrepreneurship scholars. Bank performance data show mixed results for small businesses in LMI areas and raise questions about underutilization. The CRA has undergone reforms that attempt to reflect the realities of the credit market and the banking industry. These new rules incorporate the community activist' desire to strengthen the CRA while decreasing the CRA's administrative burden satisfying the banking industry.

INTRODUCTION

Has the Community Reinvestment Act of 1977 (CRA) regulation become ineffectual, inefficient, irrelevant or superfluous? This analysis considers the CRA and its intended role in exacting accountability and stimulating change in bank lending practices. The paper considers the implications of changes in the financial services industry as it evolves and consolidates forms and geographic reach. The analysis also asks whether CRA regulation is needed for non-banking institutions or whether they can be expected to serve small businesses in Low and Moderate Income (LMI) and minority and underserved areas.

History and Legislative Overview

The Community Reinvestment Act of 1977 (CRA) was a response to concerns that banking institutions were, in some instances, failing to adequately seek out and meet the credit needs of viable lending prospects in all sections of their communities. The CRA gives enforcement authority to the four federal regulators of banking institutions to encourage the federally insured institutions to meet community credit needs in a manner consistent with safe and sound operations. The CRA requires regulators to evaluate CRA performance in routine regulatory examinations and when considering a bank's requests for charters, mergers, acquisitions, branch openings, office relocations, or deposit insurance coverage. Legislative changes to CRA in 1989 required regulators to publicly disclose the institution's rating and performance evaluation, thereby harnessing the power of public relations to the CRA's goals. The CRA responded to a concern about depository institutions transferring funds outside the communities in which the funds were obtained. The CRA emphasized *communities*, not race ethnicity, gender or other protected categories. (Hearings on S.406 before the Senate Committee on Banking, Housing and Urban Affairs, 95th Congress 133 (1977))

Critics of the CRA have argued against regulation contending that the law saddles banks with large compliance costs and that unfettered credit markets would properly allocate credit without ponderous government regulation. Banks are declining in importance as sources of capital within the U.S.

financial system makes regulation superfluous. Yet, the CRA's relevance stems from its economic impact on low and moderate income (LMI) neighborhoods and financial institutions subject to CRA regulations, but also from its fusion of economic and social policy.

Market failure results, in part, from the positive externalities associated with lending in LMI areas that are not internalized by lenders. Lending to LMI areas suffers from the informational asymmetries inherent in bank lending: borrowers know more about their probability of loan repayment and of the expected profitability of their investment than do lenders. Informational asymmetries can cause lenders to ration the amount of credit they provide to potentially high-risk customers. Government regulations can buffer the effects of the withdrawal of credit.

II. CRA Scope and Process

The Community Reinvestment Act is circuitous and opaque. The CRA ascribes to any bank that receives federal deposit insurance a "continuing and affirmative obligation to meet the credit needs of the local communities in which [it is] chartered." The statute, however, does not further specify the obligation, simply directing the regulators to "assess" each institution's compliance.

Banks must define an "assessment area" that includes their major activities and does not gerrymander out LMI communities. A bank can receive one of five ratings ranging from "outstanding" to "substantial noncompliance" based on *lending*, *investment*, and *service* activities within the area, with lending activities weighed twice as much as the other two. Examiners use four factors in assessing lending: (1) the ratio of loans made within the assessment area to deposits (the "loan-to-deposit ratio"), (2) the percentage of loans in the assessment area (the "concentration ratio"), (3) the percentage of census tracts within the assessment area in which loans were made (the "penetration ratio"), (4) the percentage of loans made to low and moderate income borrowers and to borrowers within census tracts with low or moderate average incomes.

The rating process depends largely on debatable qualitative judgments, and the regulators are often accused of inconsistency, arbitrariness, and favoritism. Uncertainty is increased by the statute's failure to specify a clear sanction for poor CRA performance. The CRA does not include strong enforcement mechanisms common to other antidiscrimination statutes. The statute provides only an invitation to the regulators to consider CRA performance in deciding on a bank's application to open or relocate a branch, to merge with or acquire another bank, or to establish a bank holding company. However, the pervasive restructuring in the industry has made such regulatory approvals attractive. Few applications have been denied on CRA grounds, but the prospect of adverse action, denial, or even delay, has motivated many banks to strive for a respectable CRA rating. The motivation was intensified by the 1995 regulations, which appeared to signal an intention by the regulators to enforce more vigorously. By one estimate, the CRA induced \$35 billion in lending and investment in traditionally under-served communities between 1977 and 1993. Community groups have taken a role as enforcers of the Act. These groups have carefully scrutinized bank lending records, urged banks to adopt lending programs designed to meet the needs of LMI communities, assisted banks in marketing the lending programs, participated in banks' CRA exams, filed written challenges opposing bank mergers with the banks' regulatory agencies, and negotiated lending agreements with banks.

III. Measuring Small Business Lending under CRA

Use of a financial service is measured by the percentage of small businesses using a specific type or source of service. Other measures of use can be constructed from dollar amounts or the number of accounts. Dollar measures will be available and analyzed later, but significant differences between results based on dollar amounts and results based on the percentage of firms are not expected; the 1987 NSSBF data yielded similar conclusions when based upon either measure (Scott, Dunkelberg & Dennis 2003).

Institutions may have different internal definitions of small-business or community-development loans. This paper focuses on the loans that are reported to CRA for CRA purposes. Small-business loans are loans for which the original loan amount was \$1 million or less and that were reported on an institution's Consolidated Report of Condition and Income (Call Report) or Thrift Financial Report (TFR) as either "Loans secured by nonfarm or nonresidential real estate" or "Commercial and industrial loans."

Examiners prefer that the majority of an institution's small-business loans be within the Assessment Area and address the specific needs of the community, especially before lending beyond the Assessment Area. An institution's CRA performance is compared to that of its peers, including banks of similar size and location. A lending institution's improvement over time is considered, with performance history demonstrating ongoing commitment to meeting the needs of its community. Peer comparisons and improvement often become more important considerations when a bank's lending performance is low. Because small-business and commercial lenders may have a significant effect on the lending and service tests, we will focus most heavily on these aspects of the overall performance evaluation.

IV. Analysis of CRA Data on Lending Patterns

The CRA regulations require larger commercial banks and savings associations to report data on their small business, small farm, and community development lending. Those who are subject to these requirements generally include independent institutions with total assets of \$250 million or more and institutions of any size if owned by a holding company that has assets of \$1 billion or more. Under the CRA regulations, small business loans are loans of \$1 million or less; small farm loans are loans of \$500,000 or less. The small business and small farm lending data, coupled with information reported about the geographic locations that constitute each reporting institution's local CRA assessment area(s), make it possible to better evaluate the performance of reporting institutions under the CRA lending test. While CRA data provide information on extensions of credit in a geographic area, they do not indicate the amount or nature of the overall *demand* for credit there.

The total number of lenders reporting small business and small farm loans in 2003 increased 6 percent to 2,103, from 1,986 reporting in the previous year. Data from 2000 to date demonstrates the number of reporting institutions extending loans. In 2003, reporting lenders consisted of 1,635 commercial institutions (a 9 percent increase over 2002), and 468 savings associations (representing a decrease of 5 percent over in 2002).

Analysis of Call Report data on small loans to businesses and farms indicates that CRA reporters account for about 91 percent of the small business loans outstanding measured by number of loans (77 percent measured by dollars). In the aggregate, about 8 million small business loans, totaling

\$279 billion were reported for 2003. The number of small business loans granted in 2003 reflects a 6 percent increase over 2002, while the dollar amount reflects an increase of 10 percent, year-over-year. Reported loans include both loans originated and loans purchased during 2003. For small business loans, the maximum loan size reported is \$1 million. In 2003, the average small business loan was approximately \$34,800, falling short of the prior three-year average of \$35,151. Measured by number of loans, 93 percent of the small business loans and 83 percent of the small farm loans were for amounts under \$100,000. Measured by dollars 32 percent of the small business loan dollars through loans of less than \$100,000. (FFIEC, 2004.).

For 2003, 38 percent of the reported small business loans (measured by number of loans) were extended to firms with revenues of \$1 million or less. The data also show that, on average, loans to firms with revenues under \$1 million are larger than loans to larger firms. For 2003, the average business loan to small firms was about \$42,250 while the average loan to larger businesses was roughly \$30,300. This relationship is contrary to expectations and to relationships found in years prior to 2000 when loans to small firms were on average about two-thirds the size of loans to larger firms. The pattern found in the 2003 data (as well as in the 2001 and 2002 data) reflects a substantial increase in the volume of credit card lending to larger businesses. Most of the reported small business loans (about 78 percent measured by number of loans and 92 percent measured by dollars) were either originated or purchased by commercial banks (data not shown). Larger commercial banks and savings associations (with assets of \$1 billion or more) originated or purchased about 76 percent by dollars of the reported small business loans. These larger banks and savings associations represent a minority of the institutions reporting such loans. No significant differences between commercial banks and savings associations were observed; larger institutions did the majority of small business lending within their institutional categories (data not shown). These patterns are little changed from previous years.

The 2003 CRA data show a large increase (about 170 percent) over the 2002 data in the total number of small business loans purchased. Nearly all of the increase occurred in loans of \$100,000 or less due to the purchase of small business loan portfolios by two large commercial banks. The proportion of small business loans made to smaller firms declined to 38 percent, down sharply from a high point of 60 percent in 1999, but up from 31 percent in 2002. The decline in the share of lending to small firms since 1999 is primarily the result of a substantial increase in reported lines of credit, renewals of such lines with larger limits, and credit card lending to larger firms.

Geographic information on business and farm loans can indicate the lending across areas by their socio-demographic and economic characteristics. CRA performance assessments include an analysis of the distribution of small business and small farm loans (of all types) across census tracts by income. The distribution of the number and the dollar amounts of small business loans parallels the distribution of population and businesses across four income groups. Low-income areas, for example, include about 4.6 percent of the population and about 4.2 percent of the businesses, but received about 3.6 percent of the number and about 4.4 percent of the total dollar amount of small business loans.

Small business lending in low- and moderate-income areas remained about the same in 2003 as in 2002, measured both by total number of loans and total dollar amount. The same year-over-year pattern is observed in middle- and upper-income areas. Small business loans are heavily concentrated in U.S. central city and suburban areas (about 83 percent of the number or dollar amount of all small business loans), as are the bulk of the U.S. population and the number of

businesses. In lower-income areas, most small business loans (about 86 percent) occur in central city census tracts. In higher-income areas, small business loans are most frequently made in suburban tracts.

V. The Criticism and Limitations of the CRA

Since its inception, the CRA has been criticized by the bankers it seeks to regulate and by the communities it is supposed to help. The banking industry decries the administrative burdens imposed by the CRA, while community groups fault regulatory agencies for lax and ineffective enforcement. Economists focus on the socialist philosophy of mandatory reinvestment calling it a "governmentally-imposed credit allocation" coercing "a private sector industry... into providing a service which contradicts the dictates of the marketplace. Forced allocation of capital ... is at best damaging to a financial institution and at worst a publicly mandated redistribution of wealth." (Macey and Miller, 1993)

The CRA regulations and evaluative criteria result in performance evaluations that do not accurately demonstrate how a bank is complying with the CRA. One argument is that the federal banking agencies do not evaluate a bank's record of lending to *minority* clients when conducting the bank's CRA performance evaluation. Other federal and state regulations and laws that prohibit discrimination do not, like the CRA, place an ongoing obligation on lenders to meet the credit needs of minority individuals or neighborhoods absent a finding of prior discrimination. A related critique is that the CRA does not employ a standard set of quantitative data when evaluating a bank for compliance, such as the number or percentage of loans a bank makes in LMI neighborhoods, or the bank's market share of loans to LMI persons or in LMI neighborhoods. In this regard, it is difficult to determine which data the federal banking agencies used to evaluate a bank's CRA performance. Banks and community groups agree that CRA ratings are left to the subjective judgment of the bank's examiner. Community groups believe that federal banking agencies assign banks higher ratings than they should.

Banking industry officials agree with the economists, but raise several other issues. Administration and substantial paperwork required by the CRA, are their number one compliance burden. The vagueness of the CRA's language and lack of specificity provides little guidance to bank officers who want to comply with requirements. Vague regulations can lead to inconsistent enforcement and abuse by regulators of their discretionary power. CRA requirements also allow regulators much discretion in their evaluations, making it difficult for bankers to predict which CRA rating they may be granted.

Finally, bankers criticize the CRA's required public disclosure of bank compliance ratings and lending data, claiming community activist groups abuse such information through damaging public opinion campaigns and increased political pressure on politicians and regulators. Both risk and costs rise when groups 'hold bank officers hostage' and demanding approval of potentially unprofitable loans or investment in less than favorable markets. Moreover, such economic activism can precipitate CRA evaluation when a bank wants to charter in a new state, merge with another bank, or open a new branch.

As the financial system shifts from a bank-based to a capital-market based system, smaller firms may have fewer non-bank borrowing options than larger firms. (Yago, Zeidman, Schmidt, 2002) argue that the CRA should be extended to include securities firms and insurance companies because a

failure to do so creates unfair competition. Insurance and securities firms have entered the banking market without having to comply with the onerous CRA requirements. Community groups actually agree with bankers that the CRA should apply to other companies that have access to capital and could therefore strengthen the financial infrastructure of their communities. Community groups also assert that changes to CRA enforcement are required for the CRA to be effective in the banking industry and in the financial services industry as a whole. Recommended CRA reforms include the following: (1) elimination of CRA 'grade inflation'; (2) proportional investments in low-to middle-income communities; (3) public hearings on all major bank applications; (4) public input on bank community development activities; (5) increased disclosure of banking practices; and (6) denial of "safe harbors" and small bank exemptions.

More than ninety-eight percent of banks currently receive a CRA rating of "outstanding" or "satisfactory." Community groups and banks give various contradictory reasons for the overwhelming statistic. Because less than two percent of its industry is rated at "needs to improve" or "substantial noncompliance," banks argue they have succeeded in responding to Congress's initiatives on community reinvestment. Banks could contend they are being vilified for actually doing a good job of meeting local credit needs. Community groups, argue that these statistics alone provide clear evidence of CRA grade inflation. Senator Proxmire postulated at the 1988 Congressional hearings on the status of the CRA that banks have "mastered the CRA examination and evaluation process to guarantee passing ratings, regardless of actual CRA performance." Another implication based on Thomas's (2002) "Friendly Regulator Hypothesis" argues that "bank regulators are more interested in appeasing and becoming friendly with banks than objectively evaluating and rating them." Community groups argue that consistent grade inflating CRA regulators must be held more accountable. Scrutiny and sanctions from regulators should come not only when the CRA rating is low, but when the CRA rating is high. The presumption needs to be shifted to reflect the studies conducted before the enactment of the CRA, which showed banks were generally not active in community reinvestment. Community groups continue to assert that it is necessary to fully effect the goals of the CRA by "the use of a detailed market share analysis mechanism that would require banks to make investments in [low-to moderate-income] communities proportional to the bank's total assets." Additionally, holding public hearings on all major bank applications, seeking and considering public input on bank community development activities, increased disclosure of banking practices, and denial of "safe harbors" and small bank exemptions would further strengthen the CRA's effectiveness.

The 1999 Federal Reserve Board study on the profitability of CRA lending reported that the majority of lending was profitable, "pleasing the double bottom line - social impact and financial rewards" (Avery, Bostic, Canner, 2003.) The 1999 FRB survey, the first systematic collection of information on the characteristics, performance, and profitability of CRA special lending programs from a broad base of institutions, provides a unique opportunity to learn about such programs. The 143 respondents offered or participated in 622 CRA special lending programs. Seventy-three percent of the responding institutions offered at least one CRA special lending program, while on average the institutions with programs offered about six programs. To limit the burden of responding to the survey, the survey sought detailed information on only the five largest of a banking institution's CRA special lending programs (measured by dollar volume of originations in 1999), a restriction that produced detailed information for 341 programs. These 341 programs may account for 91 percent of the loan dollars that responding institutions extended under CRA special lending programs in 1999. (Immergluck and Smith, 2001)

So What: Why Be Concerned about CRA and Bank Lending?

Information can be a critical tool for small business decision-making. Revisiting the CRA regulatory, reporting and assessment process allows for an examination of the value added by such information in borrowing/lending decisions. The Chief Economist for the SBA's Office of Advocacy (2005) argues "This type of information [*upon which banks are making small loans*] helps small business save time and shop efficiently for credit and it helps the banking sector understand the competition in their markets." Small business lending by banks is an important topic in small business finance. Small business lending is important because it promotes business and job retention, and in due course, capital retention in the local community. These factors promote sustainable businesses, viable neighborhoods, and the capacity to reap long-term returns. Providing the means for small businesses to stabilize and grow in LMI neighborhoods is essential to slow the outward flow of capital from communities. Shuman (2000) refers to the loss of assets from poor communities as their central problem. Community banking and small business development can reverse the outward flow of consumer spending from a neighborhood in ways that large business cannot. Branch and local banks are important to LMI communities because they support the goal of asset accumulation through delivery of financial services to SMEs within their own communities.

Many authors have documented the important role of larger banks in small business finance. As banking industry consolidation continues, we will need to track the impact of this process on SME access to capital and their loan seeking behavior. Cole and Wolken (1995) found that small firms are more likely to obtain financing from a commercial bank than from other sources. It has been emphasized that banks and SMEs benefit from long-term relationships in that they can reduce costs because both share better information about each other. Relationship lending has been studied by Greenbaum, Kanatas, and Venezia (1989), Petersen and Rajan (1994, 1995), and Boot and Thakor (2000) stress the presence of information asymmetries between borrowers and lenders and assert that banking relationships can overcome the problems associated with providing small business credit. Ely and Robinson (2001) point out that relationship lending has assumed that larger, more complex banks might find the gathering and monitoring of information for nonstandard small business loans too expensive.

CONCLUSIONS

During the last twenty-five years, the CRA has attempted to equalize the opportunities for credit in communities of all income. However, no legislation charged with the noble task of correcting pervasive economic injustice is without its flaws. The CRA has endured strong criticism from the banking industry, community activists, and economists. As a result, the CRA has undergone some reformation to better reflect the practical realities of the credit market and the banking industry. These new rules have incorporated the community activists' desire to strengthen the CRA and have decreased the CRA's administrative burden satisfying the banking industry. We started this investigation based on a question about why more borrowers did not seek or lenders seek to extend small business loans in compliance with CRA expectations. While this exploration is informative about change in the banking industry and implementation of banking enforcement and compliance practices, the data did not provide a clear basis for answering our initial question. A study of qualitative data may be needed to determine why this loan source is underutilized relative to the housing/real estate lending features of the CRA.

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