Minority Banks and Minority Communities: Are Minority Banks Good Neighbors?

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Abstract

The lagging development of many minority communities has had an adverse effect on economic growth in the United States. One factor historically associated with creating or exacerbating this minority problem is the unwillingness of banks to service minority communities adequately. The federal government used two initiatives to address banks' reluctance to aid minorities: the Community Reinvestment Act (CRA) that ended the practice of redlining and required all federally regulated banks to demonstrate that they served the convenience and credit needs of their local communities, particularly minorities, women, and other underserved groups, and the establishment and preservation of minority owned banks that were expected to be more sympathetic to the needs of their communities. This paper evaluates the extent to which minority banks have met the needs of minority communities. The assessment is conducted in the context of the ratings received by minority banks on their Community Reinvestment Act (CRA) audits. Through the use of CRA audits, the performance of minority banks is also compared to the performance of the general banking community to determine the validity and success of the government's minority banking initiative. Analysis of CRA audit ratings also compares the performance of minority banks among different ethnicities. (G20)

Introduction

Economic growth in the United States has historically bypassed many minority communities. This economic inequality, in part, was created or exacerbated by the unwillingness of banks, particularly local ones, to service minority communities adequately. Enactment of the Community Reinvestment Act (CRA) and federal regulatory support for minority banks were two of the most important governmental initiatives aimed at rectifying this situation. The extent to which these two actions succeed in accomplishing their goal, namely the increased economic well being of minority communities, is the focus of this paper.

The Community Reinvestment Act (CRA)

Title VII of the Housing and Community Development Act of 1977, better known as the Community Reinvestment Act (CRA), sought to alter the relationship of commercial banks to the communities in which they were located. Specifically, it attempted to increase credit availability to economically disadvantaged areas and persons by eliminating the practice of redlining and the concomitant disinvestment that occurred when banks exported deposits from one area in order to provide credit in another area [Traiger, 1991]. Ordinarily, redlining caused funds to flow from poorer, older, racially transitional areas to richer, more stable

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ones. Little consideration was given to an individual’s credit worthiness or income level or a community’s general viability if it was viewed as declining. The banks’ analysis, therefore, became a self-fulfilling prophecy despite their contention that redlining was not a discriminatory practice but rather a prudent investment policy intended to protect stockholders and depositors [The Background..., p. 8].

CRA required federal supervisory agencies to encourage institutions they examined to help meet the credit needs of the communities from which they drew their deposits in a manner consistent with safe and sound business practice. Provision of credit was seen as a public service owed by financial institutions to the communities in which the government had granted them the privilege of conducting business. Additionally, the banks were expected to be good citizens in return for an assured environment of limited, local competition because of chartering limitations and lower costs created by deposit insurance, no interest on demand deposits, and Regulation Q imposition of interest rate ceilings on savings [The Background..., 11-2].

Since its original passage, CRA has been revised several times. In August 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) amended the Home Mortgage Disclosure Act to require public release of CRA evaluations and ratings for examinations conducted after July 1, 1990 [Barefoot, 1990]. Later revisions involved the methods and criteria for evaluating a bank’s CRA compliance.

In keeping with the dual banking system, an outgrowth of federalism, there are three distinct federal authorities that serve as primary federal regulators in the application of national banking laws that include conducting CRA audits. The Office of the Comptroller of the Currency (OCC) audits banks to which it has issued a national charter. The Federal Reserve Board (Fed) audits state chartered banks that have chosen to join the Federal Reserve System. All other banks, namely state chartered institutions that have not joined the Federal Reserve System, are audited by the Federal Deposit Insurance Corporation (FDIC) that provides banks with deposit insurance, a prerequisite for conducting retail banking in the U.S. At one time; some banks were able to avoid most federal oversight including a CRA audit if they were state chartered and remained both federally uninsured and outside of the Federal Reserve System. However, no domestic banks fit this category any longer.

The federal regulatory authority assigns one of four ratings to a bank at the conclusion of a CRA audit. These categories are outstanding, satisfactory, needs to improve, and substantial non-compliance. Only the first two of these categories reflects the adequate servicing of the community by the bank. CRA audit ratings, therefore, can be used as a proxy for socially responsible practices within a bank’s designated community.

The criteria used in the audits differs for banks on the basis of asset size with the demarcation point being set at $250 million for individual banks and $1 billion for bank holding companies. Small banks with assets under $250 million can select among two types of CRA audits: the Streamlined Option that includes 5 criteria (loan to deposit ratio, local lending, lending diversity, geographic distribution within the assessment area, and how well complaints are handled) or the Strategic Option that evaluates the bank’s performance in comparison to the bank’s own strategic plan. In this option, the considerations include the goals that the bank sets for itself and the accomplishment levels or benchmarks that it established for itself to qualify for each rating category. Large banks that exceed the $250 million cut-off have only one option, a three-part exam that looks in detail at their patterns of lending, service, and investment within their community.