It's the Rating, Stupid: A Banker's Perspective on the CRA

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The Community Reinvestment Act (CRA) of 1977 has survived more than three decades of restructuring of the banking industry, of sporadic changes in the regulations, and of an evolution of best practices in community development. The CRA has seen many successes but is now in need of a major overhaul if it is to continue to play a meaningful role in strengthening low- and moderate-income (LMI) communities. This article frames a number of issues that should be considered as part of any process to alter the CRA or expand it to other industries.

I have worked in community development for more than 22 years both in government and in the private sector. As head of Community Development at JPMorgan Chase, where I spent the past 19 years, I witnessed major shifts in how banks oversee their CRA programs and how these changes have affected the way they meet their CRA obligations. While I have been on both sides of the table, as banker and government official, my purpose here is to provide a banker's perspective to illuminate the forces that have affected the CRA and to suggest some principles that could make it more effective.

The first section of this article provides a brief overview of the evolution of the banking and regulatory worlds, while the second highlights some of the problems that have led to inconsistent treatment, trade-offs, and unnecessary or unintended costs of regulations. While some of these problems are inherent in any regulatory process, some are particular to the CRA and so may be easier to reform.

Based on this analysis, the last section outlines some principles that might help guide the future direction for the CRA. Suggested approaches include: more clarity of focus; reevaluating trade-offs implicit in using quantitative versus qualitative tests in the examination process; and redesigning or eliminating some tests and tailoring those remaining to the strengths and skills of the different types of banks. Given the growing disparity over time between the intent of the CRA and those bank activities that receive credit during CRA exams, it is also critical to find a way to facilitate regular updating of the regulations to reflect changes in the structure of the banking industry, in the products it offers, and in the consensus on best practices for community development.

Some Key Facts About the CRA and the Structure of the Banking Industry

The original mandate of the CRA remains unaltered: to encourage federally insured banks and thrifts (hereafter referred to simply as banks) to help meet the credit needs of their communities, including LMI neighborhoods, in a manner consistent with safe and sound banking practices. Subsequently, Congress has added a few key features relevant to the analysis in this article. The 1989 legislation passed in reaction to the savings and loan crisis included requirements to make public the CRA rating based on four categories: Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. With the legalization of interstate banking in 1994 came the requirement that regulators issue separate subratings for each multistate metropolitan area and for each state in a bank's assessment areas—that is, those geographies where the bank takes deposits. (Note that deposits in any location may include not only the deposits of local customers but also those of individuals and companies located elsewhere in the United States or internationally. For example, headquarter branches are often the booking location for the accounts of large corporations.) The overall rating for a bank is computed by weighting each of the state and metropolitan ratings according to the locality's share of the institution's total deposits. The 1999

* *The views and opinions expressed in this article are solely those of the author and do not necessarily reflect those of the Ford Foundation.*

legislation to modernize the financial services industry, Gramm-Leach-Bliley, added the condition that a financial holding company must have at least a Satisfactory rating to apply for additional powers. In general, these changes have enhanced public engagement and the accountability of the regulatory system.

Congress left it to the four banking supervisory agencies to interpret and implement the CRA's single-sentence mandate. These four regulators—the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation—work jointly through the Federal Financial Institutions Examination Council (FFIEC) to issue regulations. Each regulator conducts regular exams of the banks under its respective jurisdiction to test for compliance with the CRA and issue ratings. The regulators also evaluate the performance of banks when they apply to merge, open a branch, acquire another institution, or add powers. As part of this process they can hold public hearings to gather additional information not otherwise available. When the regulators deem that a bank fails to comply with the CRA, they can give the institution a less-than-Satisfactory grade on its exam or even delay or deny its application.

The broad discretion granted the regulators has meant they must often accommodate conflicting demands. Community advocates have pushed for tougher requirements and enforcement and many groups have issued reports highly critical of the regulators. Meanwhile, the banking industry has pressed for a decrease in the regulatory burden. Bankers would also like more predictability in the exam process, more precision as to how the ratings are determined, and a more consistent application of the regulations across agencies and even across examiners within each agency to minimize discrepancies from one exam to the next.

Bankers have also sought phase-in periods to incorporate regulatory revisions into their business plans so that they do not lose credit for activities already undertaken. The length of time to complete an exam, often 18 months or longer for a large bank, can create problems when the results reflect a new interpretation of the rules. Since exams are generally administered on a three-year schedule, CRA managers have found themselves having to revise their business plans, often substantially, halfway through the cycle. Finally, regulators themselves want to use their staff more effectively to complete exams in an efficient and timely manner since mergers that have expanded the footprints of large banks have resulted in an increase in the number of geographies that need a separate rating.

The net result of these various pressures has been a greater reliance on quantitative measurements of production volume. A major step in that direction occurred in 1995, when the CRA regulations were rewritten to emphasize "production over process." A three-part test for large retail banks was adopted with 50 percent weighted on lending, 25 percent on community development investments, and 25 percent on retail (i.e., branch locations) and community development services (e.g., financial education). Included in the Lending Test are both home mortgages and small-business loans with community- development lending used only to enhance the lending score—a curious treatment given the intent of the CRA to strengthen LMI communities. The revamped regulations also introduced the concept of Performance Context which allows examiners to take account of local market conditions as well as a bank's business strategy to determine an overall rating. The new regulations also expanded the information available to the public beyond the mortgage data released under the Home Mortgage Disclosure Act (HMDA). Data must now be collected for small-business, farm, and community development loans, and the regulators have devised quantitative tests to measure the adequacy of a bank's loans, investments, and services.

Meanwhile, the large banks have continued to expand, and competition between them and nonbanks has intensified, leading to constant cost cutting and increased scrutiny of product-by-product profitability. CRA programs in these large banks have likewise grown, especially in response to the new focus on volume. As a result, specialized production units have become increasingly visible internally and thus subject to new costs and constraints. These units are now more likely to have to fully bear the time and expense of the standard array of bank audit, compliance, credit, and budget processes. CRA products in general are more likely to be vetted based on the same profitability thresholds as elsewhere in the bank, and staffing levels for CRA activities are regularly reviewed with a focus on nonincome-driving positions. Justification for those CRA activities that do not generate sufficient profits, or any profits at all, now requires a clear showing of their contribution to the bank's CRA rating separate from whether they are making a difference in the community.

Major technological advances have also made the banking industry more efficient and expanded the markets they can economically serve, increasing access to banking services for LMI individuals and small businesses. ATMs are now ubiquitous and online banking allows account access from most any computer. Innovations in information technology have made highly scalable origination, production, and servicing platforms both feasible and cost effective. Automated underwriting and credit scoring have led to faster decisions and better and less costly risk assessment, which in turn has enabled banks to make smaller loans and to vary pricing based on the riskiness of the borrower. (Although the recent credit crunch may be forcing a recalibration of the risk inherent in lending to a borrower with a given set of characteristics, these systems offer a way to array borrowers along a risk continuum and vary pricing accordingly.) Such advances have allowed the banks to serve people and businesses with a wider range of credit histories, often at lower cost, making them more affordable to LMI individuals and small businesses.

How the CRA Works/Does Not Work Today

This next section lays out some of the issues and problems that have arisen with the CRA and how they have affected the way CRA programs operate, particularly in the larger banks.

The Mission/Intent of the Statute

Subsidizing Products and Services

Missing from the statute or the regulations is a clear statement on whether the CRA's affirmative obligation to expand access to credit also requires banks to permanently subsidize products or services. (The imposition of the CRA is often justified by the special benefits banks receive by being publicly chartered and being eligible for deposit insurance. I leave it to others to determine whether banks receive an incremental profit that should be seen as a basis for the CRA to impose costs on banks.) While the development of new products and markets generally requires some up-front expenditures, ambiguity over whether a bank is expected to continue to provide a product or service that loses money or earns at a rate below the bank's minimum threshold has hurt both the credibility of the CRA and drained resources from other areas that could benefit more from the CRA. Without the prospect of profit, banks are unlikely to make major investments to promote and produce a product on a sustained basis.

Forcing a bank to lower its prices to satisfy a regulatory requirement can give pause even to those who support the idea of an affirmative obligation to find ways to build a business around helping to meet the credit needs of the LMI community. For example, I once had to explain to a senior bank official how our well-developed marketing strategy for home mortgages combined with state-of-the-art products designed to serve the LMI community would not yield a sufficient market share to achieve an Outstanding rating in the CRA exam. He was dumbstruck when I told him that we would need to offer significant subsidies (amounts as high as $8,000 per loan are not uncommon in the marketplace) to write down the interest rate, closing costs, or otherwise reduce the cost to the customer. While he had willingly embraced the principle of serving LMI communities, and indeed had devoted special resources to develop and serve this market, he could not accept that a bank should be forced to offer discounts such that the more loans that were made, the higher the overall loss. Similarly, some banks have felt forced to open branches in LMI communities that are already being served. Indeed, some of these new branches not only have turned out to be unprofitable, but their addition has even undermined the economics of the other preexisting branches. In these circumstances, the CRA only reinforces the false impression that serving these markets inevitably has to be unprofitable.

Subsidies that Expand Access to Credit

In many cases, banks have found it necessary to accept lower-than-normal fees or rates and/or absorb the higher costs of structuring a deal as part of expanding access to credit. Specialized personnel are required to deal with a project complicated by many layers of financing (including federal, state, and local funding) or developed by a local community-based organization that may lack experience in structuring deals or overseeing the construction process. But regulators have not necessarily provided incremental CRA credit commensurate with the additional expense burden. There should be no surprise, then, that the banks favor "standard" deals that also qualify under the CRA but require less or no implicit subsidy. In contrast, even direct support made through philanthropic community development grants receives credit under the Investment Test. However, the weight they receive is often insignificant because the dollar volume of grants often pales in comparison to the dollar volume of investments.

More Activities, Less Weight

Regulators are under constant pressure to broaden the coverage of the CRA, but it is clearly impossible for a single statute and regulatory scheme to resolve all the issues facing LMI communities. In practice, the greater the variety of activities desired, the less weight each gets, thus opening the possibility that some activities will not yield a sufficient payoff to warrant any significant attention by the banks. A recent attempt by the regulators to hold out the potential of CRA credit to spur banks to ramp up their foreclosure-prevention activities provides an illustration of this problem. Unfortunately, foreclosure prevention can only qualify as another community development service, a category that appears to receive only five percent weight in a bank's overall rating. (The other four-fifths of the Service Test, which accounts for 25 percent of the overall rating, relates to the equitable distribution of retail branches.) Moreover, the limits on income (LMI) and geography (assessment areas) inherent in the CRA make it a poor instrument to spur the type of broad-based actions required. Nevertheless, the banks have been well motivated to take action on their own.

Quantification

Numbers Have Become More Important Than Quality

The 1995 rewrite of the regulations steered the CRA toward rewarding dollar and unit volumes rather than focusing on rewarding those deals that do the most to strengthen and revitalize communities. The newly available data on mortgages, small business, and community development loans show this as a growing trend. While this change in approach seemed consistent with the desire of banks for more consistency and predictability, of advocates for setting higher standards of performance, and of regulators to streamline and standardize their reviews, the result turned the exams into more of a quantitative checklist.

This focus on numbers even spilled over into CRA "commitments." During the application process for the regulatory approval of mergers and acquisitions, it was for a time common for banks to announce volume targets for the newly combined institution for mortgage, small business, community development, and other loans and activities. The amounts of these pledges sometimes, but not always, resulted from negotiations with one or more community groups. The increased emphasis on dollar and unit volumes can be seen in the significant jump in the size of pledges made by a number of banks. For example, from the 1995 Chase/Chemical merger to the 2004 merger with Bank One, the size of the commitment rose 40-fold from $18.1 billion (over five years) to $800 billion (over ten years). However, this larger number mainly reflected the inclusion of additional types of loans rather than any significant growth in their specialized core community development program.

Tests Encourage Unproductive Behavior

Although at first the development in 1995 of a more quantitative approach to evaluating performance under the Lending, Investment, and Service Tests of the exam seemed to be an improvement, over time it has become clear that many of the methods chosen to measure performance were fatally flawed. In hindsight, the tests failed to account both for the extent of the opportunity for profitable business and the degree to which a market was otherwise well served. The examiners are technically able to use the Performance Context to adjust the results of their quantitative tests, but numbers still seem to dominate the exam results.

One set of tests that have proved problematic were those based on "market parity." In the case of mortgages, a bank's share of the LMI market would be tested against its share of the non-LMI market. Initially, the adoption of parity seemed appropriate because it appeared to produce the desired result. In fact, however, the market for LMI mortgages had already been growing due to new and innovative underwriting standards that emerged in the wake of the release in the early 1990s of expanded HMDA data. As adoption of these new and innovative underwriting criteria spread across the banks and eventually to Fannie Mae and Freddie Mac, the market became more competitive and thus better served. Nevertheless, the pressure from the CRA continued. As the regulations encouraged banks to achieve even higher LMI market shares, they were forced to offer loans at below-market prices. In rare cases, perhaps banks also may have lowered credit standards, despite the violation of "safety and soundness," as mandated in the 1977 act and the culture of most banks and regulators.

The challenge of achieving LMI market-share targets was made worse by the growth of the nonbank subprime mortgage companies, which captured a large share of that business. Those banks without a subprime lending unit found it increasingly difficult to originate enough loans to achieve their "fair" share of LMI mortgages; even banks with a subprime business often fell short. As a result, many banks turned to a third option: buying LMI loans already originated. Indeed, this approach had been sanctioned by the regulations to encourage growth of a secondary market. Over time, it became clear to bank executives that it was cheaper to trade loans than to subsidize their origination. A well-intentioned policy to persuade banks to meet the credit needs of the LMI community now encouraged the trading of loans that had already been made. A new business was born, though it did nothing to expand access to credit.

Other parity-type tests compare loan performance to nonmarket standards—so-called demographic tests. In evaluating the distribution of branches, for example, the share in LMI neighborhoods is compared to the percent of the population that is LMI. This use of parity has been even more problematic since it ignores any notion of economic viability. To encourage branching in LMI communities is very different from expecting every bank to allocate branches based on the distribution of the population, without regard for the size of the business opportunity or the recognition that people often bank where they work, or access banking services through ATMs, online, or on the phone. The test applies regardless of the circumstances.

Even tests that simply measure the volume of investments or community development loans have created issues by not having clear criteria. For example, when banks have pressured examiners for a standard of how much investment is required for an Outstanding or how much community development lending is required to enhance their rating under the Lending Test, the regulators have responded that the banks need to look to the evaluation of their peers whose exam results have already been made public. While bankers generally suspect that there are unstated standards for community development loans and investments based on a ratio of tier-one capital, the regulators deny such a simple relationship. In addition, the way tier-one capital is allocated accross geographies is problematic. Regulators rely on the distribution of deposits, which, as noted earlier, is not necessarily related to the location of the depositors. When, for example, the headquarter branch of a bank is assigned a disproportionately large amount of tier-one capital based on the amount of corporate or international deposits that are booked there, the expected level of investment or community development lending also rises regardless of the local business opportunity. Banks have found themselves serving a market where the potential falls short of the sum total of the expectations that regulators have for all the banks in a locality.

Although it may seem reasonable to push banks to grow their investment portfolio, it makes no sense to push them to make investments that neither benefit the community nor make a minimal profit. Perhaps the worst case was investments in SBICs, which were granted a "safe harbor" and so received a flurry of investments shortly after the issuance of the 1995 regulations as banks strove to meet the new Investment Test. Overall, these investments had little or no impact on LMI communities and provided little or no return to the banks.

The lack of reasonable, clear-cut criteria has also placed greater reliance on examiners and examiner training and has made it hard for CRA officers to set internal goals. An examiner may expect more than is reasonably possible in a given market, which only makes the CRA officer's job harder. This fact also makes it harder to determine if the benefits of an Outstanding exceed the costs (see discussion below).

While the addition of such qualitative criteria as innovation, complexity, responsiveness, and Performance Context were intended to allow for more nuanced judgments, the reality has been disappointing. These criteria all make sense if the mission of the CRA is to encourage banks to expand access to credit—consistent with their strategy, skills, and the varying opportunities that exist in each local market. In practice, however, quantitative tests tend to dominate the exam process perhaps because examiners either lack the authority to give qualitative factors the appropriate weight or because they naturally gravitate toward quantifiable measures that are easier to defend. It may just be hard to sustain the importance of qualitative factors when the quantification option exists. The result has been that projects that have great community impact may not go forward simply because a bank will not receive credit sufficient to justify the effort required.

It's the Rating, Stupid

Banks have increasingly focused on only those activities that count toward the rating, regardless of their impact on strengthening communities. As a result banks generally limit the availability of CRA products that do not achieve minimum profitability thresholds. For example, mortgage products that require subsidy or mortgage counseling grants are rarely offered outside a bank's assessment area. Similarly, loans that require the specialized skills of a community development lending officer are rarely done outside a bank's assessment area, even though the market may be underserved and the borrower is otherwise a regular customer. The result has limited the availability of financing, especially in smaller and more remote communities. Even within assessment areas, the increase in cost pressures combined with the movement toward a quantitative checklist has led banks to focus only on the exact types of loans that count for the rating and take a pass on other loans that would strengthen the community.

A Shrinking Universe of Products

More Reliance on Products with Economies of Scale

Over time, CRA programs at the larger banks have gravitated toward using mainstream business units (their mortgage companies, retail branch networks, etc.) in part in response to the need to meet the higher-volume targets. Further contributing to this trend has been the ability to leverage existing mass-market underwriting, production, and servicing platforms and the increasing cost of operating a separate CRA production facility. In the end, the skills, products, and systems of a bank's mainstream business units have often proved sufficient to attain the desired CRA rating. These units generally have achieved the volume required at minimum cost and, in some cases, at a profit. Only in the case of community development services has it been difficult to rely solely on a mainstream unit to meet the goal. The good news for the LMI community is that these products are generally well marketed to reach a broad customer base and benefit from investments in new technology, which leads to product improvements and, in some cases, even declining prices.

On the downside, the more that mainstream units have built their business around high-volume products, the more difficult it is to develop products or services expressly for the LMI marketplace. This reliance on mainstream business units has also complicated banks' internal management of their CRA programs. Now the CRA officer must negotiate goals with each of their bank's mainstream business units. Not surprisingly, the managers of these units resist anything that impairs profitability or undermines their business strategies.

Harder to Develop Niche Products or Do Complex and Innovative Deals

Business unit managers are reluctant to develop what they perceive to be unprofitable local or niche products. Even with community development real estate loans, where each loan is separately evaluated and underwritten, obtaining approval for unorthodox loans often depends on experienced credit officers who understand, for example, how government involvement can help to mitigate risk. As the number of credit officers with this special expertise has fallen, the process of justifying the credit quality of these loans has become continuous and unrelenting, despite a proven track record of high credit quality. As a result, loan officers migrate away from complicated, one-off deals that often do the most to expand access to credit.

Adding to the difficulty of developing niche or specialized products has been the passage of Sarbanes-Oxley, which imposed stricter accounting standards following the Enron debacle. For example, some banks use their foundations to make zero- or low-interest loans, much in the tradition of PRIs—Program Related Investments—made by private foundations. Now these programs have been brought under the bank's standard loan documentation, review procedures, and borrower-by-borrower limits on maximum credit exposure. The result has been to reduce the ability to use these programs for such purposes as predevelopment loans or low-cost funding for third-party loan pools.

As LMI products have devolved to mainstream businesses, the number of banks with separate, specialized units to meet the production requirements of the CRA has diminished. These units often served as a source of innovation. Two factors seem to account for the change: first, their production may no longer be necessary to meet the volume targets; and second, their ability to turn a profit on lending activities has been hurt by the increased costs resulting from greater scrutiny for credit quality, profitability, and other compliance requirements. By their nature, these units have always faced profitability challenges because their loans tend to be smaller and more complex—often with funding from multiple layers of government—and generally involve less-sophisticated borrowers. These units have also absorbed the costs inherent in incubating new products, which, in many cases, eventually migrated to mainstream businesses. Such products range from mortgages that responded to the characteristics of the LMI borrower to loans under the Small Business Administration (SBA) Express program.

Even where separate, specialized units continue to exist, they are finding it increasingly difficult to attract the required resources to develop new products. While active support from the top of the institution played a critical role in the establishment of these special units, the adoption of a more quantitative checklist approach to the CRA has seemingly contributed to the marked decrease in engagement by senior management at many banks.

More Difficult to Form Working Partnerships

Some of the best innovations spurred by the CRA have come as a result of working partnerships between banks, community-based organizations, and government. These partnerships have benefited by having people with the ability and authority to assemble complicated deals and the personal relationships necessary to develop trust between banks and community-based organizations. Working with other banks has also become harder as competition and rivalry for CRA credit has made it more difficult to collaborate.

Since centralized community development units often took the lead in working with others to help find creative ways to finance affordable housing and, more generally, community development, their absence leaves a void. With all business units under cost pressure, it has also even become more difficult to draw upon expertise from elsewhere within the bank to help with this task. Moreover, staff cuts have made it more difficult for the remaining bank employees to devote significant commitments of time to community activities.

The Growing Disparity Between the Regulations and the Real World

Markets Have Changed

Over time, some previously underserved markets have become better served. The pressure from the CRA, along with technological advances that have automated much of the approval process and lowered costs, has brought more products to the LMI marketplace. By the late 1990s, for example, many banks offered standard mortgages that worked for LMI borrowers. Similarly, prior concerns about the ability of small businesses to get loans have been, at least partially, addressed by new technology, which has allowed risk-based pricing and a lowering of minimum loan sizes. Yet, the CRA continues to push banks to focus on these same markets even though it may no longer be helping to expand access to credit but, rather, encouraging banks to take actions that make these markets uneconomical to serve.

Community Development Best Practices Have Changed

As financial markets and the banking world have continued to evolve, CRA regulations and Q&As (a vehicle used by regulators to explain how to apply the regulations to specific situations) have struggled to keep pace. The problems created by this delay are accentuated as best practices in community development have also evolved, gravitating toward a focus on mixed-income and mixed-use projects and comprehensive approaches that include workforce development, jobs, education, health, and safety. For example, in order to receive credit for an affordable housing loan outside a LMI census tract, a majority of the occupants must be low and moderate income. Yet, the current thinking is that mixed-income projects provide the best environment for low-income families, and some governments even use inclusionary zoning to reward builders if they include 10–30 percent subsidized units in projects that are otherwise market rate. In some communities, these projects create the preponderance of affordable housing, but banks often receive no credit (not even proportional credit) for the low- and moderate-income units constructed. (Update: on January 6, 2009 the regulators put out for comment a proposed Q&A that would allow for proportional credit.)

The treatment of grants is another example where the rules may not reflect the best practice to strengthen communities. Many grants for activities that are critical to the success of communities are given little weight or do not count at all. At best, they are included under the Investment Test, so their dollar volume pales in comparison to the dollar value of investments. Interestingly, although grants are more costly in that they do not offer the possibility of a direct monetary return, they earn less CRA credit than investments that can continue to qualify under the Investment Test in subsequent exams as long as they remain in the bank's portfolio.

Regulatory Drift

As with any regulatory system, ongoing interpretations and clarifications in response to requests from banks and advocates have resulted in a further disjunction between the CRA rules and reality. For example, letters of credit and loans/investments to third-party intermediaries have resisted efforts to align the regulations with common-sense approaches to strengthen communities. Letters of credit back bonds that finance affordable housing. Even though they are integral to the financing and have the same credit risk as a direct loan, the regulations treat letters of credit separately and the examiners appear to give them less value.

As for third-party intermediaries (such as CDFIs), they often offer specialized expertise that no single bank would find economical to do on its own in providing lending or investment products to the LMI community across wide geographies that include smaller communities in rural and urban areas. In these cases, they provide an excellent way for small banks to diversify risk across a larger geography than the bank could do on its own—presumably a good idea from a safety and soundness perspective. Yet, loans and investments to these third-party funds are valued less than direct loans and investments, unless the third-party has all of its activities within the bank's assessment areas. Although examiners interpret the rules differently, the latest attempt to clarify has been stalled as the agencies continue to disagree over the size of "a broader statewide or regional area that includes the bank's assessment area," and how much weight to give loans or investments that fall outside a bank's assessment area. This lack of guidance has led banks to retreat from multi-investor, multigeography loans or investment pools. (Update: On January 9, 2009, the regulators finalized a Q&A that explicitly recognizes the importance of nationwide funds and provides examiners with some additional flexibility to give credit for investments in them.)

Perpetuation of Inconsistent Treatment

Sometimes different regulators come to different decisions with regard to the CRA eligibility of specific projects or classes of projects. However, rather than resolve these differences at the FFIEC level, these variations across agencies tend to linger. The problem of regulatory inconsistency is further aggravated by the efforts of some states to impose their own CRA-type regulation, which may or may not mirror the federal rules.

Cost/Benefit Analysis

CRA Costs

Since we often focus on the benefits of the CRA, it is too easy to forget its costs. We have already seen that the CRA can lead to below-market pricing, to extra production costs, and to unexpected and unintended consequences. Another set of costs that is not often appreciated is the expense incurred by the administration of the compliance process itself. Banks must assign special staff to oversee their compliance programs, including the gathering, processing, and publication of the required data. While these activities may sound routine, they can be expensive, particularly when additional fact checkers are needed to re-review thousands of loans to check the validity of data that, while they may be collected, are not critical to the approval process.

Moreover, the collection of data that are irrelevant to the loan-approval process can offend customers (for example, information on race or ethnicity), particularly when their anonymity cannot be guaranteed. Indeed, this has been a problem with HMDA data, where researchers have reported matching over 80 percent of the mortgages to actual street addresses using readily available data sources from third-party suppliers. Another concern is the potential cost from spurious lawsuits using publicly available data. From the government perspective, the CRA also imposes costs on the regulatory system to cover the staffing needed to review data and conduct exams of the banks.

A different type of cost results from the creation or reinforcement of negative perceptions of the viability of serving LMI markets. For example, the lack of profitability at many LMI branches that banks have felt a need to open and the need to subsidize LMI mortgages have reinforced and perpetuated the impression that serving the LMI community can never be profitable for banks.

Another unintended consequence of the CRA has been to dampen the enthusiasm of banks to enter LMI markets when the price the banks need to charge to cover their costs is higher than the advocates would like. Low-priced products for low-income customers certainly have appeal, but the reality of serving those customers sometimes requires higher prices, not lower ones. The result has been that banks simply back away and do not offer a product, even when they could do so at a price point that is lower than that of the current, nonbank providers.

While support for not-for-profit organizations has been critical to the productive partnerships between banks and the community, banks have felt at times under pressure to incur additional costs. Early in the life of the CRA, many banks had the impression that they could not obtain regulatory approval of a merger or acquisition unless they made all the advocates "go away happy." This sense, valid or not, of how the process worked helped create the notion that community groups had great leeway in what they could demand. Fortunately, the regulators have helped to address this concern as they have become better able to distinguish among the different groups and assess for themselves which ones and which issues are legitimate.

The Shrinking Net Benefit of an Outstanding

Many banks still seek an Outstanding rating despite significantly higher costs than for a Satisfactory. While it may be theoretically possible for a bank to achieve an Outstanding with only profitable activities, the reality is likely to be quite the opposite, thus regularly prompting senior management to question whether the higher rating is worth the expense. Estimating both the costs and benefits is difficult as the lack of clarity of what is required for an Outstanding usually leads to an overestimation of the cost, thus disadvantaging the Outstanding option. A further shortcoming is the lack of evidence that the highest rating draws new customers. An Outstanding rating can have value, though, in mitigating negative comments that are an inevitable part of the public process for reviewing applications.

One reason banks pursue an Outstanding appears to be the natural competitiveness to match or exceed their peers. Most, if not all, of the large banks have pursued this goal. In this light, the efforts by advocates to make it more difficult for banks to get an Outstanding may be counterproductive if ratings of Satisfactory become more common and thus more acceptable. As fewer banks pursue an Outstanding, fewer resources will be devoted to the costly process of developing and testing new ideas for products and services to serve the LMI community.

Principles for the Future

These observations on how the management of the CRA has evolved suggest a number of principles that could increase the CRA's effectiveness and lower its cost.

The Mission

Keep It Focused

The language in the 1977 CRA statute allows great flexibility, but it complicates the job of the regulators. Without more parameters limiting the scope, regulators will continue to be pushed to expand the CRA to cover more and more activities with the likely outcome that completing exams in a thoughtful and timely manner will be impossible and that some activities will simply be ignored as banks concentrate only on those activities that get significant weighting in the overall rating.

Also, the statute needs to give more clarity to such fundamental issues as to whether the goal of the CRA is to see that markets are well served or to make sure every bank has a certain share of that market regardless of profitability. At the same time, the statute should avoid specifying details that will likely need to be updated frequently to remain responsive to future developments in the industry and community development.

This concern for clarity should be considered as part of any legislation to expand the CRA to other industries. While the idea of imposing an affirmative obligation may sound appealing, a broad statement provides little guidance for what types of activities or products should be monitored or required.

The CRA is not a Panacea

While it may seem appealing to try to use the CRA to address a wide range of social and economic problems, such an effort can be self defeating, especially when the actions that need to be taken are known. The success of the CRA legislation has in part been due to its aspirational nature and the sparsity of specifics. However, in the case where it is clear what needs to be done, legislation that is more targeted is likely to be much more effective. Looking to the CRA as the solution may simply delay the adoption of the type of legislation or regulations that are needed. Furthermore, every extension of the CRA runs the risk of diverting attention and resources that are presumably already being effectively used.

This danger can arise both when broadening the role of the CRA for banks as well as when looking to expand its coverage to all players engaged in the same activity. For example, advocates have wanted to expand the CRA beyond LMI to explicitly cover race and ethnicity. Yet, legislation already exists to cover discrimination and the regulators conduct separate exams to test for compliance under the Equal Credit Opportunity Act and the Fair Housing Act. If these laws are inadequate then they should be amended. In any case, CRA examiners are required to take note of any compliance problems found in those fair lending exams in determining a bank's overall CRA rating. Looking to the regulators to add further tests and standards to the CRA for discrimination seems unlikely to add much value (especially since minorities are already disproportionately represented in LMI communities), and yet it would place more of a burden on the regulatory system and on the banks as it adds further complexity and delay in completing an exam.

Similarly, advocates seem to feel that expanding the CRA to other players in the mortgage business, e.g., brokers, would somehow be an effective way to address existing problems. However, there is a much more direct way to bring uniformity to the industry and that would be to enact specific, targeted legislation that clearly covers all the players in a mortgage transaction (and not just those that happen to be covered by the CRA) and lays out the necessary rules and procedures. If such special-purpose legislation is already in place but requires regulatory action, then the focus should be to ensure that the existing delegated authority is exercised as has happened recently with new regulations promulgated by the Federal Reserve.

Build on the Natural Strengths and Skills of Banks

While it seems obvious, it is worth noting that banks cannot solve all the problems of LMI communities. However, banks and bankers have many skills that are of value and by focusing on those, the CRA is most likely to meet with success. Bankers, like others, are best able to help when they are able to use their skills and experience to develop new products and services. Success in these efforts yields a sense of pride and a willingness to do more.

Is Credit the Right Focus?

It may be time to reexamine the mission embodied in the original statute that focuses only on credit as a way to revitalize and strengthen LMI communities. Given the increased availability of all types of credit at all income levels (at least until this latest credit crunch), it may be a good time to consider transaction, savings, or other products and services for the unbanked or underbanked.

Quantity versus Quality

Reconsider the Checklist Approach

Even with a clear mission, implementation can be daunting. As we have seen with the existing CRA, regulators have increasingly turned the examination process into a checklist based on numbers. While this practice expedites the exams, simplifies examiner training, and may offer a defense against inconsistency, it also has implications for product development and working with other banks and community groups. If the specialized units and the support of senior management are critical to the effectiveness of the CRA, then more emphasis is needed on innovation, responsiveness, complexity, and partnerships with community-based organizations and intermediaries.

Vary the Exam Criteria across Types of Firms and Geographies

Different types of banks have different capabilities, and the criteria used to judge their CRA performance should reflect those abilities. Although the Performance Context could be used to recognize these differences, it has not been well applied. The creation of additional industry subcategories, each with their own type of exam, may make it possible to increase the effectiveness of the CRA and reduce the regulatory burden. Large banks with national footprints have skills that differ from those of large regional banks, which in turn can be distinguished from small banks that serve either specific subsegments of large markets or are the only local bank serving the community.

Varying the CRA tests across geographies if regulation is extended beyond assessment areas should also be considered. For example, if the extension is based on the degree of mortgage lending in a community, then it may not make sense to apply the full three-part test in those geographies where the bank has, at most, one or more mortgage loan officers on the ground.

Reconsider the Role of Deposits from Nonlocal Individuals and Institutions

Since the geographical distribution of a bank's deposits are used both to weight the local/state ratings when calculating the overall rating for the institution and to allocate tier-one capital across geographies (as noted earlier, tier-one capital appears to be used as a gauge of how much community development lending and investing is expected from a bank), it may be more consistent with the original intent of the CRA to consider only those deposits (and its associated tier-one capital) that come from individuals or institutions in that community.

Fix or Eliminate Tests

Eliminating requirements and tests that push banks to intensify their efforts even in markets that are being well served should be considered. To paraphrase a long-known truism, "you get what you measure;" the design of a test is critical to accomplishing the intended goal. If you measure market share, then banks will compete for market share at the lowest possible cost, and thus may focus on activities that have little in common with the intent of the CRA. Moreover, poorly designed tests can have negative, unintended consequences that may more than offset any benefits.

Update the Regulations Regularly, but the Statute Only On Occasions When the Mission Needs To Be Clarified or Changed

Legislation versus Regulation

In a world where nothing stands still it makes sense to restrict the statute to the basic mission and leave the implementation to the regulations, updating them regularly to account for the changes in the products offered to the LMI marketplace.

Facilitate the Updating of the Regulations

To keep the regulations current and minimize the need for examiners to make difficult judgments during exams, a better process for revising the regulations needs to be developed. Changes need to be phased in slowly to allow the banks enough time to revise and execute their business plans for managing the CRA in advance of their preparations for the next exam.

Guard against Regulatory Drift

As the regulators continue to refine the definitions and create "bright lines," it is essential to check periodically for consistency with the mission of the CRA and not just with prior regulations and rulings. Otherwise the regulations can drift away from the goal of strengthening communities.

Incentives

Reward Costly Efforts to Expand Access to Credit

By their nature, efforts by banks to expand access to credit in LMI communities are costly, resulting in a lower profit margin or even a net loss. The government should consider providing incentives to offset these low margins. One approach would simply provide financial subsidies to close the economic gap as government has done in its long and successful record of subsidizing affordable housing. Alternatively, banks that achieve an Outstanding rating could be allowed some sort of financial (perhaps lower deposit insurance premiums) or regulatory relief (such as more time between exams, a safe harbor when applying for new powers, etc.). Similarly, the issue of incentives needs to be considered before imposing CRA-type requirements on other industries.

Weed Out Inappropriate Disincentives

Even if its incentives are costly, it is important that the regulations do not inhibit behavior that helps strengthen communities. If, for example, third-party intermediaries are a desirable way to expand access to credit for LMI communities, then the existing disincentives for lending or investing in multigeography funds need to be remedied. It is essential to ensure that a loan or investment made gets full credit. Similarly, if community development services provided by community groups are valuable, then grants for this purpose should receive more weight in the overall exam than is given to grants alone.

Accountability and Enforcement

If the CRA is to remain effective, accountability and enforcement are critical. Today, these occur through a combination of regulatory action and public comments designed to cast a spotlight on the records of both the banks and their regulators. When regulators conduct their regular examinations or their mandatory reviews of banks when they apply to merge, acquire, or gain new powers, the public, including the advocates, gets to play a role. However, if merger and acquisition activity diminishes, then the effectiveness of public involvement may diminish as enforcement is reduced to the publication of the CRA ratings, an event that no longer seems to garner much public attention. For other industries, the problem of ensuring accountability could be even greater if individual firms are not subject to regular supervision and examination.

Training and Consistency

Whether the examiners are following a quantitative checklist or have substantial discretion, comprehensive and continuous training is critical to ensure the consistency of outcomes across banks and over time.

Make Sure Benefits Exceed Costs

While the CRA has laudable intentions, the ultimate test of its worthiness is whether it yields social and private benefits that exceed its costs. The monetary costs to banks and regulators depend on the profitability of

CRA activities, the amount and type of data collection required, the difficulties of conducting and processing the exam, and the hiring of staff. The same assessment of benefits versus social and private costs should be conducted before any decision is made to add requirements for the banks or to expand CRA-like requirements to other industries.

Conclusion

The CRA is in need of a serious revamp. The last three decades have witnessed significant changes not only in the banking industry but also in response to the predictable pressures on and from the key stakeholders—the bankers, the community advocates, and the regulators themselves. One key result has been a movement toward more quantifiable measures of production. These measures have had unintended consequences as well, reducing the incentives for banks to offer products that can be more complicated and costly to produce but may be effective in expanding access to credit to LMI individuals and communities. Any reform that simply piles on additional requirements or expands CRA-like criteria to other industries without considering these past experiences would be missing an opportunity to make it more effective at potentially less cost.

LMI communities and individuals face a wide range of problems, but the CRA cannot solve them all. Some hard analysis is required in order to determine what the CRA does best and what, for example, might be better done by other, more targeted legislation or regulations that can more easily cover all the relevant players. Another direction for inquiry is whether the CRA should focus on bank products other than credit—for example, transaction or savings accounts. The revamped CRA should also be clearer as to the burden that it expects banks to absorb, and more specifically whether bank profitability and long-term sustainability should be criteria in determining what is expected. Given the reality that not all the activities required as a matter of public policy will be profitable, it becomes particularly essential to be clear about what earns credit under the CRA and to make sure the rewards and sanctions are aligned with those objectives. ■

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