Insight

One Small Step for New York; One Large Misstep for Housing Finance

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Executive Summary

- Congress passed the Community Reinvestment Act (CRA) in 1977 to prevent deposit-taking banks from withholding loans or general banking services from individuals living in low-income communities.
- The CRA is almost 50 years out of date and not even fit for the purpose it currently serves.
- Despite its obsolescence, some state lawmakers are seeking to expand the CRA to non-deposit taking banks, a constituency the law was never designed to cover, to address a need those lawmakers have not demonstrated is a concern.

Introduction

State legislators in Illinois, Massachusetts, and New York have taken steps to expand the range of financial services actors subject to the Community Reinvestment Act (CRA), and other states are taking note. The CRA is a 1977 law passed to combat "redlining," where banks fail to provide services to low- and middle-income (LMI) communities. Given its age, it is not surprising that the CRA is no longer fit for purpose and fails to adequately function even for the banking constituency for which it was designed. State proposals to introduce CRA-like regimes that also cover mortgage banks therefore represent a doubling-down (and duplication) on bad federal policy – extending a dysfunctional law over constituencies the law was never designed to cover.

The Community Reinvestment Act

Congress passed the Community Reinvestment Act in 1977 to prevent banks from withholding loans or general banking services from individuals living in LMI communities.

Banks are "encouraged" by the CRA to provide services to these communities and in a multi-part evaluation are given a CRA score by the three regulators operating the CRA: the Federal Reserve (the Fed), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC). CRA ratings then factor into these regulators' decisions to approve or deny bank mergers, acquisitions, branch expansions, and branch consolidations. Put another way, banks need to have a good CRA rating to pursue changes in their business. Thus, penalties under the CRA include denial of mergers or branch expansions, as well as the loss of expedited processing on corporate and regulatory affairs.

For a primer on the CRA, see here. For more information on proposed CRA reform led by the OCC, see here.

Mortgage Banks

For now, the CRA applies only to depository lenders. A depository institution is any firm that is legally allowed to accept deposits from consumers, including savings banks, commercial banks, and credit unions. The best example of a non-depository institution is a mortgage bank. Mortgage banks are specialized banks that perform only a subset of banking activities in that they underwrite, fund, and service loans, but nothing else; they do not hold customer deposits. Mortgage banks typically fund the loans they offer with large lines of credit and make a profit by selling these loans onto the secondary market. Many mortgage banks offer better service to consumers because they are smaller, more nimble, less regulated, and offer a wider range of products to consumers; this superior service is often at the cost of higher interest rates. The most significant mortgage bank is Quicken Loans, originator of the most mortgages nationally in 2020.

Why the CRA Should Not Be Expanded to Independent Mortgage Banks (Or Anyone Else)

The CRA Was Never Intended to Cover Non-Deposit Taking Institutions

What, precisely, is the "reinvestment" in the Community Reinvestment Act? As originally drafted, the CRA was intended to cover deposit-taking institutions that, on receiving deposits from the communities in which they were physically based, would "reinvest" some of those deposits back into those communities. Non-deposit taking institutions do not take deposits – there is nothing to "reinvest." In spirit, the CRA is no more applicable to a mortgage bank than a telecom company or any other firm providing a service to the community.

Further, while deposit-taking institutions are generally subject to enhanced scrutiny and regulatory oversight, this is not without some associated benefits. Deposit-taking institutions have access to FDIC deposit insurance, the Fed's discount window, and advances from the Federal Home Loan Banks (FHLBs). Non-deposit taking institutions do not share these advantages, so why subject a telecom company or mortgage bank to the same regulatory burdens?

The CRA Is Predicated on Physical Locations

While the banking industry has changed significantly in the past 45 years, the CRA has not significantly changed at all, and does not account for online banking – or even?interstate banking. The CRA relies predominantly on an assessment of LMI lending and other activities in a bank's "assessment area" – which, in 1977, meant a bank's physical brick-and-mortar locations. Under this definition, the evaluation excludes lending that occurs online, which leaves out banks that conduct lending practices partially or totally online via the Internet. Were the CRA to apply to a mortgage bank such as Quicken, this focus on the physical would severely shortchange the bank in its assessment. Quicken is headquartered in Detroit, yet it would receive no credit for fair lending as it has no physical locations geared towards consumers there.

The CRA Is Otherwise Not in Great Shape Anyway

The CRA's failure to account for online banking may be its most obvious flaw, but it is far from its only problem. The tri-party evaluation system is tremendously opaque. Banks have long complained about? the CRA assessment, which is notoriously poorly defined, costly, time consuming, and produces results difficult to tie back to concrete examples. These regulatory costs are borne by banks regardless of size – adding to the financial burden on new or small banks needing to overhaul their systems or collect and report on extensive data – decreasing the viability of new entrants to the banking and mortgage space.

Even Federal Regulators Can't Agree

In December 2019, the OCC released a proposal to modernize and overhaul the CRA. At the time it was considered unusual for the OCC to do so without the buy-in of the Fed and the FDIC given that all three administer the CRA; the OCC, and in particular then-OCC Comptroller Joseph Otting, made it clear that the need for reform was too pressing to wait for a tri-agency approach. While the FDIC eventually joined the proposal, the Fed never did, with the Fed's reluctance believed to center on the new prominence of the dollar value of CRA investments in the OCC's proposal. Eventually the OCC published its final rule without the FDIC, which did not feel like it could commit to the desired timeline. Since this point, the Fed has introduced its own proposed CRA reform and the OCC in May 2021 announced that it would reconsider its final rule. In any event, it appears significant that there is a perceived need at the federal level to update the CRA but that the matter is complex enough to have already sunk one reform effort. For state legislators to expand CRA requirements to non-deposit taking institutions under these circumstances therefore appears hasty at best.

What Is the Need?

If the objective of state lawmakers is to promote sustainable lending to LMI communities, it is not clear for these reasons why the CRA is the best vehicle to do so. But to go one step further, it is not even clear that non-deposit taking institutions such as mortgage banks are lacking in their service of LMI communities. Research from the Urban Institute demonstrates that mortgage banks have a higher LMI borrower and area share than traditional banks. Mortgage banks make up the majority of originations in government housing programs run by the Federal Housing Administration (FHA), Veteran's Association (VA) and Rural Housing Service (RHS), and these programs are mostly geared toward the needs of LMI communities. It is not clear that this lending to LMI communities is a problem that needs fixing.

Conclusions

The proposed expansion by state legislators of a CRA regime to non-deposit taking institutions is concerning. This is not simply a case of forcing a square peg into a round hole. This is a square peg, almost wholly rotted through, being forced where it is not clear that a hole even exists. Worse, as the bill for any new regulations would be footed by private industry, these costs would inevitably pass to the very consumers these lawmakers are seeking to save.