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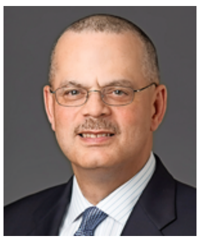
INSIGHT: Community Reinvestment Act Modernization: Reassessing The CRA Regulations (Part 1)



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Beginning a likely contentious process to overhaul the rules intended to combat redlining in low-income neighborhoods, one of the federal financial regulatory agencies has commenced a little noticed effort to revamp the regulations governing compliance with the Community Reinvestment Act of 1977 (CRA).

Recently, the Office of the Comptroller of the Currency (OCC) released an advance notice of proposed rulemaking (ANPR) seeking public comments on suggested approaches to modernizing the CRA regulations applicable to national banks, US federal branches of foreign banks, and federally-chartered thrift institutions. According to the OCC, the purpose of this revision is to better align the current CRA regulations with the transformation of the banking industry and its service delivery model over the last several decades. The banking industry broadly supports reforming the CRA regulations, although opinions vary on how best to do that. Community groups are worried that the rule changes will result in less access for lower income borrowers to credit and banking services.

Typically, the federal financial regulators have adopted a consistent and coordinated approach to amendments to regulations of statutes for which they are jointly responsible. The OCC's ANPR suggests that the agency has decided to move forward on its own without reaching agreement at this stage with the Board of Governors of the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) on a common CRA modernization approach or even the solicitation of related questions of the public. The CRA is a politically charged statute and any reformation of the associated regulations will be subject to intense public scrutiny and debate.

This article is presented in two parts. In this first part, we will briefly discuss the history of the CRA and regulations promulgated thereunder and outline the reasons for changes to the current CRA regulations. In the second part, we will discuss the OCC's initial approach to modernizing the CRA regulations with the solicitation of comments on its ANPR.

A Brief History of the CRA The CRA was enacted more than 40 years ago to combat discriminatory lending practices — ''redlining'' — in lower-income neighborhoods. These practices had deep historical roots, dating back to at least 1935 when the Federal Home Loan Bank Board caused the creation of ''residential security maps'' for 239 cities. The maps designated four categories of lending and investment risk that identified predominately African-American areas, literally with red markings, as riskiest for lending. In addition to racial discrimination, economic and institutional factors coupled with a regulatory environment that prohibited interstate branching or acquisitions and interest rate ceilings on mortgages helped limit broader access to credit. As these factors and others like urban flight led to the deteriorating condition of American cities, Congress and the public blamed the financial institutions for the lack of credit availability to lower income communities.

The CRA reaffirmed a long-standing principle that financial institutions serve the ''convenience and needs'', including credit and deposit needs, of the communities in which they do business. And as the Federal Reserve Chairman at the time, Ben Bernanke, highlighted in his speech on the thirtieth anniversary of the enactment of

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the CRA, serving the needs of the local communities has been viewed as the *quid pro quo* for the institution's access to the discount window and federal deposit insurance fund.

That said, the CRA was but the latest in a series of laws enacted in the 1960s and 1970s for the purpose of expanding access to credit. Previously enacted legislation addressed other aspects of fair lending practices, like the Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974, which prohibited discrimination because of race, sex, religion, national origin or other personal characteristics in housing-related lending, or for any credit transaction, respectively. The Home Mortgage Disclosure Act of 1975 (HMDA) was another major fair lending statute, passed to provide transparency in mortgage finance, as detailed by the Federal Reserve Bank of St. Louis.

As drafted, the CRA is a lean statute, which probably attests to the contentious atmosphere surrounding its passage (it survived a motion to strike it from larger housing legislation by one vote). It applies to regulated financial institutions like national banks, savings associations, and state-chartered commercial and savings banks, but not credit unions and nonbanks such as insurance companies and securities firms. After stating its purpose, the Act leaves its implementation to the federal financial supervisors to encourage their institutions by regulation and examination to meet the respective credit needs of their local communities in a manner consistent with safe and sound lending practices. That requirement was intended to mollify those who argued that unsound lending practices or federally mandated credit allocation to achieve societal goals would imperil financial institutions and the deposit insurance fund. The supervisors exercised this authority with the implementation of CRA regulations.

For a long time, the CRA regulations had little impact. As the Reagan administration began cutting federal subsidies for low-income housing in the early eighties, however, community groups were left scrambling for alternative funding sources. Then Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1984, accelerating bank mergers and acquisitions. CRA advocates seized on the leverage created by these transactions and used the public comment process to protest bank applications on the grounds of the institutions' failure to satisfy the convenience and needs of the community. Then, in 1989, the regulations were amended in response to the enactment of the Financial Institution Reform and Recovery Act (FIRREA). With FIRREA, Congress required the public disclosure of banks' CRA ratings and performance evaluations, expanded data collection, and made public certain data reported under HMDA. This information allowed community advocates and bank analysts to perform sophisticated quantitative analyses on how well financial institutions were meeting the convenience and needs of their communities. And in 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act requiring, in part, the inclusion of a bank's CRA examination data in determining its CRA rating.

In 1995, the CRA regulations were further amended to clarify the performance standards; customize the examinations to account for the difference in the size and business model of institutions; and reduce compliance burdens. The agencies established a three-pronged test for large financial institutions based on performance in lending, investments and services. This revision also encouraged the adoption of innovative approaches to community development needs and a streamlined examination process for small banks. The Gramm-Leach-Bliley Act of 1999, authorizing the affiliation of commercial and investment banks, made a ''satisfactory'' CRA rating a condition to become a financial holding company and to ongoing authority to engage in certain financial activities. It also required the amendment of the CRA regulations by providing for another level of transparency with the disclosure of agreements between financial institutions and third parties, and granted some relief to small institutions by extending their CRA exam cycles.

Finally, new revisions to the 1995 CRA regulations were adopted in 2005 after several years of review, public comment and scholarly research into their effectiveness. Under the 2005 regulations, ''small banks'' would be only subject to a lending test in addition to a new and more flexible community development (CD) test. The definition of ''community development'' also was expanded to include new categories of ''distressed and underserved nonmetropolitan middle-income geographies and designated disaster areas.''

Today, these regulations provide for the supervisory agencies to evaluate their respective institutions' compliance with tests that are tailored to different business models and institution sizes. Under the current framework, small banks (less than $313 million in assets) are evaluated under a retail lending test. Intermediate small banks (assets between $313 million and $1.252 billion) are evaluated under a retail lending test for small banks and a CD test for lending, investments and CD services. Large banks (more than $1.252 billion in assets) are evaluated under a lending, investment and services test. And wholesale and limited purpose banks are evaluated under a CD test that broadly considers CD loans, investments and services. Any bank can decide to be evaluated under a strategic plan that sets annual goals for lending, investments and services and must be developed with community input. Following examination under one of these tests, the financial institution receives one of four ratings from its supervisor of ''outstanding'', ''satisfactory'', ''needs to improve'', or ''substantial noncompliance'' for the performance period and the agency prepares a written report that becomes part of the supervisory record of that bank and a public evaluation that must be made available for public review.

Reasons for Changes to the Current Regulations The CRA and associated regulations have been successful in many respects in meeting the Act's intended purpose. It also is widely acknowledged by all stakeholders, including Administration officials, legislators, regulators, advocacy groups, and financial institutions, that modernization of the CRA regulations is overdue in light of the changes in the financial services industry. There is no agreement yet, however, as to the form of this modernization, and the OCC's ANPR is a necessary step in that direction.

Similarly, there is little consensus on the extent to which the CRA has contributed to lending, investments and services to low-and moderate-income (LMI) individuals and geographies that would not have happened but for the enforcement of the act by the federal banking agencies and/or the use of the CRA as a lever by community advocates. For example, citing research that has generally found that the CRA has produced net positive results for LMI communities, former Federal Reserve Chairman Bernanke nonetheless described CRA as far from perfect, with a net effect on LMIs that is ''difficult to measure with precision.'' Acknowledging the issues with the CRA, Mr. Bernanke concluded that ''at least in some instances, the CRA has served as a catalyst, inducing banks to enter underserved markets that they might otherwise have ignored. . .'' and that ''the CRA may have had a multiplier effect, supplementing its direct impact by stimulating new market-based, profit driven economic activity in [LMIs].'' These views are in accord with those of other economists and policy analysts on the effect that the CRA has had on increasing access to credit in LMIs. But, they are not shared universally.

In responding to President Trump's executive order in February 2017 to identify and report on regulatory inefficiencies and tailoring opportunities, the US Treasury Department catalogued in its reports the list of concerns that market participants, regulators and others have had with CRA compliance.

In June 2017, Treasury issued a report to the President announcing, in pertinent part, its plans to conduct a review of the CRA framework by ''comprehensively assess[ing] how the CRA could be improved.'' This review would be performed through the solicitation of input from stakeholders into each of four areas: how the banks' CRA activity is measured; how CRA supervision could be harmonized; the distribution of CRA geographic assessment areas; and the effectiveness of the regulatory review and examination process. Community advocates and Democratic legislators (like Rep. Gregory Meeks (D-NY)) feared this signaled an effort by the Trump administration to weaken the CRA.

After meeting with approximately 100 stakeholders representing the community, consumer advocates, academia, think tanks, financial institutions, trade groups and law firms, Treasury issued its CRA memorandum report on April 3, 2018, recommending changes to the CRA in each of the four areas of review. The Treasury report focused on possible regulatory and administrative changes (not legislative changes) that in Treasury's view were consistent with the original intent of the CRA.

First, Treasury highlighted the transformative changes that occurred in the banking industry since the enactment of CRA. These included the introduction of extensive interstate operations; the development of alternative delivery channels for the provision of products and services to the public; and the emergence of wholesale and limited purpose banks with no physical locations in local communities. Then Treasury recommended that the financial institution supervisors revisit the approach to determining assessment areas in order to take into account alternative channels for deposit taking and service delivery now used by banks. Treasury suggested that the CRA framework should include areas where a bank is physically located, outside of its physical footprint, and where it accepts deposits and does substantial business. This approach was intended to address alternative delivery channels, wholesale and limited purpose banks, emerging branchless banks and military banks that serve a geographically dispersed client base.

Second, Treasury observed that the examination process lacked clarity and flexibility. The report indicated that CRA eligibility determinations are vague and inconsistent, with long time lags between exam periods and the receipt of the CRA ratings. It recommended expanding the types of loans, investments and services eligible for CRA credit and clarifying the eligibility criteria. Treasury believed that the CRA regulations were too subjective and it was necessary to reform the way CRA regulations establish a bank's ''performance context'' the factors examiners review to understand the context of the bank's performance record like demographics, economic data, lending marketplace, investment and service opportunities and business strategy. Treasury also believed that the publicly available examiner guidance lacks clear guidelines for determining bank performance and recommended a less subjective evaluation technique and the establishment of clear criteria for grading CRA loans, investments and services. The report concluded that the examiners were insufficiently trained and were disadvantaged by inconsistent priorities and resources between the head office and the field offices. Treasury indicated that the examination process overemphasized the branch network in the service test.

Third, Treasury found that each of the regulators followed a different examination schedule and established separate exam cycles for large and intermediate small banks. Citing stakeholder complaints with the amount of time required to conduct CRA exams, Treasury recommended the standardization of the exam schedules across regulators. As to the scope of examinations, Treasury also noted that CRA regulators provided examiners with discretion to designate assessment areas as either full scope (meaning comprehensive reviews) or limited scope (requiring less detail).

Fourth, Treasury found that the regulators downgraded CRA ratings if their examiners discovered violations of consumer protection laws and that ratings were adversely impacted by evidence of discriminatory or other illegal credit practices in any geography of the bank or its affiliates. It recommended that the CRA regulators adopt uniform guidelines that consider a ''logical nexus'' (in the words of an OCC October 2017 policy manual update) while considering the remediation efforts undertaken by the bank. For example, Treasury argued that a UDAAP (unfair, deceptive, or abusive acts and practices) violation for a credit product that was not considered as part of the bank's CRA performance would not have a logical nexus.

Fifth, Treasury also made a number of other recommendations based in part on feedback from the stakeholder meetings. Treasury recommended the discontinuance of the practice of delaying the release of CRA performance evaluations while awaiting the results of pending consumer protection investigations or enforcement actions. It also recommended that the Federal Reserve and the FDIC adopt a November 2017 policy change by the OCC to the effect that less than satisfactory CRA ratings would not result in the disapproval of bank applications for new branches, etc. under a four-factor test. Treasury recommended that the CRA regulators clarify that a community benefit plan entered into with community groups in connection with bank M&A transactions is not required in order for the bank to prove it meets the convenience and needs of the community. Treasury recognized that nonbanks represent an increasing share of loans eligible for the CRA lending test but are not CRA regulated. It recommended that the CRA regulators monitor the impact of the emergence of nonbanks on the effectiveness of the CRA. Finally, Treasury recommended that community development investments be treated the same as community development loans for CRA credit, and that banks be allowed to store the public file electronically on their website.

The reaction to Treasury's April 2018 report was generally cautious but swift.

Federal Reserve Governor Lael Brainard said the time was ripe for modernization of the CRA regulations to make them more effective in making credit available at a time of technological and structural changes in the banking industry. She said revisiting the regulations to allow consideration of the bank's activities in its assessment area is a reasonable place to start. She also opined that banks should be encouraged to seek opportunities in the areas that are underserved and the regulations should be tailored to recognize that banks vary widely in size and business strategy and serve communities with widely varied needs. She echoed the Treasury report on the need for greater consistency in exams and ratings across the agencies and that the regulations should ensure against discriminatory or unfair and deceptive lending practices.

John Taylor of the National Community Reinvestment Coalition (NCRC) took a more skeptical approach, indicating that some provisions of the Treasury report were hopeful but lacked detail, while others were troubling. He thought modernizing the CRA to online lending and closing existing assessment area loopholes is commendable. However, he said the report is a ''far cry'' from the promised modernization because it excludes credit unions, nonbanks, and fintech companies. He worried that the report codified what he characterized as weak enforcement by the regulators by ending the presumption that merger or acquisition applications will be declined. He was very concerned with the deemphasis on the use of community benefit agreements, saying it was a ''get out of jail free card'' given that failing ratings only account for about 2% of all banks' ratings (presumably based on the assumption that at least some portion of the remaining 98% of banks should be doing more notwithstanding their satisfactory or better ratings). He agreed the exam process needed to be clarified and exam schedules standardized, and he encouraged regular communications among examiners and community groups. He worried again about deemphasizing bank branches, saying cell phones cannot replace brick and mortar banks without adversely impacting lending in LMI areas. Moreover, he disagreed with the OCC's ''logical nexus'' analysis which holds that there must be a ''logical nexus'' between the assigned ratings and evidence of discriminatory or other illegal credit practices in the bank's CRA lending activities to ensure alignment between the ratings and the bank's actual CRA performance. He argued that double sanctions could be appropriate for banks that have committed egregious legal violations.

In June 2018, Comptroller of the Currency Otting testified before the House Financial Services Committee indicating the OCC was discussing an ANPR on modernizing the CRA regulations. He said the OCC would consider expanding the types of activities that qualify for CRA consideration, revisiting the concept of assessment areas and developing metrics-driven approaches to evaluating CRA performance ''using clear thresholds.''

In his July 13 testimony to the House Financial Services Committee, Treasury Secretary Mnuchin discussed his experience with the CRA while running One West Bank. He declared that it was not his goal to weaken the CRA but to ''mak[e] it more effective for communities. . .[and] that money is not going into the communities it should be. . .[and] CRA can help communities more so than it does. . .''.

FDIC Chairman Jelena McWilliams was interviewed in August 2018 where she reportedly said that, while she supported efforts to revamp the CRA, bank branches in rural communities were important to serving the community needs. This appeared to be a response to the suggestion by the OCC favoring the elimination of geographic assessment areas from CRA regulations.

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