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Synergy and Friction –
The CRA, BHCs, the SBA, and community Development Lending

By Cassandra Jones Havard*

I. Introduction

The assumption of the Community Reinvestment Act ("CRA")¹ is that if geographic disinvestment is illegal, federally insured financial institutions will lend more funds in low- and moderate-income neighborhoods.² Geographical disinvestment occurs when financial institutions choose not to invest in certain geographical areas.³ The CRA

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² See, e.g., S. Rep. No. 95-175, at 33 (1977) ("[T]he Committee is aware of amply documented cases of red-lining, in which local lenders export savings despite sound local lending opportunities. Only recently, under the constraint of a lawsuit by civil rights groups and two highly critical oversight reports by this Committee, has the Federal Home Loan Bank Board begun to adopt an anti-red lining program.").

³ When Congress enacted the legislation, most lenders were making loans readily available in affluent or suburban areas while deteriorating inner cities had substantially less access to such loans. See Griffith L. Garwood & Dolores S. Smith, The Community Reinvestment Act: Evolution and Current Issues, 1993 Fed. Reserve Bull. 251, 251 (noting that Congress passed the CRA to ensure that banks are providing appropriate levels of financing to communities and to promote equality in lending, thus eliminating red-lining); A. Brooke Overby, The Community Reinvestment Act Reconsidered, 143 U. Pa. L. Rev. 1431, 1450-51 (1995) (distinguishing disinvestment from red-lining).
requires that federally regulated financial institutions meet the credit needs of their entire community.\textsuperscript{4}

The Home Mortgage Disclosure Act ("HMDA")\textsuperscript{5} (a predecessor to the CRA) and the CRA focused primarily on access to home mortgages.\textsuperscript{6} The more recent Community Development Banking and Financial Institutions Act ("CDBFIA"),\textsuperscript{7} expands the focus of the lending evaluation to place as great an emphasis on personal and small business lending as on home mortgages.\textsuperscript{8} The underlying premise is that to be successful, economic communities need an infrastructure of local businesses that create economic activities and sustain business profits.\textsuperscript{9} Given that premise, a

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\textsuperscript{4} Before the passage of the CRA, the absence of law requiring equal access to credit permitted the controversial practice of red-lining. Banks were therefore free to deny credit in the very neighborhoods that made up their depositor base. See infra text accompanying note 16.

\textsuperscript{5} 12 U.S.C. §§ 2801-2811 (1994). The Act "requires banks and other depository institutions to compile and make available to the public and supervisory authorities information about home mortgage and home improvement lending practices."


\textsuperscript{6} "In 1992, the Federal Reserve Bank of Boston released a detailed study of whether financial institutions in Boston discriminated against individual home mortgage loan applicants." Michael H. Schill & Susan M. Wachter, The Spatial Bias of Federal Housing Law and Policy: Concentrated Poverty in Urban America, 193 U. PA. L. REV. 1285, 1317 (1995). The authors used HMDA data and the "records on individual loan applicants from mortgage originators." Id. The study "found that being black or Hispanic was significantly related to having one’s loan application denied," with blacks and Hispanics "being 56% more likely than whites to be rejected." Id. at 1317-18.

\textsuperscript{7} 12 U.S.C. §§ 4701-4718 (1994) (also known as the Riegle Community Development and Regulatory Improvement Act of 1994).

\textsuperscript{8} Among the Act’s reforms are the establishment of community development financial institutions ("CDFIs"), which serve as alternative lenders for community development projects. See 12 U.S.C. § 4702(5) (1994); infra text accompanying note 66.

\textsuperscript{9} See Anthony D. Taibi, Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice, 107 HARV. L. REV. 1463, 1468 (1994). Taibi argues that the disparities in investment opportunities between low-income communities and other communities is a result of racial, ethnic, or class biases. This disinvestment, he argues, results in a “systematic market failure” that neither the “equality paradigm” nor the “affirmative action paradigm” addresses effectively. Id. The former approach is ineffective because it assumes that competition for resources is the
continuous, successful community development program not only provides equal access to credit, but also results in revitalized low- and moderate-income neighborhoods, small businesses, and farms.\(^{10}\)

The CDBFIA is flawed, however, to the extent that it does not take into account the effect that geographical consolidation of the banking industry will have on small business lending. The easing of geographic restrictions in banking has resulted in fewer institutions.\(^{11}\) Arguably, the concomitant effect on all business lending is a broader credit market and therefore

same regardless of the underlying socioeconomic circumstances. The latter approach is ineffective because "[i]t never questions the structure of marketplaces that routinely produce unacceptable results." \(^{11}\) See also Rochelle E. Lento, \textit{Community Development Banking Strategy for Revitalizing Our Communities}, 27 \textit{U. Mich. J.L. Reform} 773, 775 (1994).

\(^{10}\) See Allen J. Fishbein, \textit{The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement is Needed}, 20 \textit{Fordham Urb. L.J.} 293 (1993) (stating that the premise of the CRA is that banks and savings institutions have a charter obligation to meet the banking needs of their local communities); \textit{see also} Peter P. Swire, \textit{The Persistent Problem of Lending Discrimination: A Law and Economics Analysis}, 73 \textit{Texas L. Rev.} 787, 842 (1995) (arguing that because CRA compliance imposes such a heavy regulatory burden, a "safe harbor" provision, which would allow a party to meet either a general standard or a precise rule of compliance, would encourage financial institutions to invest in low- and moderate-income neighborhoods by decreasing compliance costs while increasing the amount of investment). \textit{But cf.} Jonathan R. Macey & Geoffrey P. Miller, \textit{The Community Reinvestment Act: An Economic Analysis}, 79 \textit{Va. L. Rev.} 291, 319-20 (1993) (arguing that CRA compliance is too costly, making it economically rational for banks not to invest in areas with high-risk returns).

\(^{11}\) See Arthur E. Wilmarth, Jr., \textit{Too Big to Fail, Too Few to Serve? The Potential Risks of Nationwide Banks}, 77 \textit{Iowa L. Rev.} 957, 961 (1992) [hereinafter Wilmarth, \textit{Too Big to Fail}] (analyzing the nationalization trend and resulting mergers); \textit{see also} Activists Are Challenging Bank Expansion on Much More Than CRA Performance, \textit{supra} note 5, at 7 (commenting that the new strategy employed by community activists is to challenge applications for mergers and acquisitions filed by bank holding companies on the basis that such mergers pose a threat to the future of community lending). \textit{But cf.} John A. Buchman, \textit{Can Community Banks Survive? What the Interstate Banking Act Will Mean}, 5 \textit{Bus. L. Today} 44, 44 (Jan./Feb. 1996) (positing that reports that bank mergers will lead to decrease in the number of community banks are "greatly exaggerated").
greater access to funds. However, for small businesses generally, and the community development business in particular, this may not be the case.

Ensuring credit equality to this sector requires closer scrutiny of all aspects of available small business lending. A two-pronged approach is needed. First, the Small Business Administration ("SBA") must specifically recognize community development lending as a preferred goal of its small business loan programs. This would encourage lenders to use the funds for community development business loans, and to a limited extent, discourage them from using the loans in a way that results in geographic disinvestment. Second, a bank holding company should be required to assume CRA responsibility for small business lending. The bank subsidiary's parent company would then have to scrutinize its entire SBA loan portfolio to review the availability of SBA-guaranteed loans in areas where geographical disinvestment might occur. In this Article, I argue that industry consolidation trends require transferring the locus of CRA responsibility for small business lending from the bank subsidiary to the bank holding company. Even though holding companies are closely involved in the CRA performance of their bank subsidiaries, assessing their involvement is crucial so that uniformity of lending in this highly specialized, subjective area of lending may be ensured. Focusing on the holding company also would modulate concerns about perceived riskiness that might result in credit denial to worthy small business borrowers.

This Article begins by evaluating the CRA's policy objectives through various legal perspectives. Part III discusses the recent reform in CRA regulations, reviewing the standards for evaluating a large retail bank's obligations under the CRA and the changes designed to increase credit access for small businesses. Part IV presents a critique of CDBFIA's financing schemes. Part V lays the foundation for my proposal by explaining the SBA's guaranteed loan programs and the CRA's impact when a bank holding company prepares to expand. In Part VI, I propose

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12 According to Taibi, successful "CRA reform both must reduce the discretionary power of bureaucrats and promote community economic empowerment." Taibi, supra note 9, at 1507; see also infra text accompanying note 24.

13 The community development business, as used in this Article, refers to small businesses located in economically distressed areas in need of sustained economic revitalization and development. See also 12 C.F.R. § 228.12(i) (1994) (defining a community development loan under the CRA regulations as, among other things, a loan used for activities that promote economic development by financing small business).
that the bank holding company or the parent company assume a limited but
defined role in promoting the use of federally guaranteed small business
lending. Specifically, the proposal requires that as a part of the merger
analysis, a holding company evaluate for each bank subsidiary the
geographic location of its SBA-guaranteed loans, including those that have
been sold on the secondary market. This data will assist the Federal
Reserve Board ("Federal Reserve") in determining whether SBA-guaran-
teeed lending results in geographic disinvestment. If this proposal is
adopted, the CRA might then become a more effective catalyst for
community economic development.

II. THE JURIDICAL CONTEXT OF
COMMUNITY DEVELOPMENT LENDING

It appears to be a complex task to discern whether race or neighbor-
hood decline is the impetus for credit denial in low- and moderate-income
communities. According to many critics of the CRA, credit decisions are
dictated solely by objective indicators. That line of argument posits that
there ought to be a reasonable causal connection between credit imbalance
in a community and racial disparity in lending. This complex discernment
reveals a disjoinder of these two concepts—the need to recognize and
control the harm of discriminatory lending practices and the subtleness of
that discrimination.14

This Article participates in the debate regarding the effectiveness of the
CRA by providing a concrete policy recommendation regarding the source
of funding for some CRA small business lending. As discussed below,
private lenders exercise much control over which borrowers receive these
funds, while the SBA’s role is limited to acting as a guarantor of the
loans.15 Under the immediate proposal, the SBA’s powers would include
ensuring that participating lenders have credit policies consistent with the
CRA’s objective of discouraging lending decisions based upon the
geography of the loan.

14 See Vincent Di Lorenzo, Complexity and Legislative Signatures, Lending
Discrimination Laws as a Test Case, 12 J.L. & Pol. 637, 662 (1996) (positing that
the ineffectiveness of the prohibitions found in the Equal Credit Opportunity Act
and the Fair Housing Act, combined with the ineffectiveness of the CRA, makes
stringent lending targets appear to be the only plausible way to remedy lending
discrimination).

15 See infra Parts VI and VII.
A. Defining Geographical Disinvestment

The geographical disinvestment component of red-lining is the denial of credit to an individual or business because of the location of the person or property within an identified community. When there is an inadequate flow of capital into a community, loan availability to individuals or businesses located in the neighborhood and neighborhood decline become interrelated. This fusion makes evident the disparities in the credit-granting process.

Another aspect of red-lining, discriminatory lending practices, has traditionally focused on the behavior and attitudes of lenders toward people who live in neighborhoods with declining or depressed property values. This subtle distinction means in effect that the location of the property and race become coefficients. The issue becomes not just whether the CRA has been effective in ending neighborhood decline but also whether the CRA can effectively address fair credit concerns, which focus on effects on individuals rather than on communities.

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16 See Keith N. Hylton & Vincent D. Rougeau, Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act, 85 Geo. L.J. 237, 237 (1996). Defining red-lining as geographic disinvestment focuses on the lowering of a community's property values. Neighborhood decline is a sequential occurrence. This depression in value eventually leads to the community's depreciation through a cycle of decreased expenditures, decline in property values, and abandonment.

17 See Lawrence J. White, The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction, 20 Fordham Urb. L.J. 281, 284-85 (1993) (explaining that lending decisions often have a domino effect—denial by one lender because of a reluctance to invest in the area results in denials by other lenders.)


19 Discriminatory lending practices take different forms. See Jack M. Guttentag & Susan M. Watcher, Redlining and Public Policy 11 (1980). The most common are credit denials based upon the geographical location of the loan: lenders designate areas on city maps that are undesirable for bank loans. A more subtle form of lending discrimination is a lender making a loan under less favorable terms in one neighborhood than in another. Another example is a lender declaring the value of a loan to be lower than the value of collateral. See id. at 7.
B. Assessing the CRA: Three Schools of Thought

The ineffectiveness of the CRA as a remedy to geographic disinvestment stems in great part from the statute’s imprecise language. The statute declares that regulated financial institutions have an obligation to meet the credit needs of their communities. Although few disagree with the public policy goals underlying the statute, CRA scholarship diverges into three somewhat separate theories: economic empowerment, law and economics, and discrimination. The economic empowerment theory evaluates the need for lending based on socio-geographic factors. It views CRA lending as a needed and deserved investment in a community that may have been long neglected due to private and governmental funding priorities. The law and economics model posits that the CRA is obtrusive to the lending process to the extent that it results in a bureaucratic ordering of the private marketplace. Its premise is that the unmet credit needs of the community are due to lenders’ ability to determine that these particular loans would be inefficient or risky performers. Discrimination theory views CRA performance as an offshoot of fair lending laws. Based on a disparate impact test, it finds the absence of lending to low- and moderate-income communities actionable.

The brief discussion of each theory below highlights their most valid reactions to the CRA. The purpose of the discussion is not to provide an evaluation of any one theory. Instead the discussion provides the framework in which to critique the unintended incongruence between the CRA and the SBA. Equity may well demand adherence to the presumptions that underlie both discrimination theory and economic empowerment theory, and market theory properly recognizes the higher initial cost entailed in

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20 As authors Hylton and Rougeau note, several operative terms are undefined in the statute: “How should the regulators ‘encourage’ financial institutions to meet ‘credit needs?’ What exactly are ‘credit needs?’ How should ‘local communities’ be defined and when can a financial institution determine that lending in certain communities is not ‘consistent with safe and sound operation?’” Hylton & Rougeau supra note 16, at 242.

21 For example, Taibi argues that “[w]orking toward real community empowerment must mean more than seeking more efficient and less alienating ways of producing social services and economic development programs for lower-income communities. . . . The financial system should be structured in such a way that local economies are automatically strengthened, without the need for special programs.” Taibi, supra note 9, at 1520.

22 See infra text accompanying note 40.

23 See infra text accompanying note 63.
this type of lending. However, as will be argued in Parts VI and VII, focusing on the access of community development businesses to SBA loan funds provides a concrete means of evaluating their credit access compared to other small businesses using guaranteed loans for funding. This proposed change to the existing SBA statutory scheme, along with a shift of the responsibility for CRA small business loans to the holding company level, should result in making lenders more open regarding access to these federally guaranteed funds.

1. Economic Empowerment

Community groups have been successful in their attempts to oppose bank expansion plans on the basis of the CRA.24 The statute’s express language requiring that financial institutions “help meet the credit needs of the local communities”25 is the basis for community groups’ challenges, both literal and figurative, to the entry of financial institutions into new geographic markets or expansion within the bank’s existing geographic market.26 Community groups argue that the statute presumes that financial institutions have an obligation to evaluate lending along socio-geographic lines.27 Professor Anthony D. Taibi has advanced explicit legal theories based on these previously abstract notions. He attacks the trend toward industry consolidation as a move that will have tremendous socioeconomic consequences for members of poorer communities.28 By viewing geographic disinvestment and community-based action as connected, he concludes that the larger society is responsible for the harm to these communities and must therefore assume this responsibility through a strategy of reinvestment.29

Taibi examines the structure of the financial system from the perspective of community empowerment. His arguments call for a change in

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24 Although few applications have been denied based on such challenges, community groups have used the CRA process to extract promises from banks, both unilaterally and in anticipation of expansion approval from federal regulators. See Taibi, supra note 9, at 1488.
26 See infra Part V regarding the analysis of CRA performance under bank merger laws.
27 The community empowerment theory is based in part on the idea of local determination. See generally Overby, supra note 3.
28 See Taibi, supra note 9, at 1503.
29 See id. at 1505. Taibi criticizes the CRA to the extent that it does not impose requirements on non-bank financial intermediaries.
financial policy through the use of alternative financial institutions, e.g.,
community development banks, community development credit unions,
community development loan funds, and micro-loan funds. He
vehemently and skillfully presents the argument for federal intervention on the
issues affecting lending in low-income or marginalized communities.
Specifically, he argues that a federal approach can and must address these
problems and create new opportunities that address local, community-based
financial concerns.

By viewing wider societal forces as ultimately responsible for the
conditions of low- and moderate-income individuals, the community
empowerment approach seeks funding from outside the community and
direction from within the community. Taibi theorizes that community
organizations involved in self-directed strategies are effective only if those
organizations can also address the structural causes of poverty and
unemployment.

The community empowerment theory advocates a strong supply of
credit from financial institutions. That credit basically serves as a
"reinvestment" to satisfy the economic needs of the community. Taibi's
specific model questions the continued need for economic structures that
do not promote opportunities for economic development in low-income
communities. With control over local credit, community develop-
ment financial institutions represent the economic structure that pro-
motes "independence, local control, and freedom from bureaucratic red
tape."

30 See id. at 1520-28.
31 Taibi calls for "financial institutions that are community specific in their
control, whether in the form of a broad-based community organization or simply
a local business elite focused on profits but informed by a sense of its cultural
roots." Id. at 1469.
32 To date few empirical studies exist that discuss the relationship between the
local depositor base and the local service area of specific banks. In 1992, the
Association of Community Organizations for Reform Now ("ACORN") prepared
a report based on publicly available deposit information and compared that base to
the institutions' lending patterns. See Overby, supra note 3, at 1493 n.294.
33 For example, Taibi argues that "[t]he larger issues of community empower-
ment lie in grappling with the structural forces that increasingly disempower local
communities." Taibi, supra note 9, at 1520.
34 See id.
35 See id. at 1519.
36 Id. at 1522.
The effect of the strategy is to correlate local lending to the deposit base of the bank. This approach presumes that the desire for political self-determination will cause low- and moderate-income people to come together across racial lines. Lack of access to credit will bridge differences among people and result in the shared economic goals and objectives of empowerment. Yet, even if such a scheme is effective, it still leaves undefined, particularly for regulatory oversight purposes, how, other than through lending, a community measures economic empowerment, and therefore ultimately whether the lending has been successful.

2. Law and Economics

Many groups, including most banks, oppose the CRA because it appears to be a bureaucratic reordering of the private marketplace. To the extent that the statute requires a nexus between local deposits and local lending, critics view it as credit allocation. Professors Macey and Miller were among the earliest legal scholars advancing this view.

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37 Taibi challenges several presumptions of the current financial markets, including the “objectivity” of credit standards to marginalized groups. See id. at 1514-17. The reinvestment of funds back into the community requires a nontraditional method of assessing creditworthiness.

38 See id. at 1517.

39 Taibi’s approach suggests evaluating CRA performance by a “determinative requirement that institutions invest a set portion of [loan deposits] in approved [community] investments.” Id. at 1504. Overby argues that the new CRA regulations that evaluate actual lending, investment, and service are similar to Taibi’s proposal. See Overby, supra note 3, at 1507-08.

40 See Macey & Miller, supra note 10, at 347 (arguing that the disadvantages of the CRA outweigh its advantages); White, supra note 17, at 282 (offering an economic perspective of the CRA and arguing that the statute is “fundamentally flawed” because of its stringent requirements on depository institutions). But see Hylton & Rougeau, supra note 16, at 287 (concluding that use of empirical evidence of lending discrimination rather than an economic analysis, may be more useful in monitoring compliance with the CRA and its goals).

41 In support of their main position that the disadvantages of the CRA outweigh the advantages, Macey and Miller argue that credit should be directed to those who value it most. They contend that “proponents of community reinvestment have never satisfactorily explained why the mere fact that funds are obtained from a particular locality ipso facto implies that these funds should be returned to the same locality.” Macey & Miller, supra note 10, at 308. Additionally, according to Macey and Miller, since mutual funds now offer extensive checking privileges, they are a great example of the competition between banks and other financial
Macey and Miller oppose the CRA on several analytic bases, three of which bear particular significance. First, they view as flawed the propositions that banks are local institutions and that bank deposit funds ought to be recycled back into a community in the form of loans. Second, they view the CRA as undercutting banks’ abilities to effectively compete with other financial intermediaries that do not have similar restrictions on lending. Third, they argue that the inefficiency and monitoring costs of CRA-type lending make it an unprofitable business venture for banks and may therefore impact on institutions’ safety and soundness.

The economic analysis of the CRA focuses on the correlation between information in the market and a price-based system. A perfect system would allocate scarce credit efficiently because profit-maximizing borrowers and creditors have perfect information. Borrowers would possess knowledge about the sources of supply, appropriate pricing, and terms. Creditors would possess knowledge about the demand for credit and the creditworthiness of borrowers. Given such an accurate information base, the market reacts rationally through these private borrowers and creditors, who would likewise behave rationally. Ultimately, the market directs credit to the highest users or those that value it highest through the pricing system of interest rates.

The economic model of CRA views the relationship between lenders and the geographic location of the loans as indicative of the highest rate of interest that lenders can earn. The model does not integrate as a variable the source of the funds used for loans. Rates and loan availability are indicative solely of the sum of information about the borrower’s creditworthiness. Lenders making rational judgments based on a system of perfect information need not direct lending toward “local” communities, because the effective monopoly held by depository institutions “has completely broken down as banks and thrifts compete vigorously with one another for deposits . . . . [D]epository institutions have lost an enormously important government benefit that they enjoyed at the time the CRA was enacted.” Id. at 311.

The market makes an immediate adjustment to these needs through appropriate interest rates to reflect the risk involved.\(^{47}\)

Under this theory of perfect information, the CRA’s twinning of the source of funds and local credit needs is unjustified.\(^{48}\) The price-based system allocates scarce credit efficiently and directs credit to users that value it through the pricing system of interest rates.\(^{49}\) Lenders grant credit in areas where they can earn a higher rate of interest and the default rate is lower, regardless of the source of funds.\(^{50}\) Thus, there is no nexus between deposits and loans: A low loan-to-deposit ratio does not indicate disinvestment, but rather an efficient credit allocation system.\(^{51}\)

The pervasive low-income credit problem and a bank’s responsibility to allocate credit fairly do not therefore necessarily include service to underserved groups.\(^{52}\)

The second specific objection to the CRA stems from it being applicable to commercial banks but not other financial intermediaries. While banks must comply with the CRA, financial intermediaries such as pension funds, insurance companies, and mutual funds do not have the same, or even a similar, obligation.

The expanding financial services market impairs banks’ abilities to continually attract depositors for their specific services, since a bank’s products are no longer unique.\(^{53}\) To the extent that the CRA increases compliance and monitoring costs, it decreases banks’ competitiveness.\(^{54}\)

\(^{47}\) See Macey & Miller, supra note 10, at 308.

\(^{48}\) See id. at 309.

\(^{49}\) See id. at 308-09.

\(^{50}\) See id.

\(^{51}\) See id. at 308 (“We would never insist that corn grown in Iowa farm country be returned to Iowa farms. The corn is shipped from the farms, where it is in surplus, to other areas where there is a deficit. It is not clear why credit should be different. Like corn or any other commodity, credit is allocated through a price system that directs the good to the user who values it the most.”).

\(^{52}\) Macey and Miller further argue that where credit is concerned, “the price is the terms that the banker can obtain on loans; and if the banker can earn better terms outside the local community than within, it is difficult to see why the law should deter the transfer of the credit to the higher valued user.” Id.


Macey and Miller argue against the notion that banks have a special significance in the nation’s monetary system. In fact, they argue that the CRA is in effect a “special discriminatory tax” on banks. In this regard, Macey and Miller suggest that banks in poor areas may indeed bear the real brunt of CRA compliance. The requirement that banks lend “locally” translates into poorer neighborhoods being serviced almost exclusively by the banks located in those communities. There is even the possibility that this mandate makes these local institutions the only source of available credit in poor neighborhoods. Because banks must lend in areas contiguous to their offices, banks located in declining neighborhoods are somewhat overburdened.

Third, to the extent that the CRA imposes lending “targets,” economic analysis views the statute as posing a threat to the “safety and soundness” of banks. The argument is that banks should not be required to sacrifice profitability for lending opportunities. In this regard, the low loan-to-deposit ratios in certain communities reflect the reality that banks have not met all profitable local credit needs.

According to economic analysis, much-needed diversification in asset portfolios also undercuts the argument that a bank should make loans to a community that are unprofitable. The bank’s overall economic welfare requires consideration not only of the quality of the bank’s investment strategies, but also of portfolio diversification. The CRA discourages such lending diversification. Again, there is a negative impact on banks located in poor neighborhoods, because the CRA severely limits their opportunity to generate profitable assets through diversified lending.

Economic analysis of the CRA views the statute as laudable, but its implementation as poor because of the government’s intervention. The argument posits that the CRA is unnecessary because the private market can correct the information deficiencies that hamper this particular type of

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55 Macey & Miller, supra note 10, at 312.
56 See id. at 314-15.
57 See id. at 320.
58 See id. at 319-20. However, Macey and Miller contend that “despite the occasional profitable CRA loan, the general effect of the CRA is to reduce depository institution safety and soundness” because “the existence of a few profitable loans will not make CRA activities as a whole profitable if other loans turn out to be unprofitable.” Id. at 320.
59 See id. at 324. Although I have not focused on these issues, Macey and Miller also discuss compliance costs and harm to low-income urban areas as indications of CRA’s ineffectiveness. See id. at 324-33, 340-41.
60 See id. at 294.
lending and can also allocate it fairly to those within low- and moderate-income communities that are deserving of credit.61 As inherently diametric as economic analysis is to fair lending theory, some arguments raised under this theory merit scrutiny, even if paired with different alternatives.62

3. **Fair Lending Theory**

The most recent challenge to banks' discriminatory lending practices has been in the area of fair lending. The Department of Justice ("DOJ") stunned the banking community with its charges against the Chevy Chase Savings Bank and its focus on disparate impact in lending.63 Using civil rights laws and theory, the DOJ argued that the savings bank was engaging in red-lining or discriminatory practices in violation of both the Fair Housing Act ("FHA")64 and the Equal Credit Opportunity Act ("ECOA").65

The specific allegation was that the bank's marketing strategy was discriminatory.66 The DOJ argued that the disparate impact resulted from

61 Macey and Miller do concede, however, that "[t]here is undoubtedly truth to the argument that profitable loan opportunities exist in low-income and moderate-income neighborhoods, and that some of these loans would not be made if it were not for the CRA." Id. at 319.

62 In a specific response to Macey and Miller's criticisms of the misallocation of credit and compliance burdens on banks, Peter P. Swire argues for a "safe harbor" granting automatic favorable approval to banks that have successful records of CRA performance. See Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349 (1993). In order to qualify for this safe harbor, banks would have to commit substantial investments to community development banks and other qualifying investments. The benefits of this approach would include decreased compliance costs while increasing the amount actually spent investing in low- and moderate-income neighborhoods. See id. at 349-50.


66 The DOJ alleged that Chevy Chase had a corporate policy that resulted in no solicitation in the minority communities of Washington, D.C., hired few African-
the financial institution’s failure to address the needs of low- and moderate-income persons, thus making less credit available for these groups.\textsuperscript{67}

Commentary critical of the DOJ’s approach distinguishes the CRA from fair lending. The distinctions properly point out that the protected class is different in the two statutes: the former addresses community concerns, while the latter addresses individual discriminatory concerns.\textsuperscript{68} Unlike the CRA, the FHA requires stringent proof and also imposes monetary sanctions.\textsuperscript{69}

The rather recent DOJ enforcement developments have outpaced legal scholarship in this area. However, before the recent enforcement action, Overby proposed a similar approach, arguing that the CRA is another fair lending statute.\textsuperscript{70} Specifically, she posits that the legislative intent of the CRA, as disclosed in its legislative history, is identical to that of the ECOA. The ECOA prohibits discrimination in lending on the basis of “race, color, religion, national origin, sex or marital status, or age.”\textsuperscript{71} Overby argues that the CRA’s theory of equality comes from its prohibition of any discriminatory lending acts, such as red-lining.\textsuperscript{72}

American loan originators, and implemented a commission structure for loan originators that disproportionately and adversely affected residents of minority neighborhoods. See Teitelbaum, supra note 63, at 1035. Chevy Chase offered information to rebut the DOJ’s claims and indicated that its willingness to settle the lawsuit was motivated by a desire to end any negative publicity resulting from the lawsuit. See Michael B. Mierzwinski & Richard L. Jacobs, What Hath Justice Department Wrought Through Chevy Chase?, 14 No. 3 BANKING POL’Y REP. 8, 11 (Feb. 1995); Teitelbaum, supra note 63, at 1034.

67 The DOJ sought injunctive relief, including requiring the bank to invest eleven million dollars in “African American census tracts in D.C. and suburban Maryland.” Mierzwinski & Jacobs, supra note 66, at 10.

68 Compare the CRA, 12 U.S.C. § 2901 (1994) (requiring financial institutions “to demonstrate that their deposit facilities serve the convenience and needs of the communities”), with the FHA, 42 U.S.C. § 3605 (making it unlawful “to deny a loan or other financial assistance to a person”).

69 See, e.g., 42 U.S.C. § 3613 (allowing imposition of punitive damages for violation of FHA).

70 See Overby, supra note 3, at 1438 (arguing that “equality of access and equality of opportunity should be the guiding justifications for assessing the proper scope of intervention through the CRA”).


72 See Overby, supra note 3, at 1497-98. Senator Proxmire, a proponent of the CRA, said:

[For more than 2 years the Banking Committee has been studying the problem of redlining and the disinvestment by banks and savings
As a fair lending statute, the ECOA prohibits discriminatory actions in all phases of the credit decisionmaking process; loan processing, including intake, underwriting, closing terms, and conditions; sales in the secondary market; and possibly foreclosure. Overby suggests evaluating CRA compliance by monitoring the bank’s outreach efforts to low- and moderate-income communities. Banks would be required to seek lending opportunities in low- and moderate-income communities. They would not be required to lend in such communities unless the loans would be profitable. This efforts-orientated approach clashes with the new CRA’s emphasis on performance standards.

Overby’s approach is limited to providing equality of credit access by focusing on procedure. It balances concerns with targeted CRA lending against the misinformation issues that affect credit availability in low- and moderate-income communities. Concentrating only on the bank’s efforts puts more focus clearly on whether the lending satisfies safety and soundness concerns lending might impose.

This approach allows institutions to evade the CRA when acting with good intentions. Given all the criticism of the CRA, it is tempting to limit enforcement to an efforts assessment. Discrimination theory in the CRA context differs from traditional fair lending theory in that it does not focus on discrimination against a particular individual.

This approach looks towards uncovering bias in the institution’s approach to institutions in older urban communities. By redlining let me make it clear what I am talking about. I am talking about the fact that banks and savings and loans will take their deposits from a community... and they will actually or figuratively draw a red line on a map around the areas of their city, sometimes in the inner city, sometimes in the older neighborhoods, sometimes ethnic and sometimes black, but often encompassing a great area of their neighborhood.

123 CONG. REC. 17,630 (1977).

73 See Overby, supra note 3, at 1518.
74 See id. at 1519.
75 See infra text accompanying note 94.
76 Overby’s analysis includes consideration of the meaning of equality as it relates to a borrower’s access and opportunity and as it relates to the role of community groups. See Overby, supra note 3, at 1506-18.
77 See id. at 1518-19.
providing credit access to low- and moderate-income groups. This focus isolates the discriminatory practice on the basis of a socio-geographic perspective rather than on the basis of race. But the legal theory finds no support without the requisite empirical evidence.

Against this legal and policy backdrop, the discussion turns to the recently amended statute and CRA regulations.

III. THE CDBFIA: AN OVERVIEW

The obligation to comply with the CRA is imposed at the bank subsidiary level. In regularly scheduled annual examinations, it is the responsibility of each bank subsidiary within a bank holding company to show that it is meeting the credit needs of the community it serves. The brief discussion that follows describes the tests that serve as a basis for the evaluation of CRA performance under the recently released standards.

A. The New CRA Regulations

CRA reform resulted in new regulations that measure CRA compliance by using one of four available tests.\(^7^9\) The revised rules change the focus from the bank's recorded efforts to its actual lending performance.\(^8^0\) The regulations allow the institution to elect its standard of evaluation and vary depending on the size of the institution. The performance-based test\(^8^1\) is the default standard. It is used for large retail institutions\(^8^2\) and those that do not elect to be evaluated under a different standard. The community development test\(^8^3\) applies to "wholesale"\(^8^4\) or


\(^8^0\) The new focus evaluates how an agency actually performs its services in low- and moderate-income areas, rather than how well they document their activities in those areas.

\(^8^1\) See 12 C.F.R. § 228.21(a)(1) (1997).

\(^8^2\) Basically, a large retail institution is one that does not meet the definition of a "wholesale," "limited purpose," or "small" institution. See id. § 228.12.

\(^8^3\) See id. §§ 228.21(a)(2), 228.25.

\(^8^4\) The regulation defines a wholesale bank as an institution that "is not in the business of extending home mortgage, small business, small farm, or consumer
"limited purpose" institutions. The small institution test allows banks of a certain size to opt for an abbreviated examination. Finally, the strategic plan test allows an institution to develop its own compliance method, which the examining regulatory agency must approve. Regardless of the standard that the reviewing agency uses, the possible ratings are "outstanding," "satisfactory," "needs to improve" or "substantial non-compliance."

Certain definitions are critical in assessing the bank’s CRA actions. The bank’s "geography" describes the location of the institution or bank-related activity. The geographic dispersion of a bank’s loans is a major factor in determining its CRA rating. The broader the dispersion, the less likely regulators are to conclude that there are unmet credit needs in the geographic community.

The bank’s "assessment area" consists of its geographic locality for CRA performance evaluation. It must include the area in which the bank has its main office, branch locations, and ATMs, as well as areas where the

loans to retail customers." Id. § 228.12(w). The community development test is available to institutions that request designation as a limited purpose or wholesale bank. See id. § 228.21(a)(2). Once designated, the bank retains that special status until it is changed by the bank or until one year after the regulator chooses to revoke that status. See id. § 228.25(b). The test can examine the bank’s community development lending, qualified investments, or community development services. See id. § 228.25(a).

A limited purpose institution is one that provides "a narrow product line . . . to a regional or broader market." Id. § 228.12(o).

A small bank is an institution with total assets of less than $250 million that is either independently owned or is affiliated with a holding company that has total assets of less than $1 billion. See id. § 228.12(t). The small institution test focuses exclusively on lending performance by eliminating the data collection and reporting requirements. The assessment evaluates five criteria: (1) the loan-to-deposit ratios; (2) the percentage of lending activity within the bank’s assessment area; (3) the income distribution of borrowing individuals; (4) the geographic distribution of lending activities; and (5) the asset size distribution of business and farm borrowers. See id. § 228.26(a).

See id. § 228.21(a)(4).

Id. § 228.28.

Geography is defined as "a census tract or a block numbering area delineated by the United States Bureau of the Census in the most recent decennial census." Id. § 228.12(l).

See id. § 228.12(c).
bank has a significant number of home mortgages, small business loans, or farm loans, and, at the option of the institution, consumer loans.\textsuperscript{91}

The “loan location” describes the geographic placement of the loan.\textsuperscript{92} The type of loan determines this placement. A consumer loan is in the geography where the consumer resides, a home mortgage loan where the underlying property is, and a small business or farm loan where the main business facility or farm is found.\textsuperscript{93}

Of the four standards, two – the performance-based standard and the strategic option plan – are most likely to be used by large retail banks. The discussion turns now to how these tests assess CRA compliance.

1. \textit{The Performance-Based Standard}

Under the final rule, a performance-based evaluation system replaces the twelve assessment factors previously used to evaluate the CRA performance of financial institutions. A large retail bank receives individual scores on three separate tests. Those tests are:

(a) Lending Test – The bank’s direct and indirect lending is evaluated, including home mortgage, small business and farm, and community development and consumer loans;\textsuperscript{94}

(b) Investment Test – The bank’s “qualified investments,”\textsuperscript{95} which include investments or grants that principally benefit or address affordable housing or community economic development needs not being met by the private market, are evaluated;\textsuperscript{96}

(c) Service Test – The bank’s systems for delivery of retail banking and community economic development services are evaluated.\textsuperscript{97}

\textsuperscript{91}This revised definition of the assessment area, formerly known as the bank’s service area, is beneficial to banks because it allows them to delineate the area based upon their market activity, or where the bank actually does business. \textit{See id.} § 228.41(c)(2). The regulation specifically prohibits gerrymandering. \textit{See id.} § 228.42. The definition of the assessment area was a subject of much debate. CRA I proposed that the bank be required to include some low- and moderate-income geographies in its service area. \textit{See} 58 Fed. Reg. 67,484 (1993). CRA II proposed that the assessment area include geographies located equidistant from a branch or ATM and its other geographies, even if no business is conducted within those locales. \textit{See} 59 Fed. Reg. 51,256 (1994).

\textsuperscript{92} \textit{See} 12 C.F.R. § 228.12(p) (1997).

\textsuperscript{93} \textit{See id.}

\textsuperscript{94} \textit{See id.} § 228.22(a).

\textsuperscript{95} Qualified investment is defined as “a lawful investment, deposit, membership share, or grant that has as its primary purpose community development.” \textit{Id.} § 228.12(s).

\textsuperscript{96} \textit{See id.} § 228.24(a).

\textsuperscript{97} \textit{See id.}
Each of the three tests has separate performance indicators that are measured within a performance context. The compliance rating for each test is defined by ambiguous, non-numerical standards.

a. Lending Test

The lending test evaluates the bank's lending performance. Although the test focuses primarily on direct lending activity, a bank may also request that the regulatory agency evaluate its indirect lending through its investments in loan pools, lending consortia, and subsidiaries. The lending test also evaluates the bank's lending practices to determine whether they are innovative and flexible.

The test separately measures the bank's volume and dispersion of community development lending and covered loans. The regulatory

98 The performance context evaluates the following factors:
1) demographic data on median income levels, distribution of household income, nature of housing stock, housing costs, and other relevant data . ; 2) lending, investment, and service opportunities in the bank’s assessment area(s) . . ; 3) the bank’s product offerings and business strategy . . ; 4) institutional capacity and constraints, including the size and financial condition of the bank, the economic climate (national, regional, and local), safety and soundness limitations, and [other factors] . . ; 5) the bank’s past performance and the performance of similarly situated lenders; [and] 6) the bank’s public file.

Id. § 228.21(b).

99 The possible ratings are “Outstanding,” “High Satisfactory,” “Low Satisfactory,” “Needs to Improve,” and “Substantial Noncompliance.” Id. § 228.28(a).

100 See id. § 228.22(a), (d).

101 See id. § 228.22(b)(5).

102 A community development loan is defined as “a loan that has as its primary purpose community development,” generally, and has not been reported by the institution or an affiliate under another loan category (except as a multi-family dwelling loan), and “[b]enefits the bank’s assessment area(s) or a broader statewide or regional area that includes the bank’s assessment area(s).” Id. § 228.12(i).

“Community development” is defined as “(1) Affordable housing . . . for low- or moderate-income individuals; (2) Community services targeted to low- or moderate-income individuals; (3) Activities that promote economic development by financing [small] businesses or [small] farms . . . ; or (4) Activities that revitalize or stabilize low- or moderate-income geographies.” Id. § 228.12(h).

103 Covered loans include “the bank’s home mortgage, small business, small farm, and consumer loans . . . in the bank’s assessment area.” Id. § 228.22(b)(1).
agency evaluates an institution’s lending activities using five performance indicators. Those factors include lending activity, geographic distribution, borrower characteristics, community development lending, and the innovativeness and flexibility of the bank’s lending practices.

The revised regulations allow the examining agency to consider other loan data that the institution chooses to provide. For example, a bank may request that its consumer lending activity be examined, if the bank has collected and maintained the appropriate data. An institution may submit for review data on loans outstanding, commitments and letters of credit, and community development loans originated or purchased by a consortia in which the institution participates or by third parties in which the institution has invested.

b. Investment Test

The investment test evaluates whether the bank’s lending has resulted in a benefit to its designated assessment area. After identifying the dollar amount of the institution’s qualified investments, which is independent of the institution’s capital, the innovation and complexity of those investments

104 More specifically, the indicators discern: (1) the number and amount of the institution’s covered loans in the institution’s assessment area; (2) the geographic distribution of covered loans based on the loan location, including the proportion of the institution’s lending in the assessment area, the disbursement of lending throughout the assessment area, and the number and amount of loans in low-, moderate-, middle-, and upper-income geographies in the institution’s assessment area; (3) the distribution of covered loans, particularly in the institution’s assessment area, based on borrower characteristics; (4) the institution’s community development lending, including the number and amount of community development loans and their complexity and innovativeness; and (5) the institution’s use of "innovative or flexible lending practices in a safe and sound manner to address the credit needs of low- or moderate-income individuals or geographies." Id. § 228.22(b).

105 See id. §§ 228.22(a)(1), 228.42(c)(1).

106 See id. § 228.22(a)(2), (3). The institution may also elect to have the regulatory agency review lending by the institution’s affiliates. See id. § 228.22(c). Likewise, under both the investment test and the service test, if the bank so elects, the Board can review a qualified investment made by the affiliate of the bank, if the qualified investment is not claimed by any other institution. See id. §§ 228.23(c), 228.24(c).

107 Contributions made to help promote community development include investments, deposits, membership shares, and grants. See id. § 228.12(s).
is considered. The qualified investments are then considered in connection with the community’s credit needs and the institution’s responsiveness to those needs.

c. Service Test

The service test evaluates the institution’s performance of community development services. The test has two parts, the actual delivery of retail banking services to the public and the resourcefulness of that delivery.

In assessing the actual delivery of banking services, the regulatory agency focuses on the physical location of the institution and the range of services in low- and moderate-income neighborhoods. Specifically, the

108 See id. § 228.23(e)(2).
109 This test evaluates the degree to which lending relieves a deficiency in the community’s unmet credit needs. The four criteria are: “(1) the dollar amount of qualified investments; (2) the innovativeness or complexity of qualified investments; (3) the responsiveness of qualified investments to credit and community development needs; and (4) the degree to which the qualified investments are not routinely provided by private investors.” Id. § 228.23(e).
110 “Community development services” are defined as those services that have a “primary purpose [of] community development” and are “related to the provision of financial services.” Id. § 228.12(j). Qualifying community development services include “lending executives to organizations facilitating affordable housing construction and rehabilitation or development of affordable housing; providing credit counseling, home maintenance counseling, and/or financial planning to promote community development and affordable housing; and low-cost or free government check cashing.” David E. Teitelbaum & John M. Casanova, Regulatory Reform or Retread? The Community Reinvestment Act Regulations, 51 BUS. LAW. 831, 836 (1996). These community development services “must benefit a bank’s assessment area(s) or a broader statewide or regional area that includes the bank’s assessment area(s).” 12 C.F.R. § 228.24(b).
111 See 12 C.F.R. § 228.24(a).
112 The regulatory agency evaluates the bank’s availability and effectiveness in delivering retail services by considering:

(1) the current distribution of the bank’s branches among low-, moderate-, middle-, and upper-income geographies; (2) the bank’s record of opening and closing branches; (3) the availability and effectiveness of alternate systems for delivering retail banking services in low- and moderate-income geographies and to low- and moderate-income individuals; and (4) the range of services provided in low-, moderate-, middle-, and upper-income geographies and the degree to which the services are tailored to meet the needs of those geographies.
focus is on the institution’s record of branch openings and closings, its range of services, and its provision of alternative service options, such as ATMs and computer or telephone services.\[^{113}\]

In addition to the test outlined above, the new regulations also changed the information that banks that are part of a holding company must report regarding their CRA small business lending. Previously, all institutions reported annually to the appropriate regulatory agency their total business lending. That report required identification of the dollar volume and size of all outstanding business loans. Under the revised regulations, certain institutions must also make available data about the size and the geographic location of their small business loans.\[^{114}\] The requirement does not extend to all banks because it was determined that only certain institutions engaged primarily in small business lending.\[^{115}\] As will be discussed below, this revision is not extensive enough to determine small businesses’ access to capital.\[^{116}\]

A large retail bank is not limited to the performance test as an assessment of its CRA strategy. It has the option of using the strategic business plan test, which is described below.

2. *The Strategic Business Plan Test*

The strategic business plan test is available to any institution that elects to submit an individual compliance plan to the regulatory agency. It is the most innovative of the reform measures because it allows the bank to develop its own compliance plan with annual, measurable goals.\[^{117}\] The institution also establishes or defines satisfactory performance under the plan.\[^{118}\] The safeguard for banks that choose this option is that if they fail under the plan, they may be evaluated under the lending, investment, and service plan tests.\[^{119}\]

The strategic business plan test requires more initiative on the part of the bank and more involvement on the part of the community that it serves.

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\[^{113}\] See id.

\[^{114}\] See id. § 228.11(c)(3).

\[^{115}\] See discussion *infra* at Section V.

\[^{116}\] See *infra* at Section V.

\[^{117}\] See 12 C.F.R. § 25.27(c)(1), (f)(1).

\[^{118}\] See *infra* at Section V.

\[^{119}\] See *infra* at Section V.
In order to develop a strategic plan, a bank must (1) conduct informal meetings with the community to identify credit needs;\textsuperscript{120} (2) establish specific, measurable goals;\textsuperscript{121} (3) solicit formal comments from the public on the plan;\textsuperscript{122} and (4) receive approval from the Office of the Comptroller of the Currency ("OCC").\textsuperscript{123} Although the OCC may approve the plan, the institution is also subject to the regulatory agency's interpretation.\textsuperscript{124}

The strategic option plan offers the greatest amount of control and independence in the CRA regulatory process. It may not result in the anticipated innovation in community development lending, however, because it fails to reward banks for taking the risks associated with innovative lending. The plan's short implementation time frame, mandatory public disclosure, and lack of specific guidance are all disincentives for institutions to attempt a CRA strategic option plan.\textsuperscript{125}

The CRA regulations give the bank subsidiary partial discretion in the evaluative method used and complete discretion in choosing how to carry out the obligation. The institution has much less control over how the examiner will evaluate its choice. The next section discusses some of the schemes available to banks setting up CRA compliance programs.

B. Community Development Financing

Various existing entities engage in community development financing. The community development bank network provides low- and moderate-income communities with access to capital through a combination of federal funding and private investments.\textsuperscript{126} This section of the Article gives a concise explanation of the recent legislative initiatives designed to facilitate credit access by economically distressed communities.

\textsuperscript{120} See id. § 25.27(d)(1).
\textsuperscript{121} See id. § 25.27(c)(1).
\textsuperscript{122} See id. § 25.27(d)(2).
\textsuperscript{123} See id. § 25.27(a)(2).
\textsuperscript{124} See id. §§ 25.27(a)(2) (requiring OCC approval), 228.27(a)(2) (requiring approval by the Board of Governors of the Federal Reserve System ("Board")).
\textsuperscript{125} See id. §§ 25.27(c) (limiting the term of the plan to no more than five years), 25.27(d) (requiring "public participation in plan development), 25.27(f)(i) (leaving the banks to specify its goals).
\textsuperscript{126} See Jeffrey S. Lesk & Richard M. Price, An Introduction to the Community Development Bank Network, 4 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 267, 267 (1995).
1. Financial Institutions

a. Community Development Financial Institutions

The CDBFIA encouraged the operation of community development financial institutions ("CDFIs") by creating the Community Development Financial Institutions Fund ("Fund") to finance their operation. A financial institution must be designated as a CDFI in order to receive money from the Fund. The Fund provides financial assistance through grants, loans, equity investments, deposits, and acquisition of credit union shares.

A CDFI is a specialized bank whose primary mission is to promote community development by eliminating poverty and meeting community credit needs. CDFIs exist in four basic forms. The two most common, minority-owned banks and community development banks ("CDBs"), are usually depository institutions that are federally insured and regulated.

A third form of CDFI is a community development credit union ("CDCU"). Although CDCUs are regulated financial cooperatives, they are owned and operated by low-income persons to meet check-cashing, deposit, and

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127 See 12 U.S.C. § 4701 (1994). Congress passed legislation appropriating $391 million to support CDFIs over a four-year period. See also id. § 4702 (1994); Lesk & Price, supra note 126, at 268-69. The Fund is a wholly owned government corporation, managed by an Administrator and overseen by a fifteen-member advisory board composed of nine citizens, the Secretaries of Agriculture, Commerce, Housing and Urban Development, Interior, and Treasury, and the Administrator of the Small Business Administration. See 12 U.S.C. § 4703(a)(2), (b)(1), (d)(2) (1994). The statute limits the total amount that any institution may receive to no more than $5 million for any three-year period. See id. § 4707(d)(1). An exception to the funding limitation is allowed for the establishment by the CDFI of certain subsidiaries or affiliates to serve a "targeted population" or an "investment area" in another state or metropolitan area not currently served by the institution. See id. § 4707(d)(2).

128 See Lesk & Price, supra note 126, at 269.


130 A CDB operates specifically to provide capital to rebuild lower-income communities and commonly is a subsidiary of a bank holding company. See Taibi, supra note 9, at 1523.
The fourth type of CDFI is a community development loan fund, an "unregulated and uninsured financial intermediary" that pools capital and contributions from banks, investors, and foundations to provide equity, bridge loans, or below-market financing to promote the development of affordable housing and the revitalization of retail stores or other small businesses in distressed communities.

Designation as a CDFI requires that an organization meet certain prerequisites. The institution must identify its primary mission as community development and either have an identifiable investment area or serve a targeted population. In addition to financial services, a CDFI must also provide development services in conjunction with loan or equity investments and maintain community accountability through community representation on its governing board. The statute specifically prohibits a CDFI from having a government affiliation.

A CDB readily meets the definition of a CDFI. A CDB is a private commercial bank that actively engages in community development lending. Its organizational structure may include nonbank subsidiaries.

131 See id. at 1523-25.
133 See id. at 1525.
133 See 12 U.S.C. § 4702(5) (1994). "Investment area" is defined as an area that "meets objective criteria of economic distress." Id. § 4702(16). "Targeted population" is defined as "individuals, or an identifiable group of . . . low income persons." Id. § 4702(20).
134 See id. § 4702(5).
135 See Taibi, supra note 9, at 1522. A community development bank ("CDB") is the most comprehensive of the CDFI models, because of its ability to utilize funds from affiliates to develop the community. See id. In 1993, President Clinton introduced a proposal to create 100 CDBs. The President proposed that these banks should be modeled after existing similar successful banks, particularly Shorebank of Chicago, a bank holding company. See Paul Wiseman, Chicago Bank Redefines Role in Community, USA TODAY, Jan. 8, 1993, at lB. The President's proposal was not made blindly. During his governorship in Arkansas, President Clinton solicited the help of Shorebank in establishing a rural development bank – the successful Southern Development Bancorporation. See Lesk & Price, supra note 126, at 267. Shorebank's subsidiaries offer community and economic development programs, such as affordable housing programs, a real estate company focused solely on economic development, and financing for small businesses through the Minority Enterprise Small Business Investment Corporation. See id. Backed by unlimited access to capital, and with the help of South Shore Bank, an affiliate of Shorebank, Shorebank has helped rehabilitate over 8000 apartment units. See Wiseman, supra, at 1B. South Shorebank's nonperformance loan rate is under 2%, 1.5% less than the financial industry's average. See Lesk & Price, supra note 126, at 268;
but because the entire enterprise is engaged in community development lending, it qualifies as a CDFI. The advantage of the CDB organizational form is that as a federally insured financial institution, the bank has unlimited access to capital and credibility as a lender within the community.

A bank holding company can qualify as a CDFI only if the holding company and all of its subsidiaries and affiliates satisfy the requirements of a community development financial institution. Since most banks do not qualify for such a designation, the alternative for most banks is for the financial institution or its holding company to become a "community partner" by providing loans, equity investments, or development services to the relevant investment area or targeted population.

An institution becomes a CDFI by filing a Comprehensive Strategic Plan ("CSP"). The CSP is a five-year business plan that identifies community needs and describes how the financial institution will meet those needs. The CSP requires an integrated approach: the CDFI's goals must be consistent with other applicable economic, community, and housing development plans.

Investment in a CDFI provides a safe harbor for bank holding companies and state-chartered Federal Reserve Banks. Equity investments in a CDFI are permitted without Federal Reserve approval within certain limitations. The contributions may amount to an aggregate of five

Wiseman, supra, at 1B.

136 See 12 U.S.C. § 4702(5)(A) (1994). Citibank is one of the many banks that have taken advantage of the new regulations concerning CDBs. It will receive community lending credit for its investment in a non-profit CDFI in Chicago that lends to home buyers and small businesses in distressed communities. See Gwen A. Ashton, Developments in Banking Law: 1996, 16 ANN. REV. BANKING L. 1, 3 (1997).


139 See id. § 4702(6); Lesk & Price, supra note 126, at 270.


141 The CDFI Fund reviews the applications of the institutions and evaluates them according to the statutory criteria: likelihood of success, need for equity investments, loans, extent of economic success, and geographic diversity. See id. § 4706(a). The statute also imposes reporting requirements and sanctions for violations of performance goals. See id. § 4707(f)(1)(B), (2)(c).

142 See Lesk & Price, supra note 126, at 272.
percent of a bank’s capital stock and surplus; individual investments must not exceed two percent of the bank’s capital stock and surplus.\textsuperscript{143} The holding company investment is similarly limited to five percent of the company’s consolidated capital stock and surplus.\textsuperscript{144}

Most financial institutions will find the CDFI organizational structure too limiting. The entity of choice for most bank holding companies is, therefore, the community development corporation, which is discussed below.

\textit{b. Bank-Affiliated Community Development Corporations}

Even before the passage of the CDBFIA, bank holding companies were allowed to operate nonbanking subsidiaries engaged in economic development activities.\textsuperscript{145} The CDBFIA did not affect the organization of these entities: they may qualify as a community partner under the statute. A CDB allows a bank holding company to make an equity contribution that might qualify as satisfying part of the investment test under the CRA regulations.\textsuperscript{146}

Unlike a CDFI, a community development corporation (“CDC”) is not a financial intermediary. It is a venture development organization designed to promote and revitalize community development.\textsuperscript{147} A CDC owned by a bank holding company is under the jurisdiction of the Federal Reserve.\textsuperscript{148}

When the Federal Reserve initially approved CDCs as a permissible affiliate operation, its policy goal was to encourage community partnerships between the public and private sectors. The regulations allow equity investments in CDCs or other qualifying ventures\textsuperscript{149} as a way to supplement the bank holding company’s nonequity participation in community

\textsuperscript{143} See id.
\textsuperscript{144} See id.
\textsuperscript{146} 12 C.F.R. § 228.23 (1997). Under the investment test, a bank’s qualified investments may include investments in credit unions or grants that principally benefit or address affordable housing or other community economic needs not being met by the private market.
\textsuperscript{148} See 12 C.F.R. § 228.11(a).
\textsuperscript{149} See id. § 228.24(a).
development. The objective is to minimize losses to the banking enterprise should the riskier community development lending turn out to be unprofitable.

As with other nonbanking subsidiary activities, the regulatory agency ensures that the CDC's operations are consistent with the safety and soundness concerns related to holding company operations. Additionally, any nonbanking affiliate of the holding company must meet a public benefits test in order to receive Federal Reserve approval for operation under Regulation Y.

Like all nonbank affiliates, a bank-affiliated CDC must meet a public purpose test for authorization. This test requires that the nonbank affiliate not engage in activities that unfairly compete with existing financial institutions.

The Federal Reserve Board has approved various activities that satisfy the community development requirement, including providing temporary equity investments in small- or medium-sized businesses in economically depressed areas.

CDCs may operate for profit and may transfer those profits to the holding company. The Federal Reserve does not limit the holding company's use of those profits.

Similar to CDCs, holding company ownership of a community development lending subsidiary also allows bank subsidiaries to participate in nonbanking activities in which their participation as lenders would

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152 See 12 C.F.R. § 225.24(a).

153 See id. Regulation Y, which defines the nonbanking activities that bank holding companies may engage in, defines community development as "[m]aking equity and debt investments in corporations or projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas by providing housing, services, or jobs for residents." Id. § 225.28(b)(12)(i). These are essentially pre-approved activities in which a bank-affiliated CDC can participate.


155 See Fain & Braunstein, supra note 150, at 390.
otherwise be forbidden. A bank-affiliated CDC may make, directly or indirectly, equity or debt investments in projects that satisfy the community welfare requirement.

A CDC may operate in all the geographic markets that bank subsidiaries serve. Under the current Federal Reserve regulations, a bank holding company has some discretion in meeting the disparate needs of economically distressed communities. Operating as a nonbanking subsidiary requires that the CDC promote the community welfare. Community development lending, as defined by the Federal Reserve, directs that the CDC’s lending activities be “designed primarily to promote community welfare.” Commonly permitted activities include “providing housing, services, or jobs for residents” of low- and moderate-income areas.

In the CDBFIA, Congress determined that the community development business lending initiatives also should include incentives for more involvement on the state level as well as in the secondary market. What follows is a brief description of two such proposals.

c. Other Initiatives Facilitating Credit Access

i. The Small Business Capital Enhancement Program

The CDBFIA also established an initiative, called the Small Business Capital Enhancement Program (“SBCEP”), that is administered by state governments and designed to encourage commercial lending. The

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156 See generally 12 C.F.R. § 225.25.
157 See id. § 225.24(a).
158 See id. § 225.25(b)(6).
159 See id.
160 Fain & Braunstein, supra note 150, at 139. “[T]he Federal Reserve does examine all community development proposals to determine whether the planned investment meets the ‘community welfare test,’ whether the size of the investment is appropriate to its purpose and prudent for the institution, and whether there is community involvement in the project or organization supported by the investment.” Id. The Federal Reserve’s definition explicitly exempts from the definition of community development “investments to build or rehabilitate upper-income housing or to develop any facilities not explicitly designed to create improved job opportunities for lower-income persons are presumed not to benefit the public welfare.” Id.
161 12 C.F.R. § 225.25(b)(6).
SBCEP helps small businesses access debt capital from commercial lending institutions by establishing a state loan loss reserve.\textsuperscript{163} The Fund contributes money to a state-designated small business capital access fund. The SBCEP requires that the designated state agency identify and enter into a formal agreement with commercial lenders experienced in the financial and managerial aspects of small business lending.\textsuperscript{164} If a lender charges off a small business loan loss, the institution is eligible for reimbursement from the reserve fund.\textsuperscript{165} By reducing the possibility of loss from poor loan performance, financial institutions in a particular state are encouraged to view small business lending as less risky.

\textit{ii. Small Business Loan Securities}

The CDBFIA encourages the securitization of small business loans by easing the registration and disclosure requirements.\textsuperscript{166} The CDBFIA amendments allow banks to securitize commercial loans to the same extent as residential mortgages.\textsuperscript{167} The effect of the legislation is to increase lending capacity and possibly decrease the cost of small business lending.\textsuperscript{168}

Before the passage of the CDBFIA, commercial loans were subject to registration requirements under the federal securities laws.\textsuperscript{169} Those requirements made the process of securitizing small business loans quite costly. By eliminating the prerequisites to securitization, Congress intended

\begin{itemize}
\item \textsuperscript{163} States participating in the SBCEP must designate a state agency to implement the program. The CDFI Fund will make $50 million available for reimbursement. See id. § 4743(b)(1); Lesk & Price, \textit{supra} note 126, at 271. This program requires CDFI Fund approval and matching funds from the state of one dollar for every two state residents. See 12 U.S.C. § 4743(b)(3).
\item \textsuperscript{164} "Each state must establish a separate reserve fund for each participating" lender. Lesk & Price, \textit{supra} note 126, at 271; see 12 U.S.C. § 4745(b). The state must deposit into that reserve fund premium charges for three to seven percent of each covered loan. See id. § 4745(h)(1).
\item \textsuperscript{165} See 12 U.S.C. § 4745(k)(1).
\item \textsuperscript{167} See David S. Neill & John P. Danforth, \textit{Bank Merger Impact on Small Business Services Is Changing}, 15 No. 8 BANKING POL'Y REP. 1, 17 (1996).
\item \textsuperscript{168} See \textit{id}.
\end{itemize}
to expand small business funding into the broader capital markets, rather than limiting it to banks.\textsuperscript{170}

The development of a secondary market should result in more small business lending. A concomitant result would be more bank participation in small business loan origination. Banks would be able to originate more small business loans, without having to hold onto them.\textsuperscript{171}

While the CDBFIA provides more options for banks performing community development lending, it is not the fully integrated approach that is needed. Before discussing how the federal small business loan programs can fuse with CRA-required lending, I shall identify some of the weaknesses in the legislation.

IV. EVALUATING THE CDBFIA’S FINANCING SCHEME

CDFIs promote community development by defining goals and objectives that match the community’s development needs with the necessary financial resources. Congress funded CDBFIs in order to make more credit available to economically distressed communities.\textsuperscript{172} However, the conclusion that such institutions provide better community development lending than traditional financial institutions may be unfounded. While the stated goal is to stimulate economic development in undeserved communities, its limited funding may hamper that goal.

While CDFIs may obtain some federal financing, they must raise additional monies needed to operate. Financial institutions receive limited CRA credit for making such an investment.\textsuperscript{173} CDFIs must explore and secure financing from private financing sources in order to ensure continuous operation and successful funding of development projects. Small CDFIs will especially suffer as they extend their resources to address management and funding needs.

\textsuperscript{170} See Christopher Beshouri & Peter Nigro, \textit{Securitization of Small Business Loans}, ECONOMIC & POLICY ANALYSIS WORKING PAPER 94-8, 34 (1994) (arguing that the legislative amendments will have the greatest effect on guaranteed small business loans).

\textsuperscript{171} See Cynthia A. Glassman, \textit{Banks Face Serious Challenge in Preserving Key Lending Franchise}, 12 BANKING POL’Y REP. No. 23, at 15 (Dec. 6, 1993). Ms. Glassman also points out that the advantage of creating a government-sponsored agency such as Fannie Mae or Freddie Mac is that there will be a fixed-rate long-term market for the loans. However, this type of stable market might also result in a shift of small business lending out of the banking industry.


\textsuperscript{173} See supra text accompanying note 101.
The special designation required to become a CDFI makes CDFI status difficult for most financial institutions. Additionally, successful commercial banks that have diversified portfolios are disinclined to limit their holdings to the narrow investment area or targeted populations as required for CDFI status.

CDFIs have no way to reduce their risk of loss because of the lack of diversification in their loan portfolios. Although community development lending can be quite profitable, a varied portfolio of loans reduces the threat to the institution’s solvency in the event of an economic downturn.

Likewise, CDCs have a narrow focus. A bank-affiliated CDC may engage in direct community development lending. However, banks have traditionally used these entities to manage their community development services. Often, CDCs provide technical support, necessary services, or jobs for low- and moderate-income development. They also may reduce the search cost for qualified borrowers in a particular area.

A CDC’s community lending may also be hampered by regulatory funding restrictions. Bank holding companies and thrifts are limited in the dollar amount they may allocate to a project. The restriction on parent company funding requires CDCs to become adept at fundraising. Additionally, staff resources must be taken away from core operations and devoted to fundraising efforts.

Similarly, the OCC may prohibit banks from investing in certain CDCs if there is a conflict of interest. A member of the board of directors from one bank may not serve on the board of a CDC if the institution meets certain size requirements. Similar to participation in a CDFI, a bank’s investment in a CDC will reflect only marginally on its CRA rating: it will qualify under the investment test, not the lending test.


CDCs can share the risk of default with the lending institution by participating in the loan. See Overby, supra note 3, at 1450-51 (discussing banks’ past reluctance to make loans in low- and moderate-income areas due to little or inaccurate credit risk information as well as bias); see also supra notes 2-4 and accompanying text.

See discussion in text supra note 131.

See Depository Management Interlock Act, 12 U.S.C. § 3203 (1994); id. § 3204 (listing the exceptions to the rule). The CDC may request a review of the investment from the Community Development Division, which may approve the transaction.

See supra notes 94-116 and accompanying text.
CDCs often face dilemmas in amassing both the funding and the technical expertise to meet their needs. CDCs may be unable to obtain the necessary financing for projects because they lack the required experience base to execute the project. Yet, those same organizations cannot gain experience in developing projects because they are not able to obtain the necessary financing.\footnote{For example, some CDCs attempt to address the needs of the community directly. They engage in real estate development projects such as mini-malls or apartment buildings. Often their inability to employ staff with sufficient technical backgrounds as well as their inability to purchase the special equipment necessary for real estate development are significant impediments to their success. See Schill, \textit{supra} note 174, at 774-75.}

Securitizing small business loans may not lead to greater credit access for small businesses engaging in community development lending. The largest beneficiary of this change will be the small business venture capital firm, known as a small business investment company ("SBIC").\footnote{An SBIC must have combined private paid-in capital and paid-in surplus of not less than $5 million. \textit{See} 15 U.S.C.A. § 682(1)(A) (West 1997). For a discussion of SBICs, see generally Joseph W. Bartlett, \textit{Government-Enhanced Equity Available for Investment in Traditional Venture Capital and Buyouts: the New SBIC Participating Securities Program}, 1994 \textit{COLUM. BUS. L. REV.} 589.} Those firms, structured like corporations, are licensed for operation by the SBA.\footnote{\textit{See} 12 U.S.C.A. § 681(c) (West 1997).} SBICs are to provide financial assistance through equity capital or long-term loans.\footnote{\textit{See} 15 U.S.C. § 684(a), (b)(1) (1994).} However, the average SBIC will consider community development loans too risky.\footnote{This is due in part to the repeal of statutory provisions authorizing special financing that encouraged SBICs to engage in community development lending. Elijah Brewer III et al., \textit{Performance and Access to Government Guarantees: The Case of Small Business Investment Companies}, \textit{ECONOMIC PERSPECTIVES} 16, 24 (Sept./Oct. 1996) (finding the performance of bank-affiliated SBICs superior to that of non-bank SBICs).}

What is needed is a secondary market for securitizing community development loans. When lenders have more opportunities to sell these loans in the secondary market, they will be willing to make more of them. A government-sponsored enterprise, similar to Freddie Mac or Fannie Mae, would make this lending more attractive to lenders and investors. Similarly, easing the registration requirement for community development loans sold on the secondary market, while perhaps making the requirements more stringent for other types of lending, is another way to facilitate credit access for this specific type of lending.
Although each of the programs discussed above has a significant part to play in broadening credit access for small businesses engaged in community development lending, the limitations mentioned above are significant enough to merit a critical discussion of alternatives. Focusing on the existing small business loan guarantee programs that enhance credit access for small business lending is one such alternative.

V. FUSION—USING GUARANTEED, LEVERAGED FUNDS TO PROMOTE COMMUNITY DEVELOPMENT LENDING

There is without question a move towards fewer, larger banks. The concern that small businesses' access to capital will be affected by industry consolidation is tempered by industry statistics to the contrary. Many point out that the number of capital sources to which small businesses have access is increasing. Arguably, the lending practices of a consolidated industry will harm small businesses in economically distressed communities more than small businesses not located in such communities. Eventually, accompanying the compression of the industry will be less merger activity and a dilution of the CRA because there will be no urgency for holding companies to show the strong CRA performance that was necessary as a condition of merger or branch approval. Given the industry transformation, a changed perspective regarding the holding company's direct involvement in the CRA is warranted.

184 See Arthur P. Wilmarth, Jr., Too Good to Be True? The Unfulfilled Promises Behind Big Bank Mergers, 2 STAN. L.J. BUS. & FIN. 1 n.170 (1995) [hereinafter Wilmarth, Too Good to Be True?] (noting that a study, which was confined to the states of Illinois, Kentucky, and Montana, concluded that small businesses seeking loans from out-of-state bank holding companies do not have a competitive disadvantage in lending).

185 See S. REP. No. 103-332, at 3408-09, 3411 (1994).

186 The recent bank consolidation trend may impact small business lending for at least three reasons. First, Congress removed the historical geographical restrictions in the industry. With the passage of the Riegle-Neal Interstate Banking andBranching Efficiency Act of 1994, bank holding companies may acquire or merge with other banks in any state without authorization. Second, banks face more competition from nonbanks in providing services to customers. Finally, the technological innovations in banking are costly, but necessary as consumers demand more advanced products and services. Only profitable banks may engage in these innovations. See generally Wilmarth, Too Big to Fail, supra note 11, at 1040-44.

187 See Activists Are Challenging Bank Expansion on Much More Than CRA Performance, supra note 5, at 7; Marion A. Cowell, Jr. & Monty D. Hagler, The
The use of SBA funding in this era of bank consolidation might serve as an indicator of how effectively small businesses are faring in their access to capital. The presumption against interstate banking is that small businesses suffer. To the extent that a financial institution lends outside its local geographical area, there is concern that small businesses receive reduced access to credit at an increased price.\(^{188}\) Reviewing a bank’s use of its SBA-guaranteed loans might be useful to ensure that participation in the program is by businesses in need of the program’s benefits. Guaranteeing accountability requires that the bank holding company be responsible for that review.

To examine that issue, the first section below explains the merger rules governing bank holding company expansion. Following that discussion, I explain the SBA-guaranteed business loan programs designed to provide a source of capital for small business lending.\(^{189}\) Finally, in Part VI, I recommend scrutinizing the bank subsidiary’s use of and access to SBA-guaranteed loans in an effort to encourage more community development lending.

\(\textit{A. Regulatory Approval of BHC Mergers and Acquisitions}\)

There is only one sanction for failing to adequately meet the credit needs of a community: denial of an application for expansion of a bank holding company’s deposit-taking facilities.\(^{190}\) Although each regulatory

\(^{188}\) See Wilmarth, \textit{Too Good to Be True?}, supra note 184, at 36 (noting that “large banks make significantly fewer small business loans in comparison with community banks”).

\(^{189}\) “A ‘small business’ must be independently owned and operated, not dominant in its field, and must maintain certain maximum size standards which are subject to change.” Patricia L. Brown, \textit{Selected Issues in Entity Selection for Family Businesses}, C834 ALI-ABA 1, 42 (1993); see 13 C.F.R. §§ 121.101, .201, .301 (1997). Eligibility requirements are distinct from size standards for certain business loans and guarantees. \textit{See id.} § 120.100.

agency has jurisdiction to address merger considerations, I have limited the analysis here to the holding company context, and thus to the Federal Reserve's responsibility.

The Federal Reserve may consider CRA performance as one factor in an evaluation for a bank merger or acquisition. Specifically, in reviewing the holding company's application, the agency reviews the applicability of three controlling statutes: The Bank Holding Company Act ("BHCA"), the Bank Merger Act ("BMA"), and the Change in Bank Control Act. Together these Acts measure competitiveness, safety and soundness, and convenience and needs. As originally enacted, the BHCA was limited to mergers involving holding companies. It prohibited mergers that substantially lessened competition. The BMA made the BHCA's acquisition restrictions applicable to all federally insured institutions. The effects test under these two statutes applies to any line of commerce, in any section of the country.

In appraising the probable competitive results, the review basically defines two relevant markets—product and geographic. Before a direct or indirect acquisition, the appropriate regulatory agency must consider the three effects and provide written approval of the transaction. The statutory scheme regulates the economic development of the banking industry by prohibiting mergers that result in sizable market shares.

193 Id. § 1828.
194 Id. § 1817.
195 The competitiveness factor evaluates whether the proposed merger will result in a monopoly in the relevant geographic and product markets. See id. § 1842(c)(1). The safety and soundness factor evaluates the capitalization, present and future, of both the institutions and their managerial resources. See id. § 1842(c)(2). The convenience and need factor evaluates the public benefits of the resulting merger, including a review of the acquiring institution's record of CRA compliance. See id. § 1842(c)(2)-(3).
196 See id. § 1842(c)(1).
197 See id. § 1842(a).
198 The most significant ruling under this statute was the Supreme Court's decision in United States v. Philadelphia National Bank, 374 U.S. 321 (1963). The Court held that section 7 of the Clayton Act governed bank mergers. See id. at 341-55. The decision invalidated the Federal Reserve Board's approval of the merger of the second and third largest banks in Philadelphia. The Court rejected the agency's reasoning that because the bank was well-managed, the large market concentration would not harm the area, and the convenience and needs of the city.
The easing of the geographic restrictions in banking has resulted in a wider product and geographic market. The result is a dilution of the competitiveness factor in merger decisions. Since the competitiveness factor has become less critical, the Federal Reserve Board’s merger analysis concentrates on an evaluation of the safety, soundness, convenience, and needs factors.

When evaluating the monetary effects of a merger, the regulatory agency assesses fiscal competence. This is the safety and soundness evaluation. It examines the institution’s lending policies and practices. Relevant factors include finances, earnings, and management of the banks involved.

A bank’s CRA lending must also be consistent with safety and soundness concerns. Each institution establishes its risk for all loans, in which CRA lending must be included. Essentially, this requires that CRA-type loans must fall within those defined loss limitations. The regulators’ evaluation of those parameters is limited to a reasonableness review.

The convenience and needs factor takes into account a bank’s CRA performance. The regulatory agency assesses whether the acquiring bank has implemented and maintained CRA policies and programs before filing an application. As a result, each subsidiary bank of the holding company seeking merger approval needs a satisfactory CRA record of performance.

A change in regulatory policy amended the regulatory agency’s prior practice of allowing a bank subsidiary with an unsatisfactory record of would be served by the larger bank. See id. The Court did suggest one exception was for institutions that were at risk of failing. See id. at 371-72 n.46.


See Cowell, & Hagler, supra note 187, at 92-93.


See id. § 1842(d)(3).

See id. § 2903.

The appropriate federal financial supervisory agency evaluates the CRA performance of the subsidiaries of the acquiring company. The Comptroller of the Currency regulates national banks; the FDIC regulates state chartered banks and savings banks that are not members of the Federal Reserve System; the Federal Reserve regulates state chartered member banks of the Federal Reserve System and bank holding companies; the Office of Thrift Supervision regulates thrift savings and loan companies. See id. § 2902(1)(A)-(D).
CRA performance to make commitments for future improvements. Compliance with the CRA means that all of the bank subsidiaries have existing programs that adequately address community needs at the time that the holding company applies for regulatory approval. The bank subsidiary must show that it does not engage in discriminatory lending and that its lending performance addresses the credit needs of its identified low- and moderate-income neighborhoods.

Satisfactory CRA performance evidences a CRA plan that functions effectively for residential, small business, and farm lending. It also evidences an institution that has a continuous commitment to monitoring its own program performance.

Monitoring industry compliance with CRA in an era of bank consolidation requires an evaluation that defines satisfactory small business lending. Small business borrowers have unique needs that require some flexibility in underwriting and in assessing collateral requirements. Adequate CRA performance for small business lending requires a recognition of those trade concerns as well as a loan access and review process that is responsive to their uncommon demands. The proposed change to the CRA and SBA regulations attempts to meet these needs by first identifying whether a disparity exists in meeting the credit needs of this group of borrowers. Although the new regulations require more data collection for small business lending, they do not go far enough in ensuring that there is not a void in the credit needs of this particular sector. One way of assessing those needs is to require reporting that shows how the bank is using SBA-guaranteed lending.

B. The SBA-Guaranteed Loan Programs

SBA loan programs assist a bank in meeting small business funding needs. By authorizing the SBA to provide loan guarantees, Congress has

205 Before this change, many banks were able to satisfy protectors' concerns about CRA performance by negotiating with them and making future commitments to the Federal Reserve that the bank's performance would become satisfactory. See Cowell & Hagler, supra note 187, at 89, 92, 94.
207 See id.
208 See infra Parts V.B.1-.3.
209 See infra Part IV.
210 See infra Part VI.B.
211 The proposal presented in this Article would extend the Federal Reserve's analysis of the probable effects of the merger to include an assessment of guaranteed small business loans. See infra Part VI.B.
given the agency a role in creating credit access to undeserved markets. Charged specifically with providing "business loan assistance only to applicants for whom the desired credit is not otherwise available on reasonable terms from non-Federal sources," the agency's section 7(a) and 504 loan programs are consistent with the goals of community development lending. In this regard, the SBA can serve as an integral part of a bank's CRA compliance program.

1. The Section 7(a) Program

Section 7(a) of the Small Business Act provides financing for general business loans. That financing may be through either a direct loan from the SBA, an immediate participation by a lender and the SBA, or a guaranteed loan. The guaranteed loans program, in which the SBA insures a portion of the loans against the borrower's default, is the focus of the proposed changes to the CRA regulatory structure.

Under section 7(a), the business loan guaranty program, the SBA acts as a partial guarantor of loans from commercial lenders to small firms. SBA participation provides several advantages. Banks and other lenders are willing to provide longer term financing than would otherwise be available. Often, lenders are willing to make larger amounts of credit available at lower interest rates. Neither the market nor the regulatory environment would permit these advantages for small businesses without SBA participation.

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213 See infra Part V.B.1.
214 See infra Part V.B.2.
215 13 C.F.R. § 120.2(a)(i). Certain applicants who cannot obtain commercial loans even with a government guarantee are eligible to apply for SBA direct loans. The SBA often limits eligibility for this type of assistance to qualified businesses with special needs, such as those owned by low-income or handicapped individuals, certain organizations employing them, or businesses located in areas of high unemployment. See H.R. REP. 104-873, ch. 2.2, at 28 (1996).
216 See 13 C.F.R. § 120.2(ii).
217 See id. § 120.2(a)(iii).
218 See discussion supra Part III.
219 Ineligible purposes for these business loans include debt consolidation and refinancing. See 13 C.F.R. § 120.130.
220 The SBA may lend up to $750,000 to an eligible borrower in SBA loans, with terms up to 10 years. See id. § 120.211(b).

SBA loans are generally collateralized, and such collateral may consist of
The typical government-guaranteed borrower has been in business for less than two years, lacks sufficient collateral to properly secure the requested credit, and does not have the necessary cash flow history. The guarantee can serve one of two purposes. It may provide the bank with a strong secondary source of repayment and enable the bank to grant the loan. On the other hand, the longer term and amortization may reduce the borrower’s payment. If the purpose of the loan is to provide permanent working capital, it can reduce the amount of the outstanding loan to an amount that is acceptable to the lending bank.\textsuperscript{221}

The private lender for the guaranteed loans programs may be either a bank or a qualifying nonbank.\textsuperscript{222} Also, the agency may designate active, expert lenders as certified and preferred lenders, who then qualify for streamlined lending programs.\textsuperscript{223}

The loans made with SBA guarantees are loans that would have been declined absent the credit enhancements.\textsuperscript{224} Businesses that receive section

\begin{itemize}
\item land, buildings, machinery and equipment, warehouse receipts from marketable merchandise, chattel, inventory (generally not good unless used in a bonded or otherwise acceptable warehouse). The SBA generally requires guarantees of all principals involved in the business and requires principals to further secure guarantees by means of collateralization of personal assets such as second trustees on homes or other similar collateral.
\end{itemize}
7(a) loans generally depend upon the future earnings of a company for repayment. Credit analysis does not depend upon the soundness of each transaction or the short-term viability of the business, but on the likelihood that a loan can be repaid from the borrower's stream of earnings over a term of several years.225

The newness of the business is the focus of the section 7(a) program. This factor is particularly appropriate when dealing with community development businesses.

Although these businesses initially may need technical assistance in developing a realistic business plan, often they perform sufficiently well to seek additional credit to undergo expansion. The expansion of existing businesses is the focus of the SBA's section 504 lending program, which is explained below.

2. The Section 504 Program

The section 504 program funds loans to small firms for plant acquisition, construction, conversion, expansion, or equipment.226 There is also a stringent job creation requirement that results in a boost in economic development within a community.227

The SBA guarantees a ten- or twenty-year debenture issued by a certified development company.228 The proceeds from the sale of the debentures are used to fund the loan.229 The SBA portion of the loan may fund not more than forty percent of the project. The conventional lender, usually a local bank, must provide fifty percent financing with a similar long-term commitment to the borrower.230 The borrower generally provides the remaining ten percent.

The program allows a bank to provide expansion capital to small businesses that might not qualify under conventional financing terms due to tight cash flow, insufficient collateral, or under-capitalization. Small businesses require extended amortization to meet the cash flow involved in large capital expenditures. Although this extended repayment period creates a maturity risk, the SBA guarantee minimizes the risk by creating a collateral cushion for participating banks.231

225 See 13 C.F.R. § 120.150.
226 See id. § 120.882.
228 See 13 C.F.R. § 120.933.
229 See id. § 120.801(d).
230 See id. § 120.801.
231 The SBA guarantee requires banks to finance only 50% of the total asset costs while obtaining first priority on the asset. See id. § 120.801(c)-(d).
The program is attractive to banks because the SBA and the certified development company agree to take a secondary position on all of the collateral pledged, leaving the bank heavily over-collateralized, in the event of default. Moreover, the borrower receives the benefit of a long-term, fixed-rate loan with an interest rate established by the SBA with the Secretary of the Treasury’s approval.232 Certificates representing a pool of section 504 debentures are sold monthly to investors in the private capital markets.233

A further advantage of using SBA-guaranteed loans is that the loans can be sold in the secondary market. The next section describes the benefits of securitizing SBA-guaranteed loans and lays the foundation for the argument that more focused SBA lending will provide long-term financing for community development lending while also reducing the risk inherent in such loans.

3. The Secondary Market for SBA-Guaranteed Loans

Traditionally, small business loans have been difficult to securitize because they do not provide uniform borrower characteristics. Banks have viewed the inability to assess creditworthiness and to monitor the performance of small business as an impediment to lending.234 Additionally, small businesses tend to have non-traditional assets that cannot be pledged as security and insignificant cash flow in the early years of existence.235

An active secondary market for small business lending has developed, encouraging investors who want to fund this industry while reducing their own credit risk. Holders of the securities receive monthly payments of principal and interest based on the pool of loans.236

232 See id. § 120.932.
233 See id. § 120.801(d).
234 See Beshouri & Nigro, supra note 170, at 5.
235 See id. at 4.
236 The market for small business securities has developed because the government guarantee provides protection against credit risk. See id. at 34. A small business security represents beneficial ownership of a fractional undivided interest in a fixed pool of small business loans. The holder of a certificate is entitled to a pro rata share of all interest on the loans and all payments or other recoveries of principal. Correspondingly, any losses realized from defaults on the underlying loans are shared by the investors pro rata. See id. at 19. The process of issuing small business securities begins with the accumulation of a pool of loans that meets rating agency and investor criteria as to such factors as loan size, credit quality, and
Generally, commercial banks gather the pools of SBA-guaranteed loans.\(^{237}\) The securities operate in a manner similar to mortgage or asset-backed securities.\(^{238}\) As pass-through securities, the SBA-guaranteed loans are traded in the minimally regulated government market and are exempt from registration under the securities laws.\(^{239}\)

Leveraging SBA-guaranteed loans presents several positive regulatory options for a bank.\(^{240}\) Securitizing the loans allows the bank to maintain its desired liquidity level of assets.\(^{241}\) The loans also are eligible as collateral for Federal Reserve Bank advances\(^{242}\) and improve regulatory capital ratios.\(^{243}\) In effect, the SBA-guaranteed loan yields profits and benefits equivalent to or better than a conventional loan.

Profitability in the small business market is predicated on four factors: "the ability to streamline origination and servicing costs, analyze and geographic dispersion. Those criteria include evaluating the loans to determine terms of payment, principal, interest, prepayments, and secondary market trading. SBA pools are comprised solely of government-supported loans that are less than one year old at the time the pool is formed. The pool of loans may have denomination, maturity, and risk characteristics that are identical to or different from those of the underlying loans. See id. at 34. "The securities amortize fully over maturities of 20 to 25 years, but may be called for redemption due to prepayment or default with respect to all loans or guaranteed portions comprising the underlying SBA pool." Marshall et al., supra note 220, at 287.

\(^{237}\) "The Securities consist of certificates issued by the SBA’s fiscal and transfer agent based upon pools of SBA guaranteed loans (or portions thereof) assembled by the Broker as an approved pool assembler.” Marshall et al., supra note 220, at 387; see 13 C.F.R § 120.600. “The average size of the SBA loan pool backing a particular SBA certificate is $2 million to $10 million.” Marshall et al., supra note 220, at 387. “SBA regulations govern the maximum acceptable difference between lowest and highest interest rates with respect to individual guaranteed loans or portions comprising a particular pool as well as the maximum acceptable difference between maturity dates of such loans or guaranteed portions.” Id.; see 13 C.F.R § 120.611.

\(^{238}\) See Marshall et al., supra note 220, at 387.


\(^{240}\) See id. § 684(c).

\(^{241}\) The CDBFIA allows banks to use Generally Accepted Accounting Procedures in booking the sale of loans subject to partial recourse provisions. This accounting convention then reflects the recourse provisions of the “securitization as a means of credit enhancement.” Neill & Danforth, supra note 167, at 17.

\(^{242}\) A loan participation allows a bank to make a loan beyond the regulatory set limit. See 12 C.F.R. § 935.9 (1997).

\(^{243}\) See id. § 567.6.
correct excessive portfolio risk, and leverage the profitability of the business deposit relationship, including the personal relationship of the business owner. By securitizing its small business loans, a bank creates a tangible loan supply surplus. In turn, its losses are protected by the SBA guarantees.

Large retail banks have some flexibility in their use of SBA-guaranteed loans. Specifically, the banks can use the loans as either credit enhancers or in loan participation. Using the SBA loan guarantees as credit enhancers allows the banks to close the credit gap. The SBA participates as a lender by providing credit to cover the amount of the unfunded loan commitment. That unfunded obligation represents the amount that the bank has decided is either too risky to lend or that exceeds its lending limit.

Large retail banks arguably misdirect their use of the SBA programs. It is advantageous for the bank to use the SBA loan funds as leverage for those loans for which performance is unpredictable. The bank reduces its risk of loss by making the loan under the SBA-guaranteed program. Some banks make tremendous profits by selling those loans on the secondary market. Regulations that require banks to direct SBA-guaranteed lending to those businesses truly in need of the government guarantee would result in a more resourceful use of the federal loan funds. One way to achieve this goal is to give the bank holding company a more defined CRA obligation for its SBA loan portfolio. This means that when the holding company requests regulatory authority to merge or expand, there is a focused objective regarding its small business, community development lending.

Specifically, CRA ought to mandate that the holding company take an active role in developing policies and procedures that will result in effective monitoring of the community development small business lending throughout its operations. This requirement would make the holding company responsible for overseeing its bank subsidiaries’ use of SBA-guaranteed loans. The geographical dispersion and amount of lending in this particular portfolio would assist the SBA in determining whether lenders using the program’s funds are meeting the program’s objectives. Simply put, banks ought to use the SBA-guaranteed funds in a manner that promotes fair lending for small businesses outside of the mainstream of credit access.

244 SMALL BUSINESS, BIG POSSIBILITIES, supra note 221, at 14-15.
VI. SYNERGY: DEFINING THE BANK HOLDING COMPANY'S RESPONSIBILITY

A bank holding company should bear direct responsibility for its small business, community development lending. This obligation is needed at the holding company level for several reasons. First, it compels the parent company to make an integrated assessment of how its banking subsidiaries are addressing the credit needs of small businesses involved in community development. Second, it provides more incentive for the parent company to create enterprise-wide financing vehicles for community development lending. Finally, it segregates this specialized area of government loans from conventional loans, forcing a different type of risk analysis.\(^{245}\)

This focus is an appropriate one given the SBA's mandate of facilitating capital access to small businesses. SBA’s chief concern is making credit available to small businesses that are unable to get conventional financing elsewhere, due in part to the location of the business. To the extent that the CDBFIA is concerned with credit access and alternative supplies of credit to specific groups and organizations, SBA lending has some of the same policy objectives.

To achieve this objective, the SBA’s business loan program’s definition of qualifying small business should be congruent with the CRA definition of community development lending. This requirement would result in a financial institution’s participation in the SBA’s programs in ways that facilitate feasible community development lending. More importantly, lenders would not be able to make lending decisions that result in geographical disinvestment.

SBA lending comes within the jurisdiction of the fair lending laws.\(^{246}\) The absence, however, of a systematic means of evaluating lenders’ discretion in making these decisions creates a void against which no assessments can be made. Because banks initiate these loans, the SBA is unable to determine how lenders are making decisions. The instant

\(^{245}\) See Wilmarth, Too Big to Fail, supra note 11, at 1038-40 nn.382-94 (discussing the special needs of small businesses and the effect of industry consolidation on banks’ abilities to service those needs). Although holding companies will complain that the request for more information is more costly, the need for strengthened compliance and the accompanying procedures must be balanced against that cost, with the public’s interest as an integral part of that equation.

\(^{246}\) See supra notes 63-78 and accompanying text.
COMMUNITY DEVELOPMENT LENDING

This proposal has two parts – part one addresses the CRA reforms and part two addresses the SBA reforms needed for congruent implementation of the program. 247

A. Evaluating the Needs of Small Businesses: CRA Reform

If a bank subsidiary is subject to the data reporting requirements for small businesses, 248 its holding company must submit a separate CRA plan for small business lending. That plan must show how the holding company facilitates credit access throughout holding company operations. In particular, each bank subsidiary must identify its participation in the SBA §§ 7(a) and 504 loan guarantee programs. In effect, this creates a distinct finding under the lending and investment tests for community development small business lending under the CRA. 249

Under the proposal, when the Federal Reserve makes its assessment of the acquiring institution’s CRA performance, it would evaluate the amount of credit extended through SBA-guaranteed loans. Current regulations require reporting the dollar amount and the geographic location of those loans. 250 The regulations should be amended to require that the bank subsidiary identify specifically which SBA-guaranteed loans were made in fulfillment of the bank’s CRA commitment; the bank also should be required to identify the amount or percentage of SBA-guaranteed loans that the bank sold in the secondary market. For those SBA-guaranteed loans for which the bank is claiming CRA credit, the bank must include a specific reference as to how the loan assists in community economic development as defined in the CDBFIA. Finally, in addition to the existing requirement identifying why conventional financing was not used, 251 every small business loan that is an SBA-guaranteed loan should supply supporting data on its current percentage of SBA loans.

Equally as important, the small business lending data should include information regarding rejected loans. All small business loans in the bank’s assessment area should be available for review to determine whether there

247 See supra Part IV.
248 See supra Part III.A.
249 See supra notes 94-116 and accompanying text.
250 See discussion in text at supra note 114.
is discrimination in the credit process. It is possible that lenders are engaging in racial red-lining of small business loans. Each community development business loan should carry a certification signed by the borrower stating that the lender orally discussed the eligibility of SBA-guaranteed loan funds for financing the loan. Each loan should also include the lender’s statement describing why the loan is ineligible for SBA-guaranteed loan funds. Only if there is a record available of the consistency of the underwriting standards, the terms and conditions of loans granted, and information regarding the servicing of these loans is there a basis for making determinations about the fairness of the lender’s process, as well as the fairness of the lender’s substantive decision.

An effective SBA-guaranteed lending program implies fair lending criteria. Fair lending in the CRA context means equitable opportunities for access to federally guaranteed loans, regardless of the geographic location of the business. As a consequence of fair lending prohibitions, the subtle biases inherent in geographic disinvestment should be reduced. However, because procedure alone may not be a sufficient deterrent, this proposal calls for SBA lending criteria to address geographic disinvestment as well.

As a guide for a holding company developing a CRA compliance program under this proposed obligation, four policy approaches are representative of the uncommon needs of small businesses that facilitate community development. The selected areas are particularly vulnerable to practices of unfair, subjective lending. Policies that define the parameters for bank subsidiary lenders would ameliorate the unnecessarily harsh results at that level and provide those lenders at least with a mechanism to make a less biased review.

The four selected areas are as follows: Appropriate borrower identification, underwriting standards, credit scoring, and rejection review.

1. **Appropriate Borrower Identification**

A holding company implementing the CRA should want to project the strong perception that it is committed to fair lending. To that extent, it is in the enterprise’s best interest to search for, or scout out, creditworthy

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252 The term “racial redlining generally refers to the practice of denying loans, based on the racial characteristic of the residents of an area.” Jeanine Catalano, *Important Links Exist Between Fair Lending Laws and the CRA*, 14 BANKING POL’Y REP. No. 3, at 25 (Feb. 6-20, 1995).

253 See infra Part VI.B.
community development borrowers through community outreach and education programs. Finding the borrower that needs an SBA-guaranteed loan is dictated by the location of the banking subsidiary. The bank’s assessment area, defining the geographical boundaries of the community that it serves, becomes the basis for its CRA marketing strategy. Although the average borrower might not be able to detect who the group targeted to receive SBA-guaranteed loans should be, it is imperative that the holding company develop guidelines for identifying eligible entities.

At the holding company level, directors want to ensure that the marketing strategy reflects their small business customer base. An intensive identification of the needs of the small businesses in the bank’s geographic locale may be required. CRA compliance requires responsive evaluative techniques and assessments of the community development businesses’ traditional and nontraditional needs. A bank subsidiary will be more likely to make this type of resource commitment if it has clear signals that the holding company is also invested in the process.

CDCs can have a significant and appropriate role to play in this process. CDCs tend to have unique abilities in identifying businesses and organizations that effectively service the community’s needs. In this regard, CDCs serve as effective advocates and identifiers of community needs. They facilitate the lending process to the extent that they provide the lender with additional sources of information that assist in determining creditworthiness.

2. Underwriting Standards

One aspect of the obligation at the holding company level involves creating a secondary market for community development loans. A successful market for community development lending requires flexible, unique underwriting standards. These standards require methods of assessing material information regarding future business performance and potential loan performance for this specialized type of lending.

Lenders tend to be less knowledgeable about low- and moderate-income communities. This ignorance can be costly. It requires that the lender spend more funds to gather information about these communities. Using a cost-benefit analysis, these lenders often decide not to make that

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254 See Lento, supra note 9, at 783-97 (describing the lending programs at South Shore Bank and Elkhorn Bank and Trust Company).
255 See id. at 789.
Those that do are learning as they lend. Until concentrated resources are devoted to training the people responsible for making these loans, the underwriter cannot identify the scope of the risk.

Developing the knowledge base is also critical to closing the credit gap on these loans. Although the SBA guarantee is available for up to ninety percent of the value of the loan, nothing restricts the bank from making the loan with a smaller guarantee. Again the bank holding company should have policies designed to ferret out abuses of the guarantee. To the extent that banks participating in the loan programs request more funds than are actually needed, there is less money available for other small businesses to receive.

Requiring the holding company to develop uniform underwriting standards provides much-needed support for the bank personnel that are engaged in finding and reviewing community development lending on a daily basis. Knowing what the holding company’s parameters are allows these personnel to review proposals with some creativity and flexibility, as well as with confidence.

Finally, the holding company could require that upon qualification, its bank subsidiaries become certified and/or preferred SBA lenders. Lenders who receive this certification receive expedited SBA review, reducing the turnaround time for customers.257

3. Credit Scoring

Streamlining credit approval is facilitated by credit scoring. Credit scoring is a statistical technique for determining a borrower’s ability to repay the loan. It first evaluates uniform borrower characteristics. Then, identifiers are analyzed by comparing them to historical data on repayment patterns.258 Credit scoring facilitates securitization. A bank with SBA-guaranteed loans creates its own capital market and therefore obtains low-cost funds by transferring ownership of its accounts receivables or other rights to payment.

Credit scoring is a way of making small business loans uniform. An advantage of credit scoring is that it allows banks to generate a high volume of small business loan originations. These loans are made without

258 See Neill & Danforth, supra note 167, at 14.
particular regard to the geographical location of the loan. Large banks can absorb the cost of purchasing the technology that both streamlines its credit approval process and lowers the cost of credit to customers.

While credit scoring facilitates lending in the secondary markets, it also allows lenders to use more objective criteria in a way that disadvantages a small business with little credit history. Just like individuals, some businesses lack a credit history and may need to have ways of proving creditworthiness other than proof of credit history. The holding company needs to be sensitive to this dilemma by, for example, establishing options of other forms of repayment history. For example, the ability of the principal individual borrower, instead of just the business, to repay might be relevant. Again, the holding company’s establishment of the standard gives the subsidiary bank the opportunity to act with clarity and consistency.

4. Rejection Review

Lending to community development businesses with an SBA guarantee changes the profile of qualified borrowers. Small business owners who might otherwise be unable to obtain financing because of a perceived risk are acceptable to a lender if a guarantee is provided. Lenders, who otherwise have unarticulated reasons for disapproving these loans, have an incentive to view them more favorably.

To ensure that the guarantee loan program is maximized as a source of community development lending, the holding company ought to become the final arbiter on whether a guaranteed loan is accepted or rejected. A formal review process for evaluation of all rejected community development loans should be established at the holding company level.

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259 See id. at 14, 18 (arguing that the SBA’s adoption of standardized, nationwide credit scoring methodology lends credence to the assessment that small business lending is national, not local).

260 Although small business credit scoring practices had their start at larger banks and finance companies, a commercially viable technology became available in 1995 to institutions of all sizes.” Id. at 15. Additionally, the regulatory agencies might consider absorbing some of the cost of this proposal by helping to develop the necessary technology and selling it to banks at a lower cost.

261 A by-product of the development of the pass-through securities mortgage market has been a standardization of mortgage loan documentation. “The securitization procedure was developed by the government mortgage insurance companies and now accounts for between 50 to 80 percent of all securitizations.” Id. at 17.
Reviewing rejected loan applications also provides a means for ensuring uniformity in making SBA-guaranteed lending. One possibility is to create a small business lending group made up of member banks. Each bank would bring a predetermined number of problematic community development lending applications to regularly scheduled meetings for review. Additionally, any application that a member bank rejects would automatically be reviewed by this central loan committee. This process allows a uniform assessment of why applications are denied. Its denial review process ought to be publicized so that rejected applicants are aware that any rejected loans will be reviewed in this conclusive manner.

In limited circumstances, business loans made outside of an assessment area ought to receive CRA credit by the bank subsidiary making the loans. When the bank’s reason for rejecting the loan can be identified as the bank’s inability to service the particular type of loan, then an approving sister bank subsidiary ought to be allowed to receive CRA credit for it. In such a situation, the holding company should actively monitor the bank subsidiary that rejected the loan to determine if it needs additional technical or financing assistance in order to perform community development lending at an adequate level.

If the locus of responsibility for CRA small business loans moves from the bank subsidiary to the holding company, demonstrable efforts for system-wide assessment will be possible. The congruency needed for uniform assessment and review demands changes in the SBA as well.

B. Easing the Friction: SBA Reform

Current SBA regulations do not mandate, for program compliance review, information on the geographic distribution of those loans. The SBA needs information that will allow it to confirm that banks are using the lending to facilitate credit access. Specifically, the SBA needs to collect

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262 This model draws heavily from the Delaware Valley Mortgage Plan ("DVMP"), which was established before the enactment of the CRA among local banks in the Philadelphia area.

263 This proposal does not extend as far as Klauser’s tradable CRA obligations, see Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1580 (1995), but does recognize and try to address market inefficiencies in a very limited fashion. Assuming that the performing bank subsidiary becomes successful in integrating the information into a price system, the advantage to this particular exception is that since performance is monitored by the parent company, the performing bank has more incentive to share information. See id. at 1586.
more data to ensure that banks are not using SBA loans to contribute to geographic disinvestment.\(^{264}\)

The SBA must require data that allows the agency to undertake a more systematic review of its small business lending. This data will assist the SBA in its own review of the actual placement of its lending to determine if banks are using the funding only when credit enhancement is warranted.

More can be done. The SBA ought to target community development lending as appropriate, although not exclusive, recipients of the section 7(a) and section 504 loan programs. Community development loans under the revised CRA regulations include loans that have as their primary purpose promoting economic development, such as financing small businesses and furnishing community services to low- and moderate-income persons.\(^{265}\)

The SBA’s mission to facilitate credit availability and capital access for small businesses is fulfilled when businesses that qualify for community development loans receive access to these monies. Although the SBA has several specialized programs, none of them specifically address community development lending.\(^{266}\) Essentially, this means that the SBA ought to make loan funds available to banks that are channeling the funds to businesses that truly are not able to get credit elsewhere. Similar to its preferred or certified lender programs, the SBA could establish a preferred lender program for community development lenders.\(^{267}\)

Such a program acknowledges the resourcefulness of lenders who are trying to comply with SBA guidelines and are funneling those funds properly. It would also help expose those banks that are misusing the guaranteed loan program by participating in it primarily to gain the benefits

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\(^{264}\) Limited information is currently available that supports this point. Specifically, the SBA § 504 loan program in Chicago allegedly made “most of its loans to companies in higher income neighborhoods.” Joseph Pena, “Feeble” Bank Lending Crimps South Dallas Development of $62 Million in SBA Loans in Dallas County, Only $5 Million Went to Businesses South of the Trinity, DALLAS BUS. J., Sept. 12, 1997, at 24. Additionally, a study of SBA loans in the Dallas area uncovered misuse of SBA loan funds by lenders as well. See id.

\(^{265}\) See supra notes 94-116.

\(^{266}\) The SBA’s specialized programs have focused on providing more access to minority- and women-owned businesses. See Thomas Jefferson Hasty, III, Minority Business Enterprise Development and the Small Business Administration’s 8(a) Program: Past, Present, and (Is There a) Future?, 145 MIL. L. REV. 1 (1994) (critiquing the SBA’s minority business development programs and suggesting needed reforms to make the program more effective).

\(^{267}\) See 13 C.F.R. §§ 120.440-.442 (1997) (Certified Lenders Program), 120.450-.455 (Preferred Lenders Program).
of the profitable secondary market. Many banks that do high-volume SBA-guaranteed lending are lending to borrowers who are able to get credit elsewhere. 268

Under the current regulations, the SBA makes no separate inquiry about credit availability to the borrower. Instead, the agency relies on the lender’s certification that without an SBA loan, the borrower would be denied credit elsewhere on reasonable terms and conditions. 269 Although the lender must have documentation on file to substantiate the borrower’s eligibility based on the unavailability of credit elsewhere, the lender’s submission of the application to the SBA constitutes certification to that effect. The SBA must develop a more rigorous means to eliminate inappropriate borrowers as identified by lenders.

The above-suggested changes to the CRA will act as a deterrent for lenders who might abuse the certification process. Moreover, if the SBA defines community development lending as a specialized type of lending within its small business loan program, a lender’s certification would have a different focus. SBA-guaranteed lending for community development loans would highlight the agency’s purpose in making the funds available.

Defining community development lending in SBA regulations would assure consistent application of the criteria nationwide. As a consequence, businesses that have made a financial and geographical commitment to maintain their commercial operations in economically distressed communities are recognized and served.

If the SBA adopts the CRA definition of community development lending, the location of the business becomes important. By evaluating factors such as the business’s possibility of expansion, the number of people in the firm, the geographical location of the firm, and the financial condition of the employees, 270 the SBA can establish whether the bank is lending to an economically disadvantaged community and determine the degree of diminished credit opportunities that it might encounter because of its location.

Finally, a more substantial change in SBA lending might well be warranted. There are certainly risks inherent in lending to small businesses

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268 See Pena, supra note 264, at 24.
269 See 13 C.F.R. § 120.101.
270 For a discussion about the need for an adequate work force as a significant decision in business location decisions, see Mildred Wigfall Robinson, Empowerment Zones and Enterprise Communities under the Omnibus Budget and Reconciliation Act of 1993: A Promising Concept with Some Modifications, 11 J. L. & POL. 345, 352 (1995).
located in economically distressed communities. The SBA benefits if its lenders are well versed in and understand the risk parameters of small business lending. Those lenders ought to be recognized and given priority access to program funds.

The SBA ought to establish a pilot program that specifically makes more guaranteed loan funds available to successful SBA bank lenders. A revolving fund consisting of SBA-guaranteed securitized loans would be available solely for community development lending. This initiative would reserve some SBA loan funding annually for institutions that do substantial amounts of community development lending. By making the non-guaranteed portions of loans available cyclically as they are sold off into the secondary market, SBA could actually dedicate a pool of money specifically for community development lending. This program should be limited to banks.

This supply of capital reserved for SBA-guaranteed lending would also facilitate the recommended change in CRA compliance at the holding company level. By establishing a defined market for community development lending with SBA programs, parent companies have an incentive to participate in these programs in an appropriate way. The concomitant result would be to develop and sustain another source of capital for small business community development lending.

These proposed changes to the SBA and the CRA address concerns raised by all sectors involved with CRA: community development businesses, community organizations, financial institutions, and the regulatory agencies. As a way to revitalize the economic infrastructure of communities, using SBA funds allows banks to participate in CRA lending with an accessible supply of credit; that lowers the riskiness, actual or perceived, that accompanies CRA business lending.

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271 See id. at 371.
272 The regulations authorize the SBA to initiate pilot programs to implement SBA program objectives and goals. See 13 C.F.R. § 120.3 (1997).
273 Although community development lending has more rigorous documentation requirements, it could have flexible registration requirements to make the loans more attractive to investors, thereby specifically enhancing the market for these types of loans.
274 Nonbank lenders would be ineligible to participate in this particular program since it is designed to facilitate CRA lending and they have no CRA obligation.
275 Although these funds would be set aside for CRA lending, if there are no available projects that are eligible, the funds should be made available to SBA lenders generally.
The recommended changes address some of the concerns of market theorists. Although SBA funds are available to nonbank lenders, it is crucial that the SBA reserve some funds for bank lenders doing community development lending. Because other financial intermediaries do not have a CRA obligation, it seems fair to allow banks to have some priority over SBA funds in order to comply with CRA regulations and to do what some might argue is a governmental function. To the extent that CRA is perceived as encouraging risky or inefficient loan performance, this proposal encourages banks to use SBA lending for the necessary equity cushion to make that lending less demanding.

The market’s inability to service certain communities may mean that there is imperfect information affecting the pricing structure. To the extent that imperfect information is based on discriminatory practices, the market cannot automatically make the necessary corrections. Yet the proposal correlates with fair lending theory. By making the holding company responsible for CRA small business lending, it tries to uncover the biases that may occur in this particularly local sector lending. It is important that there is a focus on each subsidiary institution’s performance and not just on its efforts. This is most effective with direct bank holding company responsibility. Without a wholesale transferral of a fair lending approach into CRA, the banking regulators need to have a concrete means of assessing the effects of industry consolidation on this particular sector.

Finally, community empowerment theory recognizes that businesses and financial institutions are critical links in developing economically sustainable communities. This proposal does not address the type of structural changes that the community empowerment model presents. When viewing financial institutions as distributing credit and resources within a community, communities should not be denied access to the deposit funds. The CRA gives community organizers scant more power than the limited power to temporarily halt the expansion of a financial institution into a new geographic market. The interests of community organizers in low- and moderate-income communities would be well served by having access to capital protected uniformly. The proposal continues the call for federal involvement in uncovering the subtle biases affecting lending decisions in low- and moderate-income communities. The change, although incremental, is much needed to monitor and improve the capital access to community development business.
VII. CONCLUSION

The existing SBA regulatory scheme fosters an approach which allows a private mechanism, lenders, to make public policy decisions about the socio-economic character of communities. Implicit in the CRA and its reforms are a recognition of the complex interdependence among policy objectives. The reform statute specifically recognizes that geographical disinvestment has an equally deleterious effect on small business lending as it does on residential mortgage lending. In small business lending, however, fair lending laws provide a limited mechanism for ensuring that SBA-guaranteed loans are used properly. A proper use for SBA-guaranteed loans is revitalizing economically distressed communities. Given this premise, lenders' decisions about access to SBA-guaranteed loans becomes an issue of credit access that must be addressed systemically.

While CRA reform has expanded the statute's focus to the actual performance of community development lending and provided more means for financing community development loans, it fails to recognize in a concrete way the special needs of small business lending in these communities. The proposal outlined in this Article would effectively combine the interests of small businesses, community organizations, financial institutions, and regulatory agencies to revitalize the economic infrastructure of communities.

The absence of a congruent and integrated approach to capital access for economically distressed communities grants lenders too much exclusivity regarding guaranteed loan funds. The era of federal funding retrenchment makes acute the need for community businesses to have access to capital. Community development business loans provide much-needed jobs and incrementally help stabilize economically distressed communities. Therefore, they must be properly distinguished as specialized lending because of their integral part in this economic revitalization. A CRA program that combines safe and sound lending with SBA-guaranteed loans can effectively fuse public policy goals.

Since the guarantee portions of these loans are fully insured, there is little risk of loss to a financial institution that uses these loans for CRA-type lending. It is possible that a community development loan will not qualify as an SBA-guaranteed loan. Those that do qualify may not meet the requisites for securitization. When SBA-guaranteed loans can be securitized, however, they create more than a credit enhancement for participating banks. Aggressive use of these two programs -- SBA-guaranteed lending and securitization of small business loans -- where
possible, makes the SBA a partner in fulfilling the federal government's public policy goal of ensuring that financial institutions make credit available to the entire community.

Reconsidering the goals of the SBA might be a way to ensure that the underlying policy objectives, as well as those of the CRA, are met. Specifically, by mandating and reviewing holding company-level responsibilities while also offering incentives that encourage participation, lenders' CRA performance and community development lending might become both stronger and more visible.