

A EUROPEAN REGULATION FOR SOCIAL RESPONSIBILITY OF BANKS? LEARNING THE LESSONS FROM THE US AMERICAN COMMUNITY REINVESTMENT ACT¹

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This article aims to discuss if and in what form regulation may prove efficient in implementing social responsibility² into the banking business. It uses the US-American regulatory framework, in particular the Community Reinvestment Act³, as a benchmark to develop ideas for an efficient European regulation.

A. Introduction

Banking has to be sound and safe for its customers as well as for the stability of the currency and economy. The development of European banking within the globalisation of financial services creates tendencies which may undermine stable economies. Both the effects of banking products and services, as well as the absence of banking in certain areas, quarters and regions as well as among certain groups and citizens should be taken into consideration not only by the public or the bank authorities but also by the banks themselves.

A new approach in bank policy is required due mainly to two contradictor developments in financial services, wherein an increasing need for financial services is contrasted with an increasing discrimination towards less profitable sectors of the economy.

There is an increasing need of access to financial services for people of all classes and with different expectations because adequate access to financial services has become:

- *indispensable* for many parts of economic and social life that were formerly available without access to bank services (i.e. retirement, payments, investment)
- *a basic need* for new forms of financed consumption, housing, job creation, small business and charitable work.
- *more necessary* because the welfare state is gradually reducing its scope in favour of more private responsibility of citizens, which impacts on the use of financial services.

The increasing need is contrasted with increasing pressure on banks and financial institutions to select clients, regions and areas more precisely according to cost-benefit criteria in a process of advanced competition which is driven through:

- globalisation of financial services,
- deregulation of financial markets,
- privatisation of formerly public banks,
- informational technologies that render the identification of cost elements easier and further non-personal service provision,
- standardisation of retail banking and a trend to cost efficiency through bigger units.

¹ The backbone of this article is a European study by Benoît Granger, Malcolm Lynch, Leo Haidar, Udo Reifner and Jan Evers finished in 1997 and published in Evers/Reifner: *The Social Responsibility of Credit Institutions in the EU*, 1998 ISBN 3-7890-5567

² Social responsibility of banks is defined as ensuring access to financial services. This does NOT mean that every one gets every banking product but that access is decided on individual features and not limited by customers statistical bankability (e.g. entrepreneurs with three and or more children are less credit worthy) or regional location.

³ Please note that in the US are a range of acts with the objective ensuring access to financial services for example the Home Mortgage Disclosure Act (HMDA) of 1975. See: Evers/ Reifner, p. 402-410 V.6.p.1

Banks have always been viewed as semi-public institutions. The idea of social and public responsibility of banking is far from new. There is a multitude of forms, structures, ownership schemes as well as products and relationships through which banks and financial institutions have tried to comply with such expectations.⁴

But in spite of this variety these aspects have remained partial and peripheral to banking itself which tends to diminish its effect at a time of major banking developments.⁵ It is legitimate to question how such effects can be ameliorated by somehow adding a collective element to each individual transaction, transforming the market into a more complex exchange mechanism into which an individual transactions and individual marketing efforts are embedded into policy requirements (act as an agent of public interest, as economic theory would put it).

Community Reinvestment - A specific instrument against insufficient supply

The US regulatory environment for the majority of credit institutions including banks and thrifts makes these institutions' business activity particularly transparent in as much as they must disclose specific and detailed information about the geographical and economic profile of their customers vis-à-vis where they undertake business activity. Behind this regulation one may perceive a presumption that credit institutions should conduct their core business in a socially responsible way with particular regard to geographical impact. The law itself is very broad:

Community Reinvestment Act 1977 12 USC 2901

SECTION 804 - Financial Institutions; Evaluation

(a) *In general. In connection with its examination of a financial institution, the appropriate Federal financial supervisory agency shall -*

- (1) *assess the institution's record of meeting the credit needs of its entire community, including low and moderate-income neighbourhoods, consistent with the safe and sound operation of such institution; and*
- (2) *take such record into account in its evaluation of an application for a deposit facility by such institution.*

However, any such social responsibility is only facilitated through the law and the regulations prescribed under it. The regulations do not actually force institutions to be socially responsible, rather encourage them just by asking the respective questions. And the question of social responsibility is circumscribed by the principle of anti-discrimination, rather than any wider starting point such as, as some have argued, that credit institutions fulfil a quasi-public function.

The basic idea of CRA is that credit is an "investment" which enables any community to use capital for the development of housing conditions, job creation, improved conditions for individual consumption and the raising of children in a supportive environment. It is seen that with more and adapted credit social costs for the public - otherwise needed for upgrading the public conditions in the community - can be saved and that the instrument credit is more focused and sustainable than subsidies spend by public authorities. As banks are the most important creditors in society the public has to keep on eye their credit behaviour especially towards communities, regions, classes and groups of people with difficulties with the pace capitalist markets require. It is Adam Smith revised: *Each individual should take into account in its personal decision in the market that its individual situation also depends on the situation of the whole which again is characterized by the situation of its weakest part.*

The US regulatory environment makes sense of the market economy paradox that investors *en masse*, such as credit institutions or equally pension funds, may jeopardise factors such as regional economic

⁴ for example: state banks, saving banks, co-operative banks, mutuals, non-banks as intermediaries. A detailed analysis for Germany, the UK and France in the country reports of Evers/ Reifner 1998

⁵ for an evaluation of reasons see Evers/ Reifner, p. 69-70

prosperity or job security for the very people who contribute to them and live or work in those areas. It does this by giving consumers the information that illustrates this rather abstract relationship enabling them to see the connection. While it is a common assumption that the United States is among the most free market orientated economies, especially when compared to Europe, the qualification that private enterprise there is concomitantly expected to fill gaps that would otherwise be left by smaller government is perhaps less immediately obvious. In fact, the US legislation with which this study is concerned stems from the philosophy that there is some sort of contract of reciprocal rights and obligations between private, shareholder owned credit institutions and the US taxpayer. In exchange for the latter guaranteeing the deposits of the former, these institutions have an obligation to extend credit and financial services in general to their entire communities in a non-discriminatory way, including those areas populated by low and moderate-income households and minorities.

Viewed from the EU banking regulatory environment, the US situation raises questions about the purpose of banking and financial service regulation beyond the questions of deposit protection, safe and sound operation and maintaining the integrity of payments systems. But again, this is not some broad social responsibility, based on a requirement that institutions undertake activity which cannot properly be described as business. Rather, it assumes that there are areas of profitable business activity which would otherwise be left unprovided for because of discrimination and prejudice. However, the question of anti-discrimination is especially problematic in this area because of the etymology of the word credit, *credere* in Latin meaning to trust. And trust is not always something which is easy to build when there are a variety of reasons mitigating against a positive credit authorisation. Some of these may be linked to income and repayments ratios or screening for financial responsibility (*legitimate*) and others linked with other factors such as pure area of residence (*illegitimate*). However, it may occur that illegitimate reasons can be concealed behind legitimate ones, consciously or sub-consciously, and this is an area fraught with difficulties - hence the element of subtle positive discrimination within the framework of the legislation to achieve results.

Since 1992 the commercially sensitive information which the institutions must disclose has been entirely in the public domain, and from that point all financial service consumers, including federal and state government, have potentially been able

to base their choice or preferment of institutions and products on more information. In any event, rather than simply having money in a bank, consumers (and regulators) are given information relating to what their money is used for.

In fact there have been three perceptible steps to CRA regulation

- (i) 1977-1992 CRA disclosure to the bank authorities only
- (ii) 1992- CRA disclosure to the public
- (iii) 1997- results rather than process CRA regulation

It is important to note that the CRA came in the wake of the highly draconian Home Mortgage Disclosure Act⁶ which will have focussed the minds of US bankers in a very severe manner. And, it is submitted that following this juncture the need for and implementation of highly detailed regulation has diminished. Instead bankers increasingly have a *socially beneficial bottom-line* to aim for rather than a prescribed way to get there. The effect of post 1992 public disclosure cannot be underestimated.

Although the legislation is concerned with the general concept of an adequate provision of financial services, it is the extension of credit which is its focus, including within its scope the activities of both wholesale and retail banks although many credit-giving and financial services institutions are left outside the regulation.

As will become apparent, the CRA has been heavily criticised from all sides but it is important to distinguish between the desired goals of the regulation, the principles behind the regulation and the regulation itself. As a result of criticism, the bank regulatory agencies adopted the new

⁶ this was implemented 1975 to fight racial "red-lining" (encircling map areas in red as areas in which no more investment would be made) by asking all financial institutions that undertake mortgage business to add to their mortgage business intelligence further statistical information about the racial and income backgrounds of their borrowers. The figures that were made public through this legislation showed that levels of credit given to minorities and low-income consumers was disproportionately low. See: Schieber, P.H.: Community Reinvestment Act Update, in: The Banking Law Journal, Jan.-Febr. 1993, p. 65

Community Reinvestment Act regulations in May 1995 and established a transition period for institutions to develop compliance procedures. Since July 1997 the new regulation is in fully in place. A brief description following:

(a) *Technical Requirements*

- Public notice posted in lobby
- Public file which includes
CRA performance evaluation

Branch and service information
Map of Assessment Area
HMDA data (if applicable)
Loan data information (Large banks)
Description of efforts to improve performance (if rated less than satisfactory)
Written comments from the public

(b) *CRA Performance Evaluation Criteria*

Performance tests

Performance standards

<p>Large bank: Lending test</p>	<ul style="list-style-type: none"> • Number and amount of loans in assessment area • Geographic distribution of loans • Distribution of loans based on borrower characteristics • Community development loans • Innovative or flexible lending practices
<p>Investment test</p>	<ul style="list-style-type: none"> • Dollar amount of qualified investments • Innovativeness and complexity of qualified investments • Responsiveness to credit and community development needs • Degree to which investments are not made by private investors • Benefits to assessment area
<p>Service test</p>	<ul style="list-style-type: none"> • Distribution of branches and record of opening and closing branches • Availability and effectiveness of alternative systems for delivering bank services to low- and moderate-income people and geographies • Range of services provided • Extent of community development services provided • Innovativeness and responsiveness of community development services
<p>Small bank: Lending test</p>	<ul style="list-style-type: none"> • Loan to deposit ratio • Percentage of loans in the bank's assessment area • Record of lending to borrowers of different incomes and businesses and farms of different sizes • Geographic distribution of loans • Action taken in response to CRA complaints
<p>Wholesale or limited purpose bank: Community development test</p>	<ul style="list-style-type: none"> • Number and amount of community development loans, qualified investments, or community development services • Use of innovative or complex investments, community development loans or services and extent that they are not routinely provided by private investors

Strategic plan	<ul style="list-style-type: none"> • Responsiveness to credit and community development needs • Achievement of strategic plan goals
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It is important to note that even after that reform the major impact of the CRA is not through transparency effects on positive customer behaviour (that they use banks with good CRA performance) but through negative pressure: community groups openly complain if they feel or see evidence in the public data of being underserved of a specific bank. This is noticed by regulators who give the bank trouble with its next requests as permission for a merger. In the effect, the bank reacts itself on community group complaints and works out "contracts" for exploring financial need with adapted products. As it can be imagined banks feel quite often "bribed" in that process and keep on maintaining pressure against the Act⁷. At the same time individual bankers openly admit that they accept the responsibility of banks for some social problems: "My personal view is – it has to be done and who if not we (the banks) are in a better position to do it ... everyone in the management today sees what a difference CRA activity makes in the communities. The task is overwhelming – we have to do it."⁸

B. Conclusions for European regulation

The CRA regulation also responds to the problems analysed for the European market. It is a good starting point for a new approach in bank regulation where banking is no longer evaluated only by safety and soundness towards its own customers or the stability of the currency, but monitored on its impact on a community, a city borough or a region.

20 years experience of the CRA could suggest that such concerns are much more developed in the United States. Indeed the opposite is true. In many Member States of the EU, the balanced economic and social development of regions has a constitutional foundation. In Germany for example, the regions are bound to support each other by constitutional law. This principle is equally present in the European Treaties where the structural fund as well as different contributions are designed to compensate for structural

inequalities throughout the EU. The true difference between the US system of affirmative action and the European system of redistribution lies in their respective private and public status. CRA is not an answer to the question of how to cope with inequalities in modern society as such. In this respect observers of the American social situation would have reason enough to think that Europeans have little to learn from the Americans. The question is whether the private sector contribution to anti-discrimination could be significantly more developed in Europe than it is until now.

In this respect the US example is indeed interesting. Just because equal distribution of economic and social opportunities is a generally accepted public good in Europe provided by States and the European Commission through subsidies and home State action, private efforts to support such policies are less developed than they could be. As it is generally assumed that public efforts will no longer suffice to counteract rising tendencies towards regional and social discrimination, Europeans have good reason to take a closer look at the US system of Community Reinvestment for elements which could be incorporated into an emerging European system of more private responsibility for the public good in general.

Two aspects have to be kept separate: *Firstly*, mistakes that have been made in the US do not have to be copied in Europe and *secondly*, differences in the banking environment in both continents necessitate a tailored approach for the EU.

- The starting point of the CRA in the US, that is to develop community reinvestment performance only as between banks and their supervisory institutions has shown little effect (but may have given the banks sufficient time to comprehend the philosophy of the CRA and integrate its requirements into their reporting system). Reporting about social effects of banking must be public in order to be successful.
- Administrative rules defining precisely how social effects should be measured and demonstrated may lead to an inappropriate bureaucratic burden for banks and divert their attention from the purpose of the required action to its administrative requirements. Such bureaucratic rules may equally produce unnecessary hostility to the regulation itself. A regulation should therefore focus on the

⁷ as a contemporary example see Wall Street Journal, "Gramm's Glass-Steagall Beef", 6.01.1999, page A22

⁸ in an interview with the Northern Trust Company Chicago 1995, full documentation in Evers/Reifner et. Cit. P. 418f.

purpose of the new 1996/97 CRA approach leaving as much discretion as possible for its fulfilment to the banks itself and enabling them to put up their own agenda as a yardstick for their respective social responsible behaviour.

- Negative sanctions for non compliance are certainly an important starting point for making banks respond to community reinvestment ideas. But banks should have the opportunity to develop more positive incentives through the use of social banking procedures in marketing, product design and public relation.
- Mere quantitative approaches such as the social distribution of products among customers have two important disadvantages: *Firstly*, the bureaucratic part of disclosure is maximised and *secondly*, data suggesting success may disguise inappropriate or bad products which diminish instead of improving economic opportunities in the long run.
- In addition, the US-American culture of pressure groups and heavy lobbying have developed an atmosphere that bankers just hand over social purpose money to communities and their pressure groups to keep them quiet.⁹ At the same time, the CRA asks banks only to do profitable business which produces another force to outsource social lending portfolios to hide losses or deliver more sponsoring than social banking. As a result, attempts to integrate social banking methodologies into mainstream banking have weakened.
- An important European contribution to the CRA could be the combination of minimum standards for the social acceptability of bank products (usury interest rate ceilings, control of costs in repayment default, rights to adaptation in difficult social situations etc.) with a general monitoring of access.
- The European market would equally have to consider the existing state owned banks, coop banks and specialised financial institutions with social purposes and give them preferential treatment if they can show that they emphasise community reinvestment more than the legislation requires.

⁹ in the quoted Wall Street Journal article it is described that to get the acceptance of the regulators for recent mergers, Travelers and Citibank announced a CRA commitment of \$115 billion (double Citibank's US deposit base) and NationsBank and BankAmerica created a 10 year package worth \$350 billion

C. Recommendations

On the background of the above analysis of the strength and weaknesses of the American CRA and of the European regulatory regime, the following points try to focus some crucial elements for an efficient European regulation.

Develop a legal basis for non-discrimination on social grounds

- (1) In spite of the emphasis the European Treaty puts on equal rights and access, it is to acknowledge there is no robust principle of anti-discrimination, either on ethnic, geographical or social grounds informing the provision of financial services in any of the large EU countries Germany, France and the UK.¹⁰ The Second Banking Directive refers vaguely to the general good in and the European Court has decided that this can cover the interests of consumers, the protection of workers, the social order and related matters. However, this is not a universal responsibility using similar criteria applied evenly throughout the European Union as a requirement under which all banks must operate. Rather each banking authority may establish what it considers to be in the general good and apply that within the boundaries of European law. This contrasts starkly with the USA position. With the globalisation of banking services creating European if not global banks it is submitted that in order to progress the principles of non-discrimination and universal equality of access to financial services it is likely that a legal basis must be developed both in administrative and private legal relations at a European level. The Banking Directives might be an appropriate scheme for such legal basis.
- (2) In France and Germany, at the State level there is a principle of equal treatment whereas for private entities there is no equivalent. With a privatisation of public tasks it is assumed that the US anti-discrimination approach must gain grounds, particularly in areas as central as financial services. In the UK one can see the development of minimum standards of social responsibility among some of the

¹⁰ this was analysed in the above quoted country reports (in Evers/ Reifner 1998)

utility companies in relation to the provision of basic services such as gas, electricity and telephone. In the latter case, British Telecom will soon be introducing a low cost service which permits incoming calls only and outgoing calls to emergency services only.

- (3) Whether the goal of non-discrimination on social grounds ought to be achieved through legal non-discriminatory principles in the EU, as it has been in the USA, is queried considering the strength of social equality heritage of continental European countries and principles of existing non-discrimination in EU law. One lesson from the US CRA development could be that it makes less sense to focus on ethnic discrimination than on social discrimination. However, if the legal approach is not to be one of non-discriminatory principles, the question of how to enforce principles to *act in the general good* becomes a matter of administrative law.
- (4) EU structural funds, in the same way as German federal arrangements, demonstrate a commitment to regional balance with regard to economic prosperity and consequently social equality. The concept of this type of non-discrimination is thus already well-understood within the EU. The legal place for anti-discrimination regulations remains to be identified.

Flexible regulation allowing priority to private initiatives

- (5) Whereas a robust commitment to achieving social goals through banking and its regulation is desired, any legislative instrument would, it is submitted, have to be of a preliminary nature, be very flexible and ultimately reflexive to market adaptation to principles of social responsibility.
- (6) There is another lesson to be drawn when looking on the US CRA: not the procedure demanded by the regulators, but the effects of banks examining their social impact, and developing new strategies and products, has been demonstrated as being successful. The force of regulators, fixed procedures and documentation requirements make the CRA inefficient and something of a last resort measure in its USA form. It is

believed that in order to get credit institutions' attention to the subject of social responsibility, measures of that magnitude ought not to be required. However, it is important to ensure that at a national and at a European level appropriate regulatory bodies are given the responsibility of ensuring that there is an adequacy and effectiveness of financial services for low income consumers and for social purposes.

- (7) It is desirable to achieve certain minimum standards in the provision of financial services such as equal access for all. There should not be cost penalties for low-income consumers. But beyond such minimum standards in, for example the areas of basic banking services, mortgage loans and small business finance, market forces should be allowed to direct activity. It has also to be questioned whether European Union funds be used to support low interest loans instead of market rate loans because this delivers wrong incentives and as a consequence fails to help the target group.
- (8) Whilst it may be appropriate to annex any legal measures on social responsibility to the Social Chapter where much of the social dimension of EU law is found, a *Recommendation* on the social responsibility of credit institutions setting out a European Code of Practice and a set of goals for Governments to aim towards may be more appropriate. Together with the Recommendation a review committee could be established to follow the implementation by Governments and private credit institutions of such proposals.
- (9) If credit institutions are to have minimum standards of social responsibility then they should be motivated to show commitment for equal access to financial services. One possibility could be a *self regulated Code of Practice* defining a basic banking service and covering responsibility for access, for quality and cost of financial services. A step in that direction was made by the European Savings Bank Association when they issued their statement of social principles in 1996. There should also be structures for review of the implementation of such statements to see how progress is being made.

(10) Transparency of these issues is highly desirable to allow the proper functioning of market mechanisms and it is imperative that information about the activities of credit institutions in respect of their social responsibilities should be in the public domain.

(11) Transparency in three areas seem to be necessary: *distribution, social effects and best practise of financial services*. A Code of Social Responsibility in Banking practice might be drawn up which sets out what such responsibilities might be and how they should be reported. It might include the proposal in the UK report that information on a geographic basis should be provided as part of an initiative to combat inadequacies of financial services, coupled with data from reports by banks to the committees which review breaches of Codes of Practice.

(12) In order to measure social effects quantitative and qualitative sociological studies could be undertaken on behalf of credit institutions and their associations, particularly to ascertain what were the effects of certain products on low income consumers.¹¹ Best practice studies could be placed with relevant international bodies.

(13) It may be desirable to include incentives towards best practice, to publicise the most successful initiatives and to allow institutions themselves to evaluate what they undertake in this regard as much as

possible. Some external and independent assessment may also be required to consolidate a robust framework. Subsidies are certainly to be considered in all areas where contamination of the credit institution business decision making process is avoided. In the example of commercial micro loans it is obvious that even best practice is not commercially sustainable and therefore subsidies are essential. However, the technique of subsidy should foster market creativity and striving for efficiency on the one hand while concentrating on that part of the business where the social responsibility leads to over average costs - in the case of the previous example, because of the high support involved.

(14) In addition, the EU Banking Directives need to remain sufficiently flexible to permit new social financial institutions to develop within appropriate prudential criteria. Further examination of this area is overdue.

(15) At a consumer level there is also room for considering what tax incentives might encourage bank customers to save and invest for social purposes and thereby provide specific funds for such purposes. Making transparent what money is used for by particular institutions can only encourage consumers to make informed decisions.

¹¹ Europe has hundreds of state subsidized research institutions for city development, housing, labour market etc.. Nearly none of them emphasises the research on new banking products that are especially designed to meet the needs of low income communities. As the banks equally do not invest into such developments, there is also a lack of ideas and of necessary consulting to make the general aspirations of CRA viable and practical. Much of discrimination is also a lack of imagination that other tools could do better. Probably the best European research the area of access to finance is done by the Private Finance Research Centre (PFRC) in Bristol - some of it financed by the British Bankers Association. More of such research would make it clearer for the state and the banks how with adopted products tax money and write offs could be saved.