Insight

Modernizing the Community Reinvestment Act—a New Proposed Rule

THOMAS WADE | MAY 10, 2022

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.
- Overseen by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency; while the agencies' reform efforts historically have been stymied by a lack of coordinated effort, they have finally achieved a joint reform proposal.
- The proposed modernized CRA would finally give banks credit for online banking, would stratify the assessment process on the basis of a bank's size and activity, better define qualifying activities, and significantly increase the data collection and reporting requirements of some banks.

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-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. The work performed by the agencies on that proposal does not appear to have been wasted, however, as for the first time since 1977 all three regulators have released a proposed rulemaking that modernizes the CRA, adapting the statute for an era of mobile and online banking, improving the transparency of the assessment process, and most important, updating a bank's "assessment area" to include more than just the physical geography around brick-and-mortar branches.

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 redundant – and that redundancy actually harms some banks, such as Ally, 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 receives no credit for fair lending there as it operates only online. Besides not giving banks the credit or rating they deserve, this faulty 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 loans made by a bank granted to low- and middle-income customers, but rather at the raw numbers – how many and 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.

The Proposed Rule

The joint proposal identifies five "key elements" that the regulatory agencies highlight as driving factors in modernization:

- Expand access to credit, investment, and basic banking services in low- and moderate-income communities.
- Adapt to changes in the banking industry, including internet and mobile banking.
- Provide greater clarity, consistency, and transparency.
- Tailor CRA evaluations and data collection to bank size and type.
- Maintain a unified approach.

If implemented as proposed, the updated CRA would update the approach to assessment areas, the bank evaluation framework, and record-keeping, data collection, and disclosure requirements.

Update the approach to assessment areas

While the proposal retains the traditional focus on geographical assessment areas around physical brick-and-mortar bank branches, federal regulators would for the first time require that, in addition, banks be assessed in areas of where they provide a concentration of mortgage and small business loans. A large bank, for example, would delineate retail lending assessment areas where it has an annual lending volume of at least 100 home mortgage loan originations or at least 250 small business loan originations in a geographical area for two consecutive years. The proposal also includes a nationwide assessment that would allow banks to receive CRA credit for any qualified community development activity regardless of location, "although performance within facility-based assessment areas would be emphasized." The regulators also propose to maintain an illustrative and non-exhaustive list of qualifying activities and in so doing better define what counts as qualifying activities, including the provision of affordable housing and investments in climate resiliency.

Update the bank evaluation framework

Under this new proposal, federal regulators would for the first time stratify the depository institutions covered by the CRA by size and business model. Existing and new tests will be categorized under four new groupings – a Retail Lending Test, Retail Services and Products Test, Community Development Financing Test, and Community Development Services Test. Large banks will be assessed on all four tests. Intermediate banks would be evaluated under only the Retail Lending Test and the pre-existing community development test. Small banks would be assessed solely on the pre-existing community development test.

In addition, federal regulators propose to provide banks with considerably greater transparency and consistency in the process of assigning CRA ratings post assessment. Performance scores would be obtained on metrics-based tests using a series of weighted averages. The regulators warned, however, that the new proposal will likely "raise the bar" for outstanding and satisfactory ratings, suggesting that the new tests are designed to be more difficult than the existing framework.

Update record-keeping, data collection, and disclosure requirements

Data standards would be revised to improve the quality of the assessment process through a series of standardized benchmarks. In addition to improving the quality and consistency of existing data requirements, the agencies propose that large banks will have to collect, maintain, and report additional data, including significant and costly data requests including on the use of mobile and online banking, as well as requiring these banks to report information on borrower race and ethnicity.

Conclusions

Significant research and years of development have resulted in a CRA proposal that finally reflects the reality of modern banking. While retaining the emphasis on physical bank branches in underserved neighborhoods that is at the heart of the CRA, the federal regulators propose to allow banks to additionally receive credit for activities in the areas in which they operate and nationwide. The proposal will transform the opaque and erratic assessment process into a consistent and repeatable metrics-based approach that will be tailored to the size and activities of the banks it covers. The new proposal is at its weakest in the suggested new data collection and disclosure requirements that will impose significant costs particularly on the largest banks, as it is unclear that this enhanced compliance burden will necessarily produce to better outcomes for underserved communities. At the very least, however, the efforts by the regulators will drag the CRA into the 21st century, incentivizing banks to lend to communities that need it most.