A Framework for Revisiting the CRA

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The Community Reinvestment Act (CRA) of 1977 was enacted to address the concern that depository institutions had not met the credit needs of their entire communities. In many ways, the act can be credited with changing the way that banks do business in low- and moderate-income (LMI) communities. While the statute itself and the regulations that implement it have changed over the intervening decades, a re-examination of the CRA now seems particularly relevant as the financial crisis and the legislative and regulatory responses to it unfold.

The banking and broader financial services industries have evolved significantly since the CRA was passed. Legislative changes, the growth of automated underwriting, and the expansion of the secondary market allowed financial institutions to grow and consolidate, while encouraging the growth of entities not covered by the CRA (see Avery, Courchane and Zorn's article in this volume). However, alterations to the CRA have not kept up with fundamental changes in the structure of the financial services industry. The 1995 changes to the CRA regulations were intended to streamline the CRA evaluation process and make it more performance-oriented. These changes achieved their goal, in part because of the public transparency of the process, the acknowledgement of the differences in bank size, the ability to enforce other antidiscrimination statutes, and the focus on safety and soundness (see American Bankers Association article). The 2005 regulatory changes were more modest, introducing a new bank size category and revising the definition of community development.

Today, the recent turmoil in the financial services industry has prompted calls for a broad re-examination of the regulation and supervision of the entire industry to ensure the safety and soundness of future lending. This re-examination has raised questions about what role the CRA should play in financial services regulation, and to what institutions the CRA ought to apply. The Federal Reserve Banks of Boston and San Francisco jointly present this publication to capture the detailed views of leading thinkers on the CRA. The contributors, including banking and insurance industry representatives, former regulators, community advocates, and academics, offer a broad range of observations and proposals. The themes summarized here generate an extensive range of questions for both policymakers and practitioners. The goal of the publication is to stimulate a thoughtful discussion on the future of the CRA.

In this article, we present an overall framework for considering the future of the CRA, describe some key implementation considerations, and examine enforcement issues. Throughout, we refer to some of the key ideas contained in the articles in this volume.

Key Questions and an Overall Framework

One of the key questions identified in the articles herein involves the philosophical underpinning of the CRA. What is its underlying intent? Is it designed to repair a market failure, perhaps a lack of information about credit quality in LMI areas? Is it intended to encourage banks to look harder for business opportunities that they would otherwise miss? Is it intended to compel banks to help meet social policy objectives, perhaps as compensation for the privilege of the bank charter, deposit insurance, or access to the Federal Reserve's Discount Window? As Lindsey asks in his article, is access to credit and financial services, real estate lending, and consumer education a public good in its own right that would be underprovided or too costly without government intervention? If the latter, is the intent of the CRA to encourage banks to do things that are somewhat less profitable (or even unprofitable) to further social goals? Have the philosophical underpinnings of the CRA evolved over time with changes in regulations and the banking environment itself?

While Congress found in enacting the CRA that banks have a "continuing and affirmative obligation" to help meet the credit needs of the communities in which they are chartered, we may also ask whether other types of financial institutions have a similar obligation. Further, if the CRA is applied to bank holding companies, nonbank lenders, insurance companies, or even hedge funds, clarifying the rationale for that broader application is important. Many point to the oft-cited *quid pro quo* rationale: that depository institutions are compelled to meet the CRA criteria in exchange for benefits such as deposit insurance, bank charter status, and/or access to the Discount Window. Therefore, if taxpayer subsidy or support is the "hook" on which the CRA hangs for banks and thrifts, recent events suggest that other industries that enjoy explicit or implicit taxpayer support should be subject to similar requirements. Establishing a clear philosophical underpinning would allow the CRA to respond to current and future needs and help in creating a needed benchmark for measuring its success.

While many of the contributions in this volume grapple with detailed questions about the nature and enforcement of the CRA, several authors ask a more basic question: Is the CRA the best way to address a lack of access to fair credit in LMI communities? Lawrence White suggests that vigorous enforcement of the Equal Credit Opportunity Act and antitrust laws could reduce discrimination and make financial markets more competitive. This larger strategic question therefore brings us back to the philosophical underpinnings of the CRA. Has the problem that prompted the creation of the CRA changed? Is the CRA the most useful approach for achieving social goals, such as poverty alleviation, greater access to affordable housing, and neighborhood revitalization? Do its benefits outweigh its costs? Has its original intent been achieved as Lindsey suggests?

Moreover, while we can frame this discussion using the CRA as a starting point, policy makers may also want to consider starting from a blank slate. What are the financial market issues in the 21st century? What inequalities are of concern? Is the CRA peculiar to banks, and a systemic treatment of these issues should start elsewhere? Are there contemporary problems best solved by an intervention that draws on, but is fundamentally different from, the CRA?

The questions posed above can seed a discussion about the future of the CRA. The articles in this volume grapple with many of these questions while suggesting different ways to organize our re-evaluation of the CRA. Broadly speaking, three main approaches emerged.

The first approach is to ***reform the existing CRA regulation and examination process.*** This approach would consider the ways in which the CRA has worked, or not worked, for banks, thrifts and communities in its current form. With feedback from key stakeholders, including banks and thrifts, federal regulators, community-based organizations, municipalities, and residents and businesses in lower-income communities, this approach might re-examine a wide range of questions like the relative weight of the Lending, Investment, and Service Tests, the definition of community development, the use of assessment areas, or focus on the enforcement process and the nature of public disclosure.

Several authors in this volume (including Rust and Taylor and Silver) point out that evaluating performance requires quality data, calling for improvements in Home Mortgage Disclosure Act (HMDA) data variables and CRA small-business data. Meanwhile, despite the evolution of the financial services industry, some argue that access to traditional bank branches and deposit accounts remains critical to LMI consumers' wealth building and small-business development. Several authors commented on the need for greater attention to the Service Test (including Barr and Taylor and Silver).

Other authors (including Quercia, Ratcliffe, and Stegman and Essene and Apgar) argue for the inclusion of affiliates and outside-assessment-area lending in CRA exams. Banks and thrifts are currently allowed to choose whether their non-depository affiliates are included in their CRA exams. Advocates have raised concerns that this option enables bank affiliates to engage in discriminatory practices, arguing that this loophole should be closed (Taylor and Silver). Others suggest that risk-based examinations of affiliates may be most appropriate (Barr).

The second approach is to ***consider whether CRA-like obligations should be extended to other types of financial institutions.*** Some authors suggest that the CRA should be extended to investment banks, bank holding companies, insurance companies, nonbank lenders, credit unions, etc. This approach suggests the need for clarity about why a CRA-like law should apply to these institutions, and would call for a much broader discussion among these financial institutions and the various entities that supervise them. Further discussion of the current enforcement of the CRA and how it might be modified to apply to a wider range of financial institutions would be needed as well.

Cohen and Agresti argue that investment banks, broker-dealers, and other financial institutions should be required to comply with an updated CRA in return for the access to the Discount Window that comes with bank holding company status. The authors offer examples of the kinds of financial services that each type of institution could provide to LMI customers. They argue that all institutions should provide fair access to financial services in exchange for the federal safety net.

Meanwhile, Pinsky argues that the Troubled Asset Relief Program and other federally sponsored "bailouts" carry an implicit CRA standard to serve all markets equally well and without discrimination, while Taylor and Silver suggest that the CRA be expanded to credit unions, nonbank institutions, and securities firms. Ludwig and colleagues recommend expansion to broker-dealers, insurance companies, and credit unions at a minimum, and to all other major financial institutions, such as hedge funds and private equity firms, given the implicit and explicit benefits they receive from the government. The also suggest that nonbanks and other newly regulated entities could partner with banks and thrifts that currently meet CRA requirements or with Community Development Financial Institutions (CDFIs).

Alternately, given that many view the CRA as a tax on the banking industry, Lindsey suggests that CRA-related activities be viewed as public goods. Adopting this rationale would discourage expanding the CRA to institutions that do not provide the core public goods of payment services, real estate lending, and consumer education.

The third approach, instead of taking the current CRA as the starting point, would ***take a completely fresh look at 21st century financial and credit markets and the financial services needed to promote strong families and neighborhoods.*** To start anew in this fashion would call on all stakeholders to take a more systemic, holistic approach to the entire financial services industry and its role in ensuring equal and fair access to credit and financial services for all Americans and in promoting community and economic development.

As a public policy expert in the insurance industry, Gainer investigates the potential role of the insurance industry in addressing household financial stability and risk within a fair and uniform regulatory environment. Meanwhile, White argues that existing laws should be more vigorously enforced, but also that worthwhile lending that is not being provided by the industry should be funded directly by the government, through entities such as the CDFI Fund.

Pinksy suggests that a new investment class be established to facilitate CRA financing, and Barr borrows from behavioral economics to recommend an "opt-out" mortgage plan under which all borrowers would start with a standard mortgage, but could choose an alternative mortgage.

Klausner suggests a market-based approach using tradable obligations along the lines of a "cap-and-trade" system. Following the emissions trading program approach, banks would have to fulfill CRA obligation quotas on their own or pay another institution to provide them. This tradable obligation approach might work in expanding the CRA to institutions such as nonbank lenders, who could more cost-effectively transfer their obligations to institutions with CRA lending expertise. This strategy could also involve partnering with CDFIs to fulfill CRA quotas.

Seidman suggests that "any financial institution that provides an essential consumer product must make that product available in a fair and transparent manner to LMI consumers in all communities in all broad geographies in which the entity does more than an incidental amount of business in the product." Based on the products and services offered, Seidman's proposal covers all essential financial services and their providers wherever they have a significant market share while enhancing public disclosures and fair lending responsibilities of the current CRA.

These three approaches are not mutually exclusive. It may be necessary not only to revise the CRA for banks, but also develop a parallel law for other institutions, and take a fresh look at the financial system.

Important Implementation Considerations

In addition to the above major themes, a number of other important considerations must inform any analysis of the future of the CRA.

People or Place?

A key theme raised by a re-examination of the CRA is the question of whether it ought to be targeted at LMI people or LMI places. The focus on these LMI geographies grew out of the fact that banks traditionally had very specific geographic markets. Therefore, the current regulations measure whether banks and thrifts are serving the credit needs of both LMI geographies and people within their assessment areas, the geographic areas where institutions have their main office, branches, and deposit-taking ATMs, as well as the surrounding areas where banks have originated a substantial portion of loans. However, the majority of lending to LMI borrowers and communities in the mid-2000s was not by CRA-regulated institutions within their assessment areas and therefore had fewer consumer protections (Essene and Apgar).

While the notion of banks and the "communities they serve" meant one thing in 1977, the significant industry consolidation and geographic expansion of institutions since then calls for an updated understanding of the relationship between financial institutions and local communities. In a world of internet banking and ATMs, should "assessment areas" still be based on branch locations? What about financial institutions with delivery mechanisms that do not rely on a branch network; what comprises their "community"? If the assessment area is not based on branch presence, how should it be defined? If an institution makes loans or passes some other threshold for market share in a geographical area, should that area be included in the bank's assessment area? Or do we lose an important local connection when we expand the geographic definition to include any area in which an institution does business?

Several authors argue that, given that banking is now defined not by geography but rather by consumer demographics, delivery channels, and product innovations, the concept of assessment area merits review. Taking a demographic approach suggests that every product or service that a financial institution offers in a geography should be equitably extended to all customers in the geography. This suggests that an institution would choose its market, and that market would define its service area. Pinsky suggests that beyond geographic market channels, economic market channels should also be considered. In fact, since 2001 several proposals have been discussed, including using market share instead of branch location to determine assessment area (Taylor and Silver). Klausner's tradable obligation approach would also transcend the problem of geography.

Another question is whether the population segments and communities targeted by the CRA should be based solely on income, or whether race should be introduced into the CRA calculus. Taylor and Silver argue that fair lending enforcement should be made a stronger part of the CRA examination. Adams notes that despite the historical context of the CRA as a response to redlining, the CRA exam does not assess whether banks and thrifts are affirmatively making loans to ethnic and racial minorities. She argues that the CRA should explicitly encourage investments and promote the creation of wealth in minority neighborhoods. Taylor and Silver suggest that a bank's performance in lending to minorities should be part of the CRA exam. Given that the guiding principle of the CRA is that financial institutions should serve the credit needs of "the entire community," and given that research consistently demonstrates differential access to credit among minority groups and in high-minority geographies, policymakers might contemplate how the CRA could better focus on the needs of these underserved communities.

Access or Fairness?

The historical problem that the CRA was intended to address was access to credit by LMI communities and borrowers. Yet, as the uneven distribution of high-cost lending makes clear, focusing simply on the expansion of access is insufficient unless accompanied by an analysis of the price, terms, and affordability of credit. To what extent should an updated regulation focus on the terms and price of credit rather than simple access to credit? Rust suggests expanding the data collected under the Home Mortgage Disclosure Act (HMDA) to better capture information on loan terms.

Process, Outputs, or Outcomes?

The early CRA examination framework contained 12 "assessment factors" that focused largely on the process by which banks engaged in CRA-related activities. Critiques of this early framework noted that the rules focused too much on bank policies and procedures rather than actual performance. Therefore, the thrust of the 1995 revisions to the regulations was to focus more on outputs than processes. The regulations emphasized the number of loans, investments, and services provided rather than the effort extended.

This transition from process to outputs has been acknowledged broadly by both industry and advocacy groups as a positive step. The CRA is seen by some as encouraging market innovations such as special marketing programs, more flexible underwriting and servicing, and borrower credit counseling. Whether through specialized units or formal partnerships, the CRA has facilitated coordination among banks and reduced information costs. Yet, counting mortgages is easier than evaluating whether an institution truly meets the needs of its community through community development lending and investments (Barr).

However, the transition from process to outputs has generated a concern about whether the CRA examination has become purely a "numbers game" (Willis). Has the examination process lost the ability to properly acknowledge the additional effort that is often extended in underwriting complex community development transactions? In other words, is there some benefit to evaluating the bank's process instead of just whether a loan, investment, or service was provided? A review of the CRA examination procedures might include an evaluation of how to balance outputs with the process used.

Beyond the question of processes versus outputs is an analysis of the outcomes of CRA-related activity. Whether the ultimate goal of the CRA is to solve a market failure, provide a public good, or promote community development, a new look at the CRA should include an assessment of whether that goal has been reached. Asking whether LMI borrowers are better off, whether credit is more available, and on more reasonable terms, and whether LMI communities have greater assets may be the most pertinent questions. There is scant research on measuring outcomes from the CRA beyond the outputs of volume, cost, access, and profitability of lending. While banks are a critical source of credit and financial services, and while they play a critical role in financing community development, they operate within a broader network of lenders, service providers, and community development funders. Teasing out their specific contribution to these larger goals will be difficult.

Important Enforcement Issues

In addition to questions about the underlying philosophy and goals of the CRA, a re-examination of the regulation also raises questions about enforcement. While most other laws and regulations, especially those relating to consumer protection, present a simple enforcement scheme–"do x and you're in compliance, fail to do x and you will suffer a specified sanction"–enforcement of the CRA is more complex. CRA performance by banks is encouraged not just through exams, but also by the public nature of the CRA examination process, and by the incentives offered. Below are three themes related to the enforcement of the CRA and incentives for CRA-related activities.

Disclosure of CRA Performance

One critical aspect of the CRA's impact on the industry and the communities it serves is the public nature of the Performance Evaluation. Any member of the public can access an evaluation (as well as the closely related HMDA data), form his/her own opinion about the institution's performance, and interact with the bank and its supervisors to encourage greater community development activity.

Given the easy public access to this information, what role does disclosure play? Should the law simply require the disclosure of information about products and services, terms, geographies served, etc., or should it compel or encourage institutions to adopt new products or practices? How can community organizations use the information to encourage change and the development of new credit products that better serve their communities' needs?

Examinations

The current CRA examination process has improved over time and now thoroughly enforces the CRA for banks and thrifts. Well-trained examiners, many of whom have considerable expertise in community development issues, periodically examine banks and prepare a comprehensive examination report. Examiners balance statistical analyses of a bank's performance with qualitative assessments of its responsiveness to community credit needs and performance context issues. Meanwhile, banks and thrifts collect, analyze, and report data in preparation for the CRA examination. Today, some argue for continued simplification and greater flexibility (American Bankers Association). Is there a way to streamline the process, make it more consistent across examiners, and reduce the costs to both the supervisors and financial institutions? Given the complexity of CRA activity at very large institutions, should a different examination framework be established for these institutions? If the CRA were expanded to other types of institutions, who would enforce it and what supervisory resources would be needed?

Incentives for CRA Performance

Regulators are required to take into account a financial institution's CRA record when considering applications for acquisitions, mergers, or new branches. Banks considering such changes thus have a strong incentive to have their CRA affairs in order. Are there similar incentives to encourage CRA-related activity at other types of financial institutions? Further, does the merger approval process adequately enforce community reinvestment obligations, or does this process merit review (Taylor and Silver)?

While an Outstanding CRA rating can be viewed as an incentive in itself, its benefits are difficult to quantify, and many institutions seem content with a Satisfactory rating. Should a new CRA rule consider some reward for excellence, for example by rewarding institutions with an Outstanding rating with favorable treatment? What kind of favorable treatment would be appropriate? Or should the CRA serve as a floor, ensuring that all institutions are at least doing a reasonably good job of meeting credit needs? Do concerns over grade inflation point to needed reforms? While some suggest that the high incidence of "passing" ratings calls for the inclusion of more rating categories (Taylor and Silver), others suggest that the ratings indicate the overall high quality of lending (American Bankers Association). For those who do not receive high ratings, should there be penalties for noncompliance? In such cases, some suggest penalty rates on loans from the Discount Window, other fines (Cohen and Agresti), or a CRA improvement plan (Taylor and Silver).

Seeding the Discussion

One error that ought to be avoided in a new look at the CRA is to exaggerate its influence. Extreme views here can result in missed opportunities. For example, erroneously ascribing to the CRA a central role in the subprime mortgage crisis runs the risk of diverting attention from more serious questions, such as the supervision of nonbank lenders, safety and soundness considerations, and fair lending enforcement (Laderman and Reid). It also ignores the positive impact the CRA has had. Not only has the CRA increased access to mortgage lending for LMI borrowers, but it has also played a role in other areas, such as multifamily housing, community facilities, and economic development. By the same token, the CRA alone will not solve neighborhood and poverty issues. If the development of LMI neighborhoods is one of the primary goals of the CRA, we ought to determine what the CRA can and cannot do for neighborhoods. Expanding government funding for the Community Development Block Grant program or the Community Development Financial Institutions Fund may be a more effective policy response to community development needs. Quite likely, many strategies are needed.

Our hope for this volume is that it will inform discussion and bring about positive change. More voices will surely join the conversation. The opportunity to revisit the CRA is before us. Our paramount concern remains enabling the financial services industry to provide access to credit and basic financial services in a safe, responsible, and equitable way to all LMI borrowers and communities. ■

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