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# Funding Prosperity in the Twenty-first Century: Exploring Modernization of the Community Reinvestment Act

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**Executive Summary**
Access to credit is key to economic prosperity but unevenly distributed within the United States. Unmet credit needs and predatory lending practices have harmed the economic security of low-to moderate income communities and communities of color for decades, including across mortgage lending, small business lending, and consumer finance.

The Community Reinvestment Act (CRA),[1] passed in 1977 in direct response to this history, is a federal statute meant to ensure that banks serve the communities where they do business. Under the CRA, banks must conduct a certain portion of their lending and investment in low-to-moderate (LMI) places and ultimately receive a rating on their performance. These ratings factor into various regulatory decisions such as approvals for mergers or new branches.

The CRA, however, does not apply to nonbank lenders, who in recent history have taken a growing share of multiple lending markets. This brief explores the various facets of this problem and their ramifications through the lens of small business lending.

## Background

*How the CRA Functions*
The CRA, as implemented by the bank regulatory agencies, establishes a series of tests to ensure that a certain portion of banks' products and services reach LMI consumers and communities. The tests begin by considering where a bank has its branches or where it otherwise conducts a considerable amount of business. Within these areas, banks receive credit, generally speaking, for providing loans and services—such as home or small business loans, checking and savings accounts, or financing for community development projects—to LMI consumers or within LMI census tracts. The ratings that banks receive from these tests are released publicly and factor into important regulatory decisions such as approvals for bank branches or bank mergers.

The CRA was a response to the history of "redlining," in which financial institutions refused to make loans to homeowners in certain areas based on the percentage of nonwhite, especially Black, residents.[2] To combat this issue, Congress leaned on the notion that banks were publicly chartered institutions with the responsibility to serve the public in its entirety, and it passed the CRA to ensure equal access to credit.

However, Congress limited the scope of the CRA to banks. The financial system has changed since 1977. Nonbank firms (or non-depository institutions), such as financial technology ("fintech") lenders that operate nearly entirely online, now provide substantial amounts of financing to people and businesses. This evolution of the financial landscape has raised the question of whether the CRA, to achieve its original goals, must be updated.

*Zooming in on Small Businesses*
To illustrate how and why CRA expansion is an important topic of discussion, this brief will focus on lending to small businesses. Small business lending spotlights the stakes of the CRA's current scope in various ways. First, access to capital is widely recognized as a top concern for underserved entrepreneurs, with some estimates placing the average cost of starting a business at $30,000.[3] Meanwhile, a major share of the market has gone to nonbank lenders whose activities lie outside the CRA's parameters. Despite these trends, small business lending has generally received less attention in discussions on CRA expansion, most notably relative to single-family mortgage lending.[4] This brief therefore aims to explore how small business finance might factor into the equation.

According to the Small Business Administration, small businesses are generally considered to be firms with fewer than 500 employees.[5] Small businesses are a powerful force in the U.S. economy, accounting for 99.7 percent of firms with at least one employee and nearly half of all private sector workers.[6] In turn, minority-owned businesses constituted nearly 20 percent of employer small businesses in 2021, with Hispanic-owned businesses on their own forming 6.5 percent.[7] Hispanic-owned businesses will likely gain a stronger foothold in the U.S. economy in the coming years, with their recent growth far outpacing that of their white-owned counterparts in terms of revenue and total count.[8] Small businesses get their financing from banks, credit unions, and non-depositories. Non-depositories can include a range of companies such as entirely online fintech providers, firms that specialize in leasing equipment to other companies, and finance companies who offer a variety of loans and other financial services.[9]

*A Note on Language*

The CRA rates banks on whether they serve LMI communities, not communities of color. However, the crafting and passage of the CRA was a response to financial practices that targeted and harmed people of color, especially Black Americans. Moreover, LMI areas and communities of color often overlap.[10] As a practical matter, he federal government collects high-quality data on minority-owned businesses, but there is no comparable data on businesses owned by LMI individuals. For these reasons, this brief will often speak in terms of business owners or communities of color.

**Unequal Access to Credit**

Access to credit is crucial to starting a business: it allows entrepreneurs to acquire space, buy equipment, hire employees and much more. It is, in short, the gateway to entrepreneurship. Yet entrepreneurs from underserved communities continue to face major hurdles in getting the financing they need to get off the ground. In 2020, white-owned small businesses received all the credit they applied for more than 60 percent of the time, while Black- and Hispanic-owned businesses fared the same only 38 and 45 percent of the time, respectively.[11]

These inequalities inhibit the full potential of minority-owned businesses. For instance, while Hispanic-owned firms number greater than 4.5 million, only a fraction of those—fewer than 350,000—have at least one employee.[12] Additionally, while Hispanic-owned firms constitute nearly 7 percent of all employer firms, they bring in only 3 percent of revenues. Meanwhile, white-owned small businesses continue to prosper, accounting for 86 percent of small business—a far greater proportion than white Americans' share of the population—and 93 percent of revenues among small business employer firms.[13]

The barriers faced by minority small business owners ripple out into households and entire communities. Most glaringly, the racial wealth gap continues to persist, with Black and Hispanic families each owning about 24 cents for every white household's dollar.[14] Small businesses are also neighborhood institutions, forming the backbones of business districts that anchor communities across America. For example, a report based on interviews with Black entrepreneurs in Washington, D.C. and Baltimore–including florists, restaurateurs, apparel retailers, bookshop owners, and beyond–highlighted how these entrepreneurs saw the importance of their businesses as coming not just from what they sold or provided, but where they did so.[15]

**Is CRA Modernization the Answer?**

Calls to expand the CRA to non-banks have most often used mortgage lending as the driving case, an understandable choice given homeownership's relationship to wealth-building. Small business lending similarly presents a curious area of exploration for CRA expansion.

First, non-banks have a strong presence in small business finance: in 2021, non-depository firms accounted for $550 billion in small business lending, nearly half of the total.[16] In other words, there is clearly a business interest in small business lending, but little commensurate regulation under the CRA. Moreover, a recent update to the CRA regulation has made it possible to bring these lenders into the fold: whereas the old CRA regulation designated a bank's "community" to be where its bank branches were, the new rule looks at other indicators of business activity such as the geography of loan originations.[17] As such, though non-depositories do not have branches, the latest CRA update has set the regulatory groundwork for considering how they might be assessed under the law.

Second, the disparities present in overall small business financing exist in the nonbank sector as well. In one recent Federal Reserve study, small businesses of color had their credit applications fully approved by online lenders only 24 percent of the time compared to white small businesses' 31 percent. A much worse case was that of finance companies, who fully approved minority entrepreneurs' applications 22 percent of the time and white business owners' applications 56 percent of the time.[18]

Third, research has suggested that the CRA has a material impact on small businesses in LMI communities. One 2018 study explored the effect on more than 500 census tracts of losing CRA eligibility alongside more than 400 that gained eligibility at the same time—it found that small business lending decreased in the former and increased in the latter, strongly suggesting the positive effect the statute has on incentivizing lending to LMI census tracts.[19] Another study explored similar dynamics in eligibility of census tracts and found that the CRA increased small business employment over time, especially for neighborhoods with greater percentages of people of color.[20]

That having been said, CRA expansion is much easier said than done. The principal technical issue with expanding the law is the wide diversity of the types of businesses that lend to small firms and the consequent array of business models that regulation would have to account for. The current CRA rule is very firmly grounded in the bank business model: for instance, one test that bank examiners use to determine a CRA grade entails counting the volume of a bank's lending to LMI communities as a percentage of its deposits from that area. This test would be moot for lenders who, by definition and law, cannot take customer deposits. Similarly, it is unclear what the CRA's enforcement mechanism would be for non-banks, as current sanctions on poorly rated banks—related to branch openings or bank mergers, along with other issues—do not translate neatly to other types of companies. These problems would repeat themselves several times over: in its analysis of the non-depository institutions that lend to small businesses, the Consumer Financial Protection Bureau identified eight types of organizations.[21]

There is also a broader conceptual issue at stake. Part of the rationale for regulating banks under the CRA is that they hold a special type of relationship with the communities in which they do business. More precisely, a bank is not a bank without deposits, and one could argue that the CRA compares lending and deposit-taking so that a bank does not take the cash it needs from one community while lending in another. Moreover, the taking and lending of deposits is in many ways a public service, delegated to banks by the federal government and facilitated through federal deposit insurance. Banks, in other words, are connected to communities through a *quid pro quo* relationship and empowered by federal authority.[22] It is not clear that this dynamic applies to, say, online lenders with different business models.

Both of these issues, however, while not easily resolvable, are not dead ends. For one, the issue of incorporating new business models is a technical matter and can be met with a set of technical solutions. For example, another test included in the recent CRA rule would assess a firm's lending in specific places not as a percentage of bank deposits, but as a percentage of total lending. While counting aggregate deposits would not make sense for a non-depository company, counting aggregate loans could. Tests like these could be modified and built upon.

Furthermore, while other lenders are not linked to communities in the way banks are, it could also be argued that they should not be cleared of any burden to underserved places. The spirit of the CRA goes beyond just banks and includes an overarching goal of remedying historical disparities in access to credit. Left unchecked, nonbanks can sustain and in fact grow these disparities—as seen in the aforementioned data.

**Conclusion**

The unequal distribution of economic opportunity and wealth continues to persist in American life. One key pillar of the current arrangement is inequality in access to credit, which inhibits underserved communities' access to homeownership, small business ownership, and other forms of wealth-building. The Community Reinvestment Act may well be among U.S.'s best tools for combating this problem, but it does not reach all flows of credit.

As shown through a case study of the small business sector, expanding the CRA to non-banks could constitute an effective way of further extending credit access to underserved people and places.

**Endnotes**


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[10]See e.g., Ben Horowitz, Michou Kokodoko, and Kim-Eng Ky, "CRA-Modernization Proposal Could Improve Credit Acces for Native Americans and People of Color in Minnesota" (Federal Reserve Bank of Minneapolis, July 27, 2022), https://www.minneapolisfed.org/article/2022/cra-modernization-proposal-could-improve-credit-access-for-native-americans-and-people-of-color-in-minnesota.

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[12]Office of Advocacy, U.S. Small Business Administration, "Facts About Small Business: Hispanic Ownership Statistics," September 26, 2023, https://advocacy.sba.gov/2023/09/26/facts-about-small-business-hispanic-ownership-statistics/.

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