City Ordinances and Low-Income Lending Reports: Policy and Legal Concerns*

Raymond Natter

June, 2012

The American Banker recently reported that a new trend is gathering momentum among many cities to restrict municipal deposits to only those banks that provide detailed reports on their lending practices in low-income communities. Under these laws, the banks can lose municipal deposits and contracts for other services if the city determines that they aren't doing enough to provide credit to low-income residents.

On May 15, 2012, the New York City Council passed the "Responsible Banking Act" that is expected to be enacted into law, notwithstanding the Mayor's veto. Under the law, banks seeking to hold city deposits must submit detailed information, broken down by census tract, on the bank's efforts to: (i) address the credit and financial services needs of small businesses; (ii) *develop* and offer financial services products most needed by low- and moderate-income individuals and communities and provide physical branches; (iii) provide funding for construction of affordable housing and economic development programs; (iv) provide permanent mortgages for consumers purchasing affordable housing; (v) restructure delinquent mortgage loans and take other actions to prevent foreclosure, and provide detailed data on such efforts; (vi) invest in community development efforts of the city; and (vii) positively impact the city through activities including charitable giving.

All of the information submitted by the bank will be considered by a newly created "Community Development Advisory Board" that will use that data, as well as information gathered at a public hearing, to determine the performance of each bank in meeting the needs of the city's communities. The report will evaluate a bank's performance relative to lending, investment and service "benchmarks" established by the board. The city's

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

banking commission will then use the board's annual report when evaluating whether a bank will be designated as an acceptable depository for the city's funds. Other cities that have either passed or are considering similar ordinances include Cleveland, Philadelphia, Los Angeles, Pittsburgh, Boston, Milwaukee, Minneapolis and San Diego.

Policy Concerns

The laws in question can be viewed as an attempt to use a city's economic power to coerce banks into making loans, investments and charitable gifts to benefit low- and moderate-income individuals, families and communities, and to engage in other activities, such as charitable giving, to benefit the underserved populations. Banks are encouraged to develop new ("innovative") products to serve these populations. Since FDIC insured banks are already rated by the Federal Government with respect to their lending and investments in low- and moderate-income areas under the Community Reinvestment Act, these may be seeking a higher level of such activities. The local laws also impose new measures not covered by Community Reinvestment Act evaluation.

Improving the economic condition of the poor and underserved are important societal goals. Everyone benefits when poverty is reduced and economic opportunity is made more available. However, the recent financial crisis also demonstrated that lending is a two edged sword. While it can enable economic improvement, it can also result in unsound loans that cause hardships and losses for the consumer, the financial institution, and the economy as a whole. As succinctly summarized by Congressman Barney Frank, "the problem underlying the recent financial meltdown was that people were getting loans they couldn't afford them."

These city ordinances seem to be intended to encourage banks to make more loans and investments to people who, by definition, are least able to afford to take on new debt. While loans to low-income individuals and mortgages to purchase affordable housing should be made, they should be made carefully. Prudent lending standards should be observed, and innovative products should be avoided, not encouraged. Pressuring banks to make certain loans in order to obtain municipal deposits will create an incentive for banks to lower their underwriting standards in order to comply with lending and investment benchmarks established by city boards. As we have seen, the results can be disastrous for all concerned.

©2012 Barnett Sivon & Natter, P.C.

The city ordinances could also be viewed to be at cross purposes with the recently enacted Dodd-Frank Act. Under the Dodd-Frank Act, innovative mortgage products, such as interest only loans, are frowned upon, and banks are required to make mortgages only if they believe that the borrower has a reasonable ability to repay the loan. The goal of the federal legislation is to increase bank safety and soundness by discouraging risky lending and investments. The city ordinances, on the other hand, encourage banks to take more risks, lend and invest in low-income areas, develop innovate products, and enhance credit availability to less than pristine customers. This appears to be in conflict with the spirit and goals of the Dodd-Frank Act.

Legal Issues

The New York City ordinance does not require a bank to comply with the lending, investment, services, and charitable giving benchmarks that will be established under the law. Instead, banks that do not comply will receive a poor evaluation by the city's Community Development Advisory Board. This poor evaluation will have to be taken into account by the Banking Commission when designating banks eligible to receive city deposits. However, in light of the public nature of the evaluation, and the public disclosure of the names of banks eligible to receive city funds, as a practical matter, a bank that receives a poor evaluation will not be eligible to obtain city deposits. Any court reviewing this legislation would no doubt find that while the legislation on its face is not mandatory, in reality it establishes eligibility to receive city funds.

One question raised by the law is whether a city has the right to impose requirements on private parties wishing to do business with the city. When a local government acts in a *proprietary* manner, contracting for services, for example, it is generally free to establish the conditions and requirements applicable to prospective bidders, in order to protect the government's interests as a counterparty. However, the courts have also held that a state local government cannot use its spending power to achieve a *regulatory* goal. Thus, the Supreme Court struck down a Wisconsin law that precluded state contracts with repeat National Labor Relations Act offenders was in effect a regulatory measure that was intended to deter NLRA violations, which was not within the province of the state's authority. Likewise, the Supreme Court found that a state law prohibiting recipients of state funds from using that money to deter union organization was invalid, because the goal of the law was the furtherance of the state's labor policy, not the efficient

©2012 Barnett Sivon & Natter, P.C.

procurement of goods and services. In 2003, the New York trial level court ruled invalid a New York City law that sought to prohibit the city from making deposits in any financial institution that makes mortgage loans with an interest rate or fees in excess of certain thresholds. The court ruled that the law was regulatory, not proprietary, because its goal was to regulate the conduct of the financial institutions, and not to protect the city in its role as a contractor. The court concluded that the city law was invalid because it conflicted with the National Bank Act and federal regulations.

City laws that condition the placement of deposits on a bank's activities in making loans, investments, and charitable contributions to targeted populations and areas would clearly be regulatory under these precedents. These laws regulate conduct, and do not address the concerns of the city as a contractor. As regulatory measures, the laws would conflict with the National Bank Act, which provides the Comptroller of the Currency with exclusive authority to require reports from national banks. Mandating that national banks provide detailed reports on their lending, investment and charitable activities in order to obtain municipal deposits would directly conflict with this federal statute. It is possible that these city laws could also interfere with other federal provisions, depending on how the benchmarks are established.

Conclusion

City ordinances designed to coerce banks into making loans and investments to lower income consumers and localities raise significant policy and legal issues. The financial crisis shows that the easy availability of credit may have unintended consequences for the borrower, the lender and the economy as a whole. Laws imposing conditions on counterparties to a city contract can also be challenged if the goal of the law is to effect regulatory change, rather than to protect the city as a contractor. These local laws appear to be regulatory in nature, and are therefore subject to legal challenge to the extent they impose conditions that conflict with federal banking law.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.

©2012 Barnett Sivon & Natter, P.C.