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**Give Credit Where Credit Is Due: An Approach to Revamping CRA Mark A.  
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The Community Reinvestment Act (CRA) is in need of a major overhaul. Much about

the financial services industry has changed and much has been learned about the strengths and

weaknesses of the Act since it was enacted in 1977 and of the regulations which last underwent a

major rewrite more than 15 years ago. Over this time, the share of financial assets held by banks

has fallen as banks faced new competition from non-bank institutions, such as money market

funds and independent mortgage companies. A few very large banks have emerged with nationwide branch networks, and the number of banks has declined in half to about 8000

nationwide. Newly emerged internet banks have been able to serve national customer bases

without opening local branches. The practice of community development has evolved to encompass not just low income housing but also mixed-income housing, jobs, education, health,

public safety and more. Further, the shift by bank examiners to more of a focus on production

volumes has resulted in unintended consequences that have undermined CRA's effectiveness.

Not only does the CRA need to be brought up to date, it needs to be able to continue to

stay current into the future. The regulatory system needs to be redesigned to allow for more

regular and timely updates, allowing more rapid responses to what is working and what is not.

By being more amenable to continuous improvement, the CRA should be more open to innovation and experimentation given the greater opportunity for making midterm corrections.

This chapter starts with a brief overview of the CRA and its successes. It then outlines

some ways to facilitate more regular updating of the CRA regulations, followed by a review of a

number of ways to increase the effectiveness of CRA in helping to stabilize and revitalize low-

and moderate-income (LMI) communities.

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## **An Overview of CRA**

The CRA legislation was enacted to encourage banks to help meet the credit needs of all

communities where they take deposits, with the intention of helping to stabilize and revitalize

LMI communities, consistent with the safe and sound operation of the institution. It created an

affirmative obligation for banks to seek to expand access to credit to underserved consumers and

neighborhoods, and unlike many compliance statutes and regulatory schemes, was specifically

not structured as a prohibition of certain behavior. The focus on deposit-taking grew naturally

out of the banking industry structure that existed then, consisting mainly of local banks taking

local deposits and lending (“reinvesting”) them back into their local community.

Broad authority to implement the law was delegated to the four regulatory agencies that

oversaw the banks (the Office of the Controller of the Currency, the Federal Reserve, the Office

of Thrift Supervision, and the Federal Deposit Insurance Corporation). Even today the statute

provides few details or restrictions, except that each bank must be given one of four ratings:

Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance and that the rating

be made public as part of a written document called the Performance Evaluation. Bank examiners evaluate the performance of individual banks and arrive at ratings for those states and multi-state metropolitan where the bank takes deposits and then sums them all up to arrive at an overall rating for the bank.

Working together, the agencies have developed regulations to provide the basis for evaluating a bank's compliance with the Act. The last major re-write of the regulations took

place in 1995 when regulators, responding to public concerns that the examinations focused too

much on efforts to lend rather than actual results, shifted from measuring processes to measuring

production levels. Since then, the exams for all retail banks with assets greater than \$1 billion

(these banks, called “large, retail banks,” account for over 80% of deposits in the nation) have

consisted of a Lending Test, an Investment Test, and a Service Test, all of which focus on the

LMI marketplace. These three tests receive, respectively, a weight of 50%, 25%, and 25% toward the determination of a bank’s overall CRA rating.

The evaluation of a bank’s performance under the Lending Test primarily considers home

mortgage and small business lending. Community development loans, a separate category that

includes the financing of affordable housing projects and local retail strips in LMI

neighborhoods, receive only secondary recognition and can only be used indirectly to enhance a

bank’s rating. Also included in this category are loans to community development financial

institutions (CDFIs) which are loan funds that specialize in serving the LMI community.

The Investment Test is mainly driven by purchases of CRA-eligible bonds, mortgage-

backed securities, and limited partnership interests in projects funded through the Low Income

Housing Tax Credit (LIHTC) or the New Markets Tax Credit (NMTC) programs. Yet, it also

includes grants to nonprofits engaging in community development activities—the dollar total of

which is generally relatively small and so receives little weight.

The Service Test places most weight on the geographic distribution of branches and branch services and gives only limited consideration to so-called community development services, which includes such activities as providing mortgage counseling to first-time homebuyers. In addition to rating the bank on each of the three tests, any bank that fails to

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better on the Lending Test than a “Needs to Improve” is automatically disqualified from receiving an overall rating of “Satisfactory” or better.

As for smaller banks and wholesale and special-purpose banks, they face different sets of testing protocols. Small banks (less than \$250 million in assets) are basically judged on the simple ratio of their lending in the local community compared to their deposit base. No consideration is given to how many of the loans serve the LMI community. Banks that are the next size larger (but less than \$1 billion in assets) are called “intermediate small banks” and are judged on their lending ratio as well as on a community development test that combines community development lending, investments (including philanthropy), and services. Such a community development test is also at the core of the exams for wholesale and special-purpose banks, but no such test exists for large, retail banks. While every bank has the option of developing its own “strategic plan” as the basis for their exams, few have been willing to undertake the regulatory and public process of getting one approved.

To encourage banks to help meet the credit needs of LMI communities, CRA contains a system of carrots and sticks. CRA’s most potent incentive has proven to be the power to delay or reject applications by a bank to merge or acquire another bank based on a finding of inadequate CRA performance. (Regulators have also been given the ability to reject applications to open and

close branches based on a bank's CRA record, but it is unclear to what extent this power has

been invoked or even quietly threatened in recent years.) The wave of bank mergers that began

in force in the 1990's proved to motivate banks to achieve a strong CRA rating, which was thought to allow the regulators to move more quickly to an approval. In no case did the banks

want to risk having their applications rejected as happened in 1989 when the Continental Illinois

Bank applied to acquire another bank.

The ratings themselves are also thought to have value as a matter of public relations.

Most banks care about their public image; they do not want to have a less-than-Satisfactory

rating. Moreover, the ratings are also seen to matter when the public has a chance to air their

views at public “meetings” which the regulators can convene as part of the process of reviewing

an application. These “meetings” provide the regulators with the opportunity to gather oral testimony on a banks’ performance in meeting the convenience and needs of its communities—

an option they have exercised a number of times, especially for the mergers involving the largest

banks. When these situations arise, bankers have been comforted by being able to hold up their

“Outstanding” ratings as a way to balance any criticisms voiced by members of the community,

advocates, public officials, and others. The result has been that the vast majority of banks have a

CRA rating of “Satisfactory” or better, and nearly a fifth have an “Outstanding” rating with the

proportion much higher for the very largest banks which relied extensively on acquisitions and

mergers to attain their size.

## **Positive Impact**

Banks have undertaken many CRA-eligible activities that have helped to stabilize and

revitalize LMI communities. Yet, developing statistical proof that CRA has made a difference

has been a challenge since it is hard to isolate due to a lack of counterfactual – what would have

happened without CRA? Regardless of the measurement difficulties, it seems clear that CRA has

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encouraged banks to learn more about how to serve the LMI marketplace in a safe and sound

way, to recruit and train specialized staff, and to support the growth of specialized consortia.

### **Improved Communication**

CRA has encouraged banks to build better lines of communications with the community

and with community groups. As a result, CRA has helped banks better understand the needs of

their communities and correct misperceptions as to market risks and opportunities. Products and

services tailored to the needs of the community have emerged and banks have found ways to

serve the communities in safe and sound ways. One notable example was the development in the

early- to mid-1990's of new underwriting standards for home mortgages, thereby facilitating a

dramatic growth in mortgage lending to lower income populations and neighborhoods. New

mortgage lending data made available as a result of expanded reporting under the Home

Mortgage Disclosure Act (HMDA) revealed untapped market opportunities. Through dialogue

and careful testing, banks were able to identify and remove unnecessary barriers to serving this

marketplace, resulting in loans that performed (and still perform) well considering the state of

the economy overall.

In contrast, the subsequent proliferation of toxic-loan products in the early 2000's

had

little, if anything, to do with CRA or community involvement (in fact many community groups

raised alarms about the growth of predatory lending products and marketing), despite the more

recent sensational claims in the media and elsewhere to the contrary. In fact, according to a study

by the Federal Reserve, of all the subprime loans made in 2005 and 2006 (the peak years of the

housing bubble), only 6% were extended by CRA-covered lenders to LMI borrowers or

neighborhoods in the communities for which they had a CRA responsibility, (i.e., where they

took deposits) (Kroznor, 2008). This fact clearly draws into question any notion that CRA was

somehow a driver of the crisis.

### **Dedicated Staff**

Another positive result was the establishment within many of the larger banks of dedicated units

that became proficient at structuring complex affordable housing or community economic development deals involving multiple sources of subsidies and players. As experience with these

types of deals proliferated, loan and credit approval officers learned how to think “outside the

box,” recognizing that government subsidized rents and sale prices actually lowered the risk by

lowering the exposure to the usual ups and downs of the economy. The emergence of these

specialized units was seen by many bankers and advocates as a means to facilitate the growth of

community development lending and investing, and to build trust between the banks and their

communities, strengthening important lines of communication.

### **Working Together**

Finally, CRA helped nurture new bank/community/government partnerships as well as

new government programs. Collaborations between banks and community-based organizations

helped spawn the development of many CDFIs with specialized skills for serving lower income

communities. The banks have provided CDFIs startup funding, technical assistance, loans

with

interest rates at or below market, and operating support. They collaborated in the development of

the Low Income Housing Tax Credit (LIHTCs) and New Market Tax Credit (NMTCs) programs

and are major investors. Banks have also worked with community groups to set up consortia to

provide mortgage counseling or other forms of financial education (e.g., credit counseling).

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## The Challenge of Measuring CRA Performance

Measurement of a bank's CRA performance suffers from a core problem—the lack of an easy and direct way to measure the incremental impact of a bank's CRA activities on LMI communities. Since 1995 the regulators have increasingly relied on output measures of production. Not surprisingly, what gets measured gets done. Since the production measures are proxies at best, they have led to unintended consequences. Some have given too much credit for activities that are not directly linked to revitalizing and strengthening communities while giving too little credit to other activities that have a significant incremental impact. Some have even had negative consequences.

The problem of imperfect measures of impact is compounded by the difficulty of determining if a bank has done enough or at least tried hard enough. The examiners have found themselves basing their decisions on the volume of a bank's particular CRA activity or on whether a bank is serving the same share of the LMI market as it is of the middle- and upper-income markets (so called parity measures). The reliance on these types of tests raise a number of questions: Should a bank be expected to serve a certain share of the market or do a certain volume of business regardless of the shares held by competitors or the size of the market?

What

if the amount expected turns out to be much larger than the market can support, or would preclude other banks from meeting the requirements that CRA places on them? What if a bank

cannot serve a market profitably, regardless of the volume? If that is the case and society still

thinks the market should be served, should the government provide a subsidy or should the bank

be expected to absorb the cost? This situation arises with public goods where society as a whole

benefits from the provision of a product or service, but the provider of the service might not be

able to charge enough to make a profit. A case in point might be financial education (See Lindsey, 2008). If it turns out that the expectation is too large or too unprofitable, should a bank

be allowed to substitute the provision of alternative products or services to meet its obligation to

help meet the credit needs of a community?

At first glance, it may seem to make sense to rely on measures of the number or dollar

amount of loans a bank has made, or evaluate the bank's share of the LMI marketplace compared

to its share of the middle- and upper-income marketplace. But the results can be misleading as

they do not take into account the impact of the loans or whether the loans would have otherwise

been made. For example, a \$50,000 loan to a small business, or a \$500,000 loan to a small

affordable housing project, may be more critical to the well-being of a community than hundreds

or thousands of home mortgage loans that would be made as a matter of course by any number of

different mortgage companies. Similarly, philanthropic grants given to support local organizations involved in community development receive little credit because they involve small dollar amounts and so pale in comparison to other investments with which they are paired

in the Investment Test. Yet, grants can have a critical and large impact as can relatively small

amounts of below-market financing that allow, for example, CDFIs to be able to cover their operating costs and help borrowers by offering low-cost financing.

One way the regulators have tried to control for the size of the market is to look to parity tests

where a bank's share of the marketplace is compared to its share of the middle- and upper-

income segments of that same market. It may, at first, sound sensible to expect that a bank

making a reasonable effort to serve the LMI segment for mortgages would have the same share

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of that market as it does of the middle- and upper-income segments—if it has 10% of the latter, it

should have 10% of the former. Unfortunately, the world is much more complicated. In this example, a bank looking to ensure it achieves a 10% share will aim higher than 10%, especially

if it seeks an “Outstanding.” If enough banks do the same, then they will collectively be seeking

a total of more than 100%—a mathematical impossibility. This problem was made worse by the

emergence in the late 1990’s of independent mortgage companies that focused on the LMI marketplace. By taking a disproportionately large share of the LMI market, these firms made

achieving parity even more mathematically impossible. Basing parity tests on non-market, demographic data (e.g., the number of LMI homeowners) can further remove them from any

relationship to a reasonable measure of market opportunity. Similar issues are raised by the

parity tests used for small business lending and the location of bank branches. Unintended

### Consequences Impair CRA’s Effectiveness

In order to meet volume and parity measures, banks have sometimes undertaken activities

that are a waste of resources, if not counterproductive altogether. Banks have been driven to buy

market share by subsidizing borrowers, for example, through significant and costly reductions in

fees and rates, and to open unprofitable branches in LMI neighborhoods, sometimes even

damaging the economics of local banks that were already there. Banks have even resorted to

buying mortgages from each other to boost their mortgage numbers, providing employment for

mortgage traders bankers but doing nothing to increase the number of mortgages available in the

community. By encouraging investments that do not make economic sense, CRA has had the

counterproductive effect of undermining the business case for lending and investing in LMI neighborhoods.

The focus on production has also led banks to rely more on their mainstream businesses

and less on specialized units to generate the large volumes consistent with the examination

criteria. While mainstream units, with their emphasis on scale and mass production, have been

able to turn out impressive production volumes that meet the criteria for CRA eligibility, they

rely on systems that often lack the flexibility to offer one-off products or modify product features

to respond to variations in local needs. The managers and staff of these units rarely have the

time or expertise to interact and collaborate with the community on a regular basis. Moreover,

these units also manage to a bottom line which makes them reluctant to devote resources that

could be deployed more profitably elsewhere, and causes them to be constantly looking for the

lowest cost, short-term way of meeting their CRA targets.

The shift away from specialized units has, in at least some cases, moved overall responsibility for CRA to non-business areas of the bank such as regulatory compliance and

philanthropy. These support functions are often not well positioned to encourage innovation and

engage in active collaboration with communities. They lack the specialized staff to offer one-off,

high impact (but often low-dollar value) products or services or vary their products and services

across localities depending upon local needs.

## **Undervaluing of Community Development**

Another problem is that some products or services that are critical for stabilizing and revitalizing LMI communities are simply undervalued. The best example is the current exam

procedures for large, retail banks, which, in essence, relegates community development loans,

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services, and philanthropic grants to second-class status. As noted earlier, the Lending Test looks

to community development loans as only a way to enhance a bank's rating; grants (and so-called

"patient capital") receive little weight in the Investment Test, and such important community

development services as credit and mortgage counseling receive only minor recognition under

the Service Test.

### **Inconsistent Treatment Persists**

The lack of more frequent update to the regulations or the Q&As (the Interagency Questions and Answers that provide more detailed guidance on specific questions faced by both

the banks and the examiners) has served to perpetuate inconsistent treatment by regulators. For

example, only recently, after many years of complaints by bankers and advocates, did the regulators finally update the Q&As to address difference in how they treated the financing of

housing projects where less than 50% of the tenants are LMI. Previously, some mixed-income

projects received no credit regardless of their contribution to community development, some

received proportional credit. Even now differences in the treatment of letters of credit for

affordable housing projects persist. Some regulators treat them much the same as they do loans

while others do not, even though the bank is just as much at risk for default on the project as they

would be if they made a loan.

## **Diminishing Incentives and Opportunities for Public Input**

CRA's power has been seriously affected by the current financial crisis. Preserving the

safety and soundness of the banking system has been a driving force behind recent bank mergers

and acquisitions, and CRA has clearly taken a back seat. Moreover, the wave of mega-mergers

may be over, so the very large banks may no longer place as high a value on an “Outstanding,”

especially in the face of falling revenues and rising loan losses. Fewer banks seeking or receiving

an “Outstanding” could have a domino effect by lessening the peer pressure to undertake the

extra effort required. Moreover, fewer major mergers also could mean fewer public meetings. As

noted earlier, these meetings have proven to be excellent vehicles for integrating public opinion

into the decision making process as well as for attracting media attention to a bank’s record in

serving low- and moderate-income communities.

### **Some Ideas for Unblocking the Road**

To maintain its long-term effectiveness, CRA needs to be able to adapt more rapidly to

changes in markets, the structure of the financial services industry structure, and community

development best practices. More frequent updates could also remove some of the pressure to

update everything at once by allowing smaller but steadier steps and giving more time, where

appropriate, for a consensus to build among the stakeholders who include not just members of

the community, but advocates, bankers, the regulators, and others. Moreover, frequent updates

would also allow the regulators to address more quickly inconsistent evaluation policies within

and across agencies. The following outlines some steps to make it easier to update the regulations on a more regular basis.

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## **Encourage a Dialogue to Find Common Ground**

One thing the major stakeholders can agree on is that lack of consensus makes it hard to

change the rules. There need to be forums where differences can be thrashed out and areas of

overlap found. While public hearings provide an important opportunity for the different stakeholders in CRA to air their differing points of view, they do not offer an opportunity for a

dialogue among the stakeholders to build trust and explore possible areas of agreement on how

to improve the effectiveness of CRA. History, differing perspectives, and the inherently adversarial nature of the protest aspect of CRA make it difficult for such conversations to occur

spontaneously. The regulators should convene small groups, each with a cross-section of the

stakeholder interests, to engage in an open dialogue.

## **Take Small, but More Regular Steps**

A more regular process of updating the regulations would also allow for change to come

in smaller doses, hopefully also allowing more time for additional areas of consensus to evolve

among the stakeholders. The longer the time between changes, the more pressure builds up for

more extensive changes and the increased likelihood that the players will take sides and hold to

more rigid positions.

## **Move beyond Zero Sum**

The current CRA exam framework makes change difficult because of its “zero sum” nature. The current weighting system serves to play one group against another since giving more weight to one activity will generally reduce the importance of another activity in determining a bank’s overall rating. For example, giving more weight to community development lending

within the Lending Test would necessarily require that less weight be given to mortgages or

small business lending. Thus it is hardly surprising that those who want to preserve the level of

attention now paid to home mortgages and small business loans are reluctant to contemplate

changes that may lead to a reduction in the importance of these loan activities.

A prototype for escaping this zero-sum trap already exists in the regulations. Banks must

achieve at least a minimal “passing” grade on the Lending Test in order to get an overall rating

of “Satisfactory” or better. Other products and services or groups of products and services (e.g.,

a community development test, see below) could receive similar status, making the passing of

each of them of equal importance, at least with regard to being able to achieve a passing grade

overall.

### **Designate a Lead Agency**

The difficulty of trying to reconcile the many perspectives of all the stakeholders is only

compounded by having to reach agreement among all of the bank regulators. There needs to be a

way to designate one of the bank regulators as the lead, set a timetable for action, and provide

sufficient staffing and analytic resources to carry out the role on an expedited basis. That

regulator should also have the ability to be the ultimate arbiter of any disagreements among the

parties.



## **Possible Reforms to the Rules of the Road**

With the roadblocks reduced, a number of options exist for making the CRA a more effective tool for helping LMI communities. Many can be implemented through regulatory changes. In particular, the exams could be restructured to be clearer, faster, and more specific about what is required or desired from the banks of different types and sizes and in different neighborhoods. Some of the existing tests need to be modified, and in some cases totally replaced. Some reforms, though, do require statutory changes.

### **Find a Better Mix between Quantity and Quality, Production and Process**

Finding the right balance between quantitative and qualitative measures is essential since, as noted earlier, smaller loans can have as much, or more, impact on communities than larger ones. The parity tests need to be eliminated or at least tempered with other measures of the impact on LMI communities. The definition of community development might also be expanded to include the whole array of activities that are essential to creating vibrant communities, including access to jobs, health, safety, education and more.

Process measures of the type that were scorned as part of the 1995 reform could help provide a more nuanced test of community impacts that cannot be identified with existing measures. For example, testing the extent of a bank's efforts to assess the needs of its LMI

communities would encourage banks to maintain an on-going dialogue with local leaders.

A

similar impact could result from a test to gauge if the community truly has access to bank officials with sufficient authority to be responsive to their ideas and concerns. In determining if a

bank is doing enough extra to justify an "Outstanding," the test could require evidence of

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innovative products and services, or of the dedication of sufficient expertise and resources to be

able to structure innovative deals. This test would also encourage continued support for separate,

specialized lending units. Of course, these types of tests call for examiners to be both well-

trained and empowered to make the necessary judgments in the field.

### **Incorporate a Safety Valve to Guard against Unintended Consequences**

As long as the CRA has to rely on imperfect measures for the desired outcome, the exam

process should provide for a safety valve to minimize the chances that the regulations will force

banks to undertake activities which are of limited or no incremental value to the community and

undermine the argument that it can make good business sense to serve these markets. Before

being made to over-saturate or over-subsidize the market for a particular product of service

covered by the CRA exam, a bank should be allowed to make the case that the community is

already being well served (it may not even be optimal for every bank to provide the same

product or service), or that the economics simply cannot work (e.g., banks have been known to

offer subsidies of \$8,000 or more to try to increase their market share of lower income home

mortgages). A formal "appeals" process should be established so that banks can have the ability

to refute any initial judgment of inadequate performance based on numbers alone. Banks that

make the case successfully would then have to find other ways to meet their CRA

responsibility,

such as by providing a unique, high-impact product or service.

### **Create a Community Development Test for Large, Retail Banks**

The exam protocol for large, retail banks lacks a community development test that combines community development lending, investments, grants, and services. Yet, these

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activities are critical for stabilizing and revitalizing communities. Such a test would allow each of these activities to receive meaningful recognition. Furthermore, by treating all of these activities under one umbrella, a bank would be free to respond appropriately to the mix of local needs and opportunities, whether they be loans, investments, grants, services or a melding of all four. Consideration might also be given to expanding CRA eligibility for grants to the full range of activities that are integral to a thriving community.

One way to provide a transition to a community development test would be to give banks

the option of adding community development loans and services to the existing Investment Test.

Banks could also be allowed to increase the weight given to this expanded test (perhaps up to 50

percent) with a concomitant reduction in the weight given to the now narrower Lending Test.

The importance of mortgage and small business lending can still be maintained by setting minimum standards as discussed below.

### **Revise Exam Protocols to More Closely Reflect Institutional Strengths and Characteristics**

Additional exam protocols need to be established to take advantage of the geographic

reach of Internet banks and others that serve regional or national banks. Currently, loans or

investments in a nationwide or regional loan or investment fund earn full CRA credit only if

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money is channeled into geographies where the bank itself takes deposits. This approach restricts

the ability of these funds to put the money where it can do the most good, and deprives of capital

specifically those communities that suffer from a limited presence of deposit-taking institutions.

Banks serving a nationwide market should be offered full credit for CRA-eligible loans,

investments, and services made in any geography across the country, as long as they have

adequately served the communities in which they take deposits. (An alternative way to accomplish the same goal could be to broaden the geographic boundaries determining CRA eligibility under a community development test to encompass whole regions.) A similar approach might be applied to regional banks that would be able to serve all localities within their region. Such a rule would help to ensure that every LMI community has access to capital at competitive prices and allow for further geographic diversity in the portfolios of internet banks that now feel pressure to concentrate their CRA activity in their headquarter cities. Moreover, this approach would free the loan funds to find the best deals and allow them to serve all of the LMI communities within their service area.

A new exam protocol for the largest banks is also need to shorten exams that can currently consume 18 months or longer. These protracted exams tie up the resources of all parties for months, and banks find themselves halfway through their business plans for the next exam before they fully know what rules they should be operating under. The result is an elongated feedback loop that slows the process of continuous improvement for all parties concerned. Exams need to be completed faster, or at a minimum any changes in how activities are being evaluated need to be communicated on a real-time basis. And banks need to be given sufficient advanced notice of changes so they can incorporate them in their business plans.

Special rules could also be developed for banks that have affiliates (i.e., other

subsidiaries

of the holding company) that are relatively large and perform activities that would be included in

a CRA exam if they were a direct subsidiary of the bank itself. Currently, the examiners do not

look at non-bank affiliates unless the bank itself volunteers to include them in its exam.

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approach would be to take into account the size and nature of the affiliates in determining the

appropriate level of CRA activity expected from the institution.

Another alternative, particularly for Internet banks that serve national markets but take

deposits only in limited geographies, would be to require them to create custom-made “Strategic

Plans.” Once the plans are approved, a bank would be able to be confident of how much of its

efforts can go to communities beyond its hometown. Before adopting this approach, however, it

would be useful to better understand the historic reluctance of banks to take up the option of

creating strategic plans.

### **Provide Special Credit for Serving Communities Otherwise Left Underserved**

Advocates are concerned that the current system leaves some communities undeserved by

CRA. The provision of full credit for investments made directly or through funds covering

broader national or regional areas should help remove some of these inequities. However, the

existence of banks that serve local markets without having local deposit-taking facilities may in

some cases leave local banks smaller and only subject to the small bank lending ratio test that

does not even focus directly on serving the low- and moderate-income community. Even if a

large national bank has a local deposit-taking presence, it may not pay much attention to a

locality that is so small that it has little bearing on the institution's overall rating. In these circumstances, the regulators should follow the precedent set for giving credit for serving designated disaster areas and offer extra credit to any bank that lends, invests, or provides community development services in these communities, regardless of where the bank takes

deposits.

## **Formalize a Process to Adjust Exams for Local Market Conditions**

Communities in Cleveland and Chicago have different needs and the CRA should be able to be highly responsive to those differences. One way to do this would be for the regulators to be more proactive in compiling assessments of local needs. In each locality a bank would then have the option of choosing the activities it wants to undertake from the menu so identified. In contrast, under the current system, a bank can try to justify local variations in the products or services it provides by making its case as part of its “Performance Context”—a document it has to prepare as part of the examination process. However, this path is unlikely to be taken because of the danger that the examiners will not give enough credit for those special activities to justify having undertaken them in the first place.

An alternative might again be a “Strategic Plan” which would allow a bank to set out in advance the criteria by which they want to be judged on a geography-by-geography basis. Once the plans are approved, banks would be able to set their local business plans accordingly.

## **Make “Satisfactory” an Explicit Floor and Specify Required Products or Services**

To add teeth to CRA and to clarify its requirements, an overall rating of “Satisfactory” should be made an explicit pre-requisite for a bank to apply for any of the regulatory approvals covered by the CRA statute. In addition, the products or services required for a “Satisfactory”

should be laid out through a series of minimum standards. Failure to achieve these minimums

would result in an overall rating below "Satisfactory." This approach eliminates the zero-sum

problem, at least with regard to qualifying for a "Satisfactory," and addresses some of the

concerns of advocates that the regulators have not been tough enough “graders” or have not

flunked enough banks. It also could provide greater clarity for banks as to what is required.

In particular, minimum levels of performance should be set for individual products or services or for groups of them (just as the existing Lending Test looks at the collective performance of a bank with respect to both home mortgages and small business loans).

Groupings make sense particularly when better performance on one component can compensate

for a lesser performance on another.

In addition to requiring a minimum performance level for home mortgage and small business loans, there could be a “minimum” test for retail services which could combine an evaluation of the geographic distribution of branches, an examination of the bank’s policy with

regard to closing branches, and an assessment of the effectiveness of any alternative delivery

systems for the same products and services found in branches. Another grouping might cover

compliance with such consumer laws as those that cover discrimination, consumer safety, and

unfair and deceptive marketing practices. Still another might include the components of a community development test as described above.

Calibrating the “height” of these minimums requires an evaluation of the costs of meeting

them versus the incentives needed to induce banks to comply. Just as the incentives built into

CRA are limited, any requirements that banks supply particular products or services may also

have to be limited. If the minimum standards are set too high individually or collectively, then

the regulations will run the risk that some banks may choose to live with a failing grade. While

those banks that anticipate needing any of the delineated powers in the statute, (e.g., for permission to merge or acquire), will be highly motivated to try to comply, others may not.

## Collect the Necessary Data, Publish Enough to Empower the Public

The issue of data collection can be contentious. Advocates and researchers always seem to be looking for more extensive data under CRA, while banks are concerned about cost (which may be particularly burdensome for small banks), customer privacy, disclosure of proprietary information that could be valuable to their competitors, and fueling a proliferation of law suits. Primary consideration needs to be given to what data the regulators need in order to examine the CRA performance of banks. That data should be collected on a regular basis.

A second major consideration is to provide the public with the information it needs to be active and well-informed participants in the CRA process. The more fact-based the public discussion, the more constructive it can be. Moreover, the public can help identify issues for the examiners to pursue more closely. However, not all the data collected from the banks need be made public. One approach might be to determine what amount of information is necessary to allow advocates and others to make the case that a problem may exist. By making public at least that critical amount of data, the public would be able to present a prima facie case that would shift the burden of proof back to the banks to explain why the facts appear as they do or at least spur the examiners to do more in-depth analyses. The regulators could even give CRA credit to banks that make the data easier to use and understand.

## **Hold Public Hearings Annually to Review the Latest CRA Data**

Input from the public has played a crucial role in highlighting community needs in general and in specific communities, as well as providing insights on how well a bank is meeting

those needs. This input is in danger of being lost as fewer mergers and acquisitions will reduce

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the opportunities for public involvement. The regulators should consider holding joint meetings

ever year to review the latest CRA data. The agenda of these meetings could also be expanded to

include a regular dialogue among stakeholders on ways to make CRA work better for all the

parties involved.

### **Tighten Complementary Laws**

Anti-discriminatory laws can be critical to helping lower-income communities thrive.

The apparent targeting of minorities with toxic subprime products has hurt many of these communities. Rather than explicitly include race or ethnicity in CRA, a better approach may be

to strengthen and effectively enforce existing fair-lending laws. It might also work to help to add

an affirmative obligation to those laws rather than to enmesh the CRA itself in the process of

investigating discrimination, which often requires reviewing individual loan files, a process that

seems best done as it is now by the regulators as part of their fair lending examinations.

### **Beyond Credit**

The original sharp focus of CRA on “credit” may be outdated and it may be time to include other kinds of bank products and services. To explicitly require the provision of transaction and savings accounts that serve lower-income communities, for example, may require new legislation, although the current statute seems to provide some latitude to cover non-

credit products and services that help expand a person's or business's capacity to access credit.

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## **Rethink the Incentives for an Outstanding Rating**

New incentives may be necessary to spur banks to continue to seek “Outstanding” ratings. CRA’s power to influence bank behavior has been seriously diminished by the current

financial crisis. The limited prospects for mergers and acquisitions, at least for the very largest

banks, do not bode well, thus removing a key reason for many banks to seek an “Outstanding.”

To compensate, additional incentives may be necessary just to maintain the status quo. One way

to bolster CRA would be to offer to provide an explicit monetary benefit for achieving an “Outstanding.”

In addition the government should consider subsidies for products or services that generate externalities that benefit the community as a whole. It has already been shown that

monetary incentives can induce banks (and others) to provide more products and services in

lower-income communities. Notable successes have been the CDFI Fund and the LIHTC and

NMTC programs.

## **Beyond Banks**

Over time, the share of financial assets held by banks has fallen and banks have faced

increased competition from non-bank financial companies (Avery et al, 2008). These changes

have lead advocates to propose expanding the affirmative obligation of CRA to other financial

institutions. Mortgage, securities and insurance firms are often cited. While the logic of bringing

more resources to bear on helping to revitalize and stabilize LMI communities seems sensible,

the experience with CRA points to the types of issues that need to be addressed individually for

each industry. Such issues include: What products and services are going to be covered and how

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will performance be measured? Will the firms be examined or just subject to additional regulations? Will there be opportunity for the public to weigh in? What incentives will be provided to encourage the firms to make the desired extra effort? Would monetary incentives

help, particularly if profitability is an issue? The clearer the answers are to these and other questions, the more effective the legislation regulations can be in helping revitalize and stabilize communities.

### **Some Cautionary Thoughts**

While reform can do much good, it can also have unintended consequences. Of particular

concern are four possible directions that reform could take. First is the possibility of trying to do

too much in one exam. The CRA cannot be seen as the panacea to address such issues as

discrimination when other existing legislation and regulations are not working as well as

advocates would like. In this regard, the new Consumer Financial Protection Bureau should be

able to handle a number of compliance issues that advocates have wanted to build more formally

into the CRA, thus allowing the CRA exams to focus on evaluating a bank's affirmative actions

to help LMI communities.

As experience has shown, the proper evaluation of the impact of a banks' activities

on

LMI communities requires time and training. The addition of such issues as race and ethnicity to

CRA exams would increase the scope of the exams and so risk diminishing the amount of attention that can be paid to any one part of the exam. The result could be a return to a more

mechanical exam that will fail to reward those banks that are truly making a difference in their

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communities. In addition, the more tasks given to the examiners, the longer the exams will take.

The longer the exams take, the more attenuated the feedback loop.

Another area where change could have unintended consequences would be if pressure

from advocates leads to an arbitrary reduction in the number of “Outstanding” ratings.

Hopefully, some of the proposals laid out earlier will help to address concerns that standards are

too loose and have led to grade inflation. If, however, fewer banks receive an “Outstanding,”

then even fewer may seek it. Part of the motivation for at least the largest banks was to match

their peers. The danger is that once their peers no longer have an “Outstanding,” other banks will

start to question if the credential is worth the effort.

A third area regards proposals to expand a bank’s CRA responsibility to include all localities where it makes loans (e.g., home mortgages), even ones where it does not collect

deposits and may not even have any employees. Advocates are concerned that some communities are underserved by CRA. As mentioned earlier, this problem could be addressed

directly by identifying such communities and giving banks credit for serving them, regardless of

where they take deposits. The danger in expanding the full set of CRA responsibilities to these

communities is that existing resources will simply be spread even more thinly, a result that is

especially likely with regard to philanthropic grants and below-market loans the totals for which

are generally set on a corporate-wide basis without consideration of the need or the number of

jurisdictions potentially involved.

Moreover, the threshold for triggering coverage could have a result opposite to that intended. It could incent the bank to leave that market entirely, thus reducing the availability of

loans in the very communities that the change is intended to help. In a bill now before Congress,

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a bank that serves as little as 0.5% of a market would incur a local CRA responsibility. Such a

low threshold might lead banks to refrain totally from serving a community, thus depriving it of

the additional competition and so decreasing access to credit. Lastly, any increase in the geographies covered will, again, only serve to lengthen the exams or diminish the amount of

time examiners can spend on communities now covered, thus again potentially forcing examiners to reallocate their time, further attenuating the feedback loop.

A fourth area of concern is a desire by some to look to Congressional action to bring about the needed changes to CRA. While some changes can only be made through legislation,

the bulk of the changes can be made by the regulators themselves. Relying exclusively on

Congress poses two problems. First, as slow as the regulatory process can be, the legislative

process is intentionally designed to be hard to move. This situation is further compounded today

by the likely opposition from the many legislators that currently believe that CRA was a driver of

the subprime crisis, despite clear evidence to the contrary. Second, the danger with legislative

action is that it could produce an even more rigid system by reducing the broad discretion now

given to the banking regulators. To the degree that detailed prescriptions become embedded in

the statute, regulators would be severely limited in their ability to fix even minor problems as

they arise.

## **Conclusion**

Much has changed since CRA was enacted and since the last major rewrite of the regulations. The CRA regulations can and should be updated to rectify shortcomings and to

adapt to changes in the banking industry and community development best practices. The CRA

also needs to be more easily updated on a regular basis to keep it more current in the future.

Some aspects of reform also require legislation, but it is critical that statutory changes do not

limit regulatory flexibility by being overly prescriptive. The CRA needs to be able to evolve over

time to maximize its effectiveness in helping to stabilize and revitalize LMI communities.

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