

## Insight

# The Community Reinvestment Act Revisited

**THOMAS KINGSLEY | OCTOBER 24, 2023** 

### **Executive Summary**

- The Community Reinvestment Act (CRA), a 1977 law designed to promote financial inclusion by requiring banks to provide services to low- and middle-income communities, has not been meaningfully updated in decades and notably does not support electronic banking.?
- The CRA's federal regulators have released a joint final rule seeking to provide greater clarity and consistency to the CRA assessment process; in particular, banks will be required to make CRA loans in areas where they have a concentration of business and not simply a physical branch.
- While a CRA update is necessary and the final rule represents the best chance of reform in decades, the rule as formulated may encourage banks to exit lending in underserved communities as rule compliance would be onerous and costly; moreover, the rule does not cover nonbank lending so would not even cover the majority of credit extensions.

#### Introduction

The Community Reinvestment Act (CRA) was passed by Congress in 1977 to prevent banks from withholding loans or general banking services to individuals from low- or middle-income areas, a practice known as "redlining." The CRA is therefore the bedrock of financial inclusion initiatives underpinning the provision of banking services to population segments banks might otherwise deem unprofitable. The CRA architecture is also enormously important to banks, as good performance in the annual assessment leads to rewards in the form of "points" that banks can "spend" on desirable activities such as issuing new charters, opening new branches, relocating branches, consolidating, and embarking on mergers and acquisitions. For more information on the CRA, see the American Action Forum's primer?here.?

Three financial regulators oversee implementation and enforce compliance with the CRA: the Federal Reserve (Fed), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC). CRA compliance applies to all FDIC-insured depository institutions, including national-bank holding companies, saving associations, and state-chartered banks. Any (effective) reform of the CRA requires at least the implicit buy-in of all three agencies; a?significant reform effort?in 2019 led by the OCC under then-Chairman Joseph Otting and joined by the FDIC was stymied by lack of support from the Fed. A second attempt at reform by the OCC in 2020, this time going without the support of either the Fed or the FDIC, also struggled to get out of the gate: While the rule was finalized by the OCC, it was the subject of significant legal challenge for violating the Administrative Procedures Act. Then with the incoming Biden Administration in early 2021, the new leadership at the OCC fully rescinded the rule before banks had to comply.

This latest regulatory reform effort represents yet another attempt to reshape the CRA, but the odds of success are considered significantly higher by virtue of being a joint proposal of the Fed, FDIC, and OCC. While the agencies have sought to bring "greater clarity and consistency" to the process, meaningful questions remain as to whether proposed loan concentration rules will incentivize banks to -income areas to avoid triggering CRA thresholds.

#### The Need for Reform?

Despite the importance of the assessment, the CRA has not been meaningfully updated since implementation and does not reflect the development of online banking at all (as originally drafted, the CRA did not even account for?interstate?banking).?As banks increase their range of internet banking services, the CRA is increasingly nonapplicable – and that lack of applicability actually harms some banks that operate only online. Even today banks are judged on the services they provide to vulnerable populations within a given "assessment area," the geographic region around a physical branch.??

Under current implementation, evaluations for CRA compliance rely on servicers having physical brick-and-mortar locations as their nexus. More specifically, an assessment area is considered?to be the "geographies where the bank has its main office, branches, ATMs and surrounding geographies in which the bank has originated or purchased a majority of its loans." Under this definition, the evaluation excludes lending that occurs online, which leaves out banks that conduct lending practices partially or totally online. For example, Ally, the only fully online bank in the United States, is headquartered in Detroit, yet it does not receive no credit ?for fair lending there as it operates only online. Besides not giving online banks the appropriate credit or rating, this definition of assessment area may compel banks to cut their services to certain communities since they know it won't make a difference under examination for CRA compliance.?

CRA regulators don't currently look at the percentage of banks' loans granted to low- and middle-income customers, but rather at the raw numbers – how many and in what amount. This metric essentially moves the goalposts for banks based on their size, as it's nearly impossible to compare a global bank to a community bank regarding the number and dollar value of loans they originate.?

The assessment mechanism is also curiously poorly defined. Based on interviews and no discernable metrics, banks have no insight into the rating process, nor the reason given for receiving a particular rating. Even the ratings themselves ("excellent," "substantial") are undefined. The assessment process itself is costly and time consuming, and this compliance burden hits small banks harder and acts as a deterrent to new market entrants.?

#### A New, New Proposal

Under the final rule, a revised framework would apply to banks based on asset size and business model, with banks classified as large, intermediate, small, or limited purpose, with a different compliance framework for each. Depending on classification, banks (and their subsidiaries) will be assessed on "one or a combination" of seven performance tests: the Retail Lending Test; the Retail Services and Products Test; the Community Development Financing Test; the Community Development Test; the Small Bank Lending Test; and the Community Development Financing Test for Limited Purpose Banks. Of these tests, the Retail Lending Test receives the most significant weighting in a CRA calculation, will be expanded to cover geographic areas not limited simply to where banks have physical branch locations, and will apply for the first time to community banks with over \$600 million in assets.

That banks will have their current CRA requirements expanded to cover a greater geographic area – and, where their customers actually are – is a significant and necessary update of the CRA regime. Yet where previous attempts at CRA reform gave banks CRA credit for these extra-geographic activities, under the latest proposal banks will instead be penalized for them. The logical result of this weighting will be that banks may instead withdraw from these areas in order to keep loans below the CRA compliance threshold.

The final rule is at its weakest in the suggested new data collection and disclosure requirements. These will impose significant costs particularly on the largest banks, as it is unclear that this enhanced compliance burden will necessarily produce better outcomes for underserved communities. The additional regulatory burden will also continue to discourage new entrants into banking.

The banking industry has also noted that under the final rule CRA compliance would be assessed not on those areas where banks make loans, but rather where they take deposits. This measure is significantly more vulnerable to economic shock, with the agencies themselves estimating that 71 percent of banks would receive low or failing grades on a version of the updated retail lending test. Such results would significantly impair banking activity. To regulators, this may not be an undesirable result – FDIC Chair Martin Gruenberg noted last year that banks would need to engage in significantly more lending activity to achieve the highest results.

Notably, the federal financial regulatory agencies do not require authorization from Congress to update CRA requirements but would need that approval were they to attempt to expand CRA requirements to nonbank lenders. Nonbanks currently fund half of all loans in the United States and the majority of all mortgages – rendering the CRA an expensive compliance exercise for traditional banks that does not cover the credit landscape.

#### Conclusion

Federal Reserve Board Member Michelle Bowman criticized the joint-agency proposed rule to update the CRA as overly complex and unnecessary, but only one of these arguments seems clear cut. Clocking in at nearly 1,500 pages, the proposal will apply a significant and costly compliance burden on banks of all sizes. Less obvious is Bowman's charge that revisions to the CRA aren't necessary, and that the federal agencies have not sufficiently proven that banks aren't doing enough to meet the credit needs of low-income communities. That the current version of the rule relies on physical bank locations shows it is clearly outdated, and as a measure of success the racial homeownership gap is wider now than in 1968. CRA reform *is* necessary, and this latest proposal represents the best – and most likely to succeed – effort seen to date. Too little thought, however, seems to have been given to both the unintended results and the cost of the new regime.