CRA 2.0: Communities 2.0

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Congress predicated the Community Reinvestment Act (CRA) on one principle and two key facts when it passed the act in 1977. The principle is core and remains true. The facts point to what can and should change to make the CRA more effective in what has become a different kind of marketplace.

The principle is that banks had an affirmative responsibility to serve everyone in their markets equally well without regard to place, race, gender, or ethnicity. This principle serves the fundamental precept of our nation—freedom of opportunity and justice for all—and fulfills the purposes of a robust financial services sector.

The first fact is that banks, at the time the CRA became law, had clearly delineated geographic markets—or footprints. The second fact is that the primary business of banks at that time was to provide a prudent savings option for a vast majority of Americans. Various estimates suggest that almost 70 percent of the long-term savings of Americans were in banks in 1977, when Congress passed the CRA. The CRA defined "markets" as those places where banks took deposits.

In theory and in practice, the CRA has supported community development well. In fact, it has largely defined community development. For better or worse, it is significantly more difficult to lend and invest in markets that are not included in CRA footprints. In practice, underserved submarkets (most often minority and low-income but defined primarily by CRA-shaped geography) comprise the "community" and the provision of financial services is the means to its "development." The CRA has supported countless community development organizations, strategies, and initiatives. It has proved to be a remarkably effective law because it has connected opportunity markets to opportunity capital and financial services.

Since its passage, almost everything having to do with the CRA has changed. Competition, technology, product and service innovation, demographics, and consumer patterns and behavior have transformed banking. At a minimum, two changes are key: the vast majority of banking is defined around complex consumer demographics rather than geography, and deposit-taking is now a relatively small, but still significant, line of business from the perspective of a bank's financial performance and shareholder concerns. Banking no longer centers around place and savings.

Banking today centers around consumer demographics, delivery channels, and product innovations. The rise of online banking services is an indication of the transformation, suggesting that technological tools rather than revolving doors are, or soon will be, the primary way that consumers enter banks.

The financial market crisis that started in 2007 will reverberate through banking, financial services, and community development for the next decade. The transformation in form and structure of the financial services industry, the need to reinvent products ranging from securities to ratings, and the apparent redefinition of financial markets regulation will shape for a generation or more our nation's commitment and capacity to make opportunity finance available to everyone.

The focus of the past few decades on emerging demographic markets, efficient ways of serving those markets, and new products that meet their needs will anchor financial services regardless of the framework. This focus will ensure a role for the CRA in whatever new form it might take. Bankers talk openly and often about the critical importance of Latino markets, for example, and follow up anxiously with concern about whether they are doing enough to capture market share.

As a result, the CRA no longer should be viewed as a policy for the fringe markets. The fringe markets of the 1970s and 1980s are rapidly becoming the broadcloth of the U.S. and global economy and will continue for decades to come. The CRA—in a new form, CRA 2.0—can be a bank's portal to opportunity markets, the emerging growth markets of coming decades, Communities 2.0.

This transformation to CRA 2.0 requires at least four things to happen.

1. Policymakers need to reaffirm the fundamental principle of the CRA as central to broad economic prosperity in the United States and other nations. This is, first, a matter of economic policy, and second, antipoverty or community development policy. The principle of the CRA is more important than ever. Banks, as well as all financial institutions that rely on taxpayer support, explicitly and implicitly, still have an affirmative responsibility to serve everyone in their markets equally well without regard to place, race, gender, ethnicity, and other discriminatory factors, some of which we have learned about only because of the CRA.

The CRA will be stronger when the transaction, or the exchange, is more transparent and accountable; that is, when everyone understands what all sides are giving and what they are getting. This requirement opens a set of questions that policymakers, economists, and political theorists will need to focus on.

- How do you quantify the value of multifaceted government support for financial institutions? What, for example, is the value of deposit insurance relative to the value of Treasury's liquidity for JPMorgan Chase in its acquisition of Bear Stearns?
- What factors currently define the CRA as antipoverty and/or community development policy? What would characterize it instead as economic growth policy? Are there existing models that the CRA can use that would accentuate its economic role?
- What, in this scenario, would differentiate the CRA from more familiar economic growth strategies, such as investments in education or infrastructure? Is there a danger that the CRA would lose its ability to focus on low-income and low-wealth persons and places? What would prevent mission creep?

The $700 billion bailout program (TARP) that Congress created raises the stakes—and raises new questions. The role of government capital in stabilizing and sustaining the financial services industry, much more than just banks, carries with it a clear and irrefutable obligation that participating institutions meet the implicit standard of the CRA—serving all markets equally well and without discrimination. However, the complexity of the intervention and the diversity of the institutions exacerbate the challenge of how to implement solutions.

- Are the policy expectations of distressed institutions such as AIG different from those of a healthy one? If part of the cause of distress is irresponsible practices, would mandating responsible practices (beyond basic safety and soundness) be a reasonable path to institutional health?
- With so much of the financial services sector ailing or failing, would the imposition of CRA-type responsibilities help or hinder systemic recovery? Would the CRA take the blame if distressed institutions fail? (After CRA opponents falsely blamed the CRA for the financial market mess in the first place, is there any cause to doubt that they would scapegoat the CRA?)
- Is the disorder in the financial marketplace a unique opportunity to introduce a new systemic requirement that all players share responsibility for responsible financial services, opportunity finance, and community reinvestment? For policymakers, the question is: Will there ever be a better time?

Policy should also recognize that much, but not all, of CRA 2.0 activity will be either below-market rate (as determined by conventional risk-assessment models) or philanthropic. This touches on a set of questions that are already in play: Is the CRA already diluted by the increasing focus on profitable CRA opportunities? Is there an optimal balance of below-market and market-rate CRA portfolios? What are the parameters for acceptable cross-subsidy strategies by CRA-covered financial institutions, particularly when their financing often involves multiple subsidy streams (such as tax credits)?

2. The CRA's (or its successor law's) definition of markets needs to reflect financial markets as they exist today rather than as they were in 1977. The CRA still should apply to geographic markets, but deposit-taking is an obsolete marker for markets. By current estimates, less than 20 percent of Americans' long-term savings now are deposited in banks. A more appropriate and useful definition of financial institution markets, for the sake of the CRA and otherwise, is everywhere each financial institution offers and/or provides products and services and everyone it serves. If a bank offers a credit card to a low-income person, for example, its CRA responsibility (to provide comparable service for all its products and services) should, in principle, extend not only to that person but to the geographic market where that person lives.

Implementing this policy may not be as easy as it seems. Policymakers would need to find a reasonably simple but clear way of defining markets. The challenge is that consumer markets are often volatile and fast-changing. The response may be that financial institutions are well prepared to respond to these challenges. The financial services industry knows where to find customers, regardless of their income or wealth, and how to market and sell to them. And, increasingly, it knows what products and services customers need. A small but significant portion of the industry, as the current credit crisis has proved, took advantage of that knowledge to prey on consumers.

The capacity of the financial services industry to identify markets demographically is extraordinary, and it can be used to create opportunities for low-income and low-wealth individuals. If the market research capacity of, say, Ameriquest or Countrywide were turned to good purpose, for example, financial institutions could compete in "opportunity markets," where nonconforming assets present potential for both incremental and disruptive market gains.

Just as Web 2.0 reflects a current idea of community, CRA 2.0 should do the same. Banks have choices about the markets they will serve, but the markets they choose to serve will define the community reinvestment markets for which they are responsible. As a practical matter, just as the CRA in its current form exempts the smallest banks, CRA 2.0 needs a reasonable minimum standard. Rather than using asset size, however, CRA 2.0 should apply a materiality test. If a financial institution's share of a market is material (that is, at least five percent of the market), it should be subject to whatever the appropriate expectations might be under CRA 2.0. Credit card banks, for instance, target products to particular market demographics, as they should. If Capital One held a dominant market share for revolving credit-card products in Southeast Washington, DC, for example, it might carry a commensurate responsibility to provide revolving credit across the demographic and economic spectrum.

In short, financial institutions could choose their markets, and their markets in turn would define their CRA 2.0 service areas. This is primarily a problem for market research.

- Can policymakers define markets in ways that are consonant with the ways market players think and act?
- Are there existing tools in the well-developed business of market research that enable ready answers to materiality questions? To market share in consumer markets that change?
- Will this approach work if the test is applied on a periodic basis only—for example, only when a financial institution is acting on its CRA requirements or strategy? New Markets Tax Credits, for example, accept a one-time test at the moment an investment is made. Would such a test work here?

3. Under CRA 2.0, financial institutions should use diverse delivery channels to fulfill their responsibilities to their redefined communities. In 1977, banks had few viable delivery channels and relied primarily on successful community development corporations (CDCs) and other nonprofits defined by local geographies. CDCs remain central in some markets, but over the past 30 years sophisticated capital, product, and service delivery channels have emerged. How well do we understand these channels? What challenges might financial institutions face as they become comfortable with entities that operate with different purposes? How can CRA-covered financial institutions learn to use the best-available channels rather than just the most familiar?

A significant number of well-known and well-respected delivery channels exist that have the capacity to deliver billions of dollars—possibly tens of billions of dollars—of opportunity financing annually. After years of working with the CRA and other levers, many banks have preferred partners in their existing markets. Most nonbank financial institutions, however, have few, if any, partners to draw on.

These delivery channels incorporate local, regional, and national market-based financial collaborations involving banks, Community Development Financial Institutions (CDFIs), government, and diverse financial counseling agencies. In some cases, these systems are mature, sophisticated, and ahead of the curve. Some are led by banks and some by CDFIs. All (of the effective and scalable ones) are grounded in markets defined by economic activity but not by government policy. Today this delivery system is good but not great—but it is not far from providing a capacity commensurate with market demand and need.

To that end, CRA 2.0 should recognize and encourage financial institution engagements through both geographically and economically delimited market channels. Geographic market channels are familiar. Economic market channels (which might also be geographic) include a number of intermediary strategies.

- Investing in, lending to, and offering products through CDFIs, including but not limited to participating in syndicated or related asset sales.
- Participating in syndicated or related asset sales through other financial institutions with differing capacities within particular markets; for example, an East Coast bank or investment manager that offers products or services (credit cards or investment accounts) in, say, Rapid City, South Dakota, might participate in CRA 2.0 activities through a Rapid City–based financial institution.
- Participating in municipal or state government financing channels that meet CRA 2.0 standards.
- Financing CRA 2.0 innovation, research and development, and infrastructure in addition to, not instead of, intermediary financing.

Lawmakers ought to focus primarily on how best to fit these delivery channels to financial institutions under the CRA.

- What are the challenges of aligning the capacities of the delivery channels to the demands of CRA 2.0? To what extent is that investment simply building balance-sheet strength and capacity (in the manner of the CDFI Fund in the Department of the Treasury) versus supporting research and development? Is there sufficient support for innovation to enable the delivery channel players to keep pace with demand for appropriate, safe, and sound delivery channels?
- How can key players on both sides (financial institutions and delivery channels) learn to work together without a shotgun policy?

Last, CRA 2.0 investors face a significant challenge in finding and using delivery channels. Opportunity Finance Network, my organization, has developed a ratings system for investors in CDFIs with the goal of reducing funding and transaction costs. Still in its early stages, the CDFI Assessment and Ratings System (CARS) provides investors with normative ratings of CDFI financial risk and performance and impact risk and performance.[1] Ratings reports are detailed quantitative and narrative assessments. The question remains whether CARS can or should be adapted to serve other delivery channels or whether other ratings systems might emerge to meet market demand. A ratings system infrastructure to give CRA 2.0 investors transparency and consistency seems both desirable and inevitable.

4. Congress should create a new investment class to facilitate CRA 2.0 financing by stipulating either: (1) a new group of products (such as CRA 2.0 mutual funds) with explicit and appropriate fiduciary standards that include opportunity finance; or (2) that managers of existing products (such as pension funds) would not violate their fiduciary requirements by investing in CRA 2.0 opportunities (some at market rates and some below-market rates) that might carry a different level of risk than other assets they manage. In fact, Congress might make it clear that financial managers who are not investing in CRA 2.0 are not fulfilling their fiduciary responsibilities, since the principle of CRA 2.0 is that every person should have access to the resources for economic opportunities.

This idea circles back to the first one—that the CRA should be a core component of economic growth rather than just a policy for an outlier of economic policy. This may be the most important idea among the four, but it is also the most challenging.

- How long would it take to introduce a new fundamental principle into a well-established financial system—money and investment management? What resistance would policymakers face?
- What impact would we see from a new fiduciary requirement that allows or requires even a slight exception to standards of financial return or yield? What laws, policies, and practices would be involved?

1 *For more information, see http://opportunityfinance.net/financing/finance_sub4.aspx?id=56.*

Conclusion

Market innovations will always outpace statutory and regulatory solutions. The CRA as it is currently applied is obsolete because of its form, but not because of its purpose or intent. The policy fix is relatively simple, even though the implementation of the changes I suggest would take years to complete. A forward-looking version of the CRA would continue to serve low-income and low-wealth individuals and communities if the regulatory form were sufficiently dynamic.

CRA 2.0 can and should start from market opportunities and respond to market changes. Within the next two to four years, the U.S. government likely will rewrite the basic laws and regulations that govern financial market activities and behavior in response to the unraveling financial market conditions. This is a once-in-a-lifetime opportunity to make fair and just access to economic opportunities a foundation of the structure of U.S. economic financial markets. If we miss this opportunity, we will lessen the odds that economic and financial market recovery over coming years and decades will be full and robust and so put at risk the vitality of our long-term economic growth. ■

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