

Community Reinvestment Act Regulatory Reform

Recommendations to Bank Regulators June 2011

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Introduction

Over the past year, national and local community, consumer, and civil rights organizations have been engaged in discussions about how to improve and update the regulations governing the Community Reinvestment Act (CRA). Convened by the National Community Reinvestment Coalition, participants in the discussions were Enterprise Community Partners, Housing Assistance Council, Local Initiatives Support Corporation, Low Income Investment Fund, National People's Action, Opportunity Finance Network, Pathstone, and the Woodstock Institute. Our organizations believe that revised CRA regulations must account for changes in the financial services industry so that the CRA better promotes increased access to responsible loans, investments, and banking services for communities. This paper outlines our recommendations for a new CRA regulatory structure that we encourage the bank regulators to adopt.

The banking industry has changed dramatically since the Community Reinvestment Act became law in 1977. Rather than basing CRA obligations solely on where a financial institution takes deposits, we believe regulators should consider both the functions a bank performs (such as home mortgage lending, small business lending, deposit accounts, credit card services), and where they are performed, in determining the institution's CRA obligations. An institution providing deposit accounts and services through a branch network would meet its CRA obligations differently than an internet bank headquartered in one city offering home mortgages nationwide. In addition, many financial institutions today are hybrids, providing a range of banking services. An institution with multiple functions and products should have a total CRA obligation that reflects the sum of its parts with appropriate attention to the size of the institution and volume of its business.

The current three part structure of CRA exams should be retained. Under our proposal, banks would continue to be examined on their lending and services but the current investment test would be replaced with a community development test. Assessment areas would be updated to better reflect where banks conduct their business and to be more relevant to the particular test. In general, we would not expect small banks to be subject to the full set of obligations outlined below. Very large banks should have the most frequent CRA exams.

We believe that these recommendations can result in comprehensive CRA exams that are nevertheless more efficient than current exams and do not require a significant expansion of regulatory staff resources.

A chart summarizing CRA obligations for various banking activities follows along with a full narrative description of our recommendations.

Community Reinvestment Act (CRA) Obligations For Various Banking Activities

Activity or Product	Functional and Geographic Obligations		
	Lending Test	Retail Consumer Service Test	Community Development Test ¹
Deposit Accounts and Services	No obligation	Yes	Yes
branch based		In branch network area	In branch network area; if satisfied, credit for additional CD activity elsewhere.
internet		In branch network area for local deposits. National obligation for other internet deposits	In branch network area for local deposits. National obligation for other internet deposits
institutional, escrow, trust accounts		No obligation	Nationwide obligation.
Home Mortgage lending (including MBS issuances and loan servicing)	For home mortgage lending only. ² Obligation in branch network area and other significant local home mortgage markets. ³ National obligation for home mortgage activity elsewhere.	No	Yes. Lending in markets with local branches generates local CD obligation. Lending elsewhere generates national obligation. ⁴

¹ Under this recommendation, a community development test would replace the current investment test. CD test would include CD investment, lending and at least some activities (e.g., assistance to relevant nonprofits) now considered community development services. Qualitative factors should include responsiveness to local community performance context and national community development challenges, as well as leadership.

² Original purchases of mortgages or mortgage-backed securities (MBS) would be considered as part of the lending test. Loan originations and other primary market activities will be considered separately from secondary market activities. Loan originations should be weighted more than secondary market loan purchases. Servicing of mortgages should also be an activity considered by CRA exams, imposing penalties for abusive servicing and rewarding banks for sustainable loan modifications.

**Community Reinvestment Act (CRA) Obligations
For Various Banking Activities (continued)**

Activity or Product	Functional and Geographic Obligations		
	Lending Test	Retail Consumer Service Test	Community Development Test
Small business/small farm lending (including small business credit cards, purchases of small business loans originated by others, including for securitization)	For small business/farm lending only. ⁵ Obligation in branch network area and other significant local small business/farm markets. National obligation for small business/farm activity elsewhere.	No	Yes. Lending in markets with local branches generates CD obligation there. Lending elsewhere generates national obligation.
Consumer lending (including credit cards)	For consumer lending only. Obligation in branch network area and other significant local consumer lending markets. National obligation for consumer lending activity elsewhere.	No	Yes. Lending in markets with local branches generates CD obligation there. Lending elsewhere generates national obligation.
Wholesale, limited purpose, and other institutions that do not do a significant amount of consumer or small business lending (including investment and trust banks and institutions specializing in commercial real estate financing)	No	No	National obligation.

³ Significant local markets” are markets where 1) a bank has significant local market share or 2) a substantial share of a bank’s activity is located.

⁴ As stated above, it could be appropriate to establish community development obligations in geographical areas in which an institution has a disproportionately high market share of loans (home or small business) compared to its market share elsewhere.

⁵ Purchases of small business loans or securities would be considered as part of the lending test the first time a loan is sold.

Reforms to the Lending and Service Tests

Lending Test

Home mortgage and small business lending: Home mortgage and small business lending will continue to be prominent activities scrutinized by the lending test. We are recommending that in addition to originations, servicing and modifications be elements on the lending test. The quality of servicing and modifications has a profound impact on whether loans are sustainable. Servicing and modifications have become prominent issues during the current foreclosure crisis and will likely remain elevated in importance for years to come.

Servicing: Bank servicing of loans must be on the lending test. Ratings should be downgraded if the bank is engaged in abusive servicing practices such as usurious late fees and high-cost forced place insurance. Loan modifications that are sustainable and affordable should be on the lending test. However, if a bank and/or its affiliate is engaged in a pattern and practice of abusive loan origination, commendable servicing and loan modification practices should not be allowed to compensate for the abusive loan origination practices. Since abusive loan origination practices were a major cause of the current foreclosure crisis, the key to preventing future crises is a policy of zero tolerance for predatory lending in the CRA and other fair lending regulations.

Consumer Lending: Small dollar consumer loans that serve as an affordable alternative to payday loans should be on the lending test. A subset of these are “credit builder loans” that are fully collateralized (by deposit accounts or other collateral) and are used as a means to help borrowers build good credit histories. In addition, providing lines of credit to abusive payday lenders must be penalized on CRA exams. The agencies can build upon their past experience in cracking down on bank partnerships with abusive payday lenders when assessing bank lines of credit to fringe financial institutions and deciding whether the bank financing is enabling predatory products.

Reporting to Credit Bureaus: Selective reporting of borrower payment history is an abusive practice that should be penalized on CRA exams. Regular and timely loan payments must be promptly reported in the same manner as delinquencies. Also, consideration of employment history and rent payments at the request of the borrower should be considered favorably.

Service Test

Types of services considered: Retail banking services including deposit accounts, check cashing, and money orders should be on the service test.

Specialized services: IDAs (individual development accounts) and other specialized retail services for low- and moderate-income (LMI) populations should be on the service test.

Qualitative factors: The quantitative factors should be tempered by consideration of affordability, and safety and soundness. Unsafe, unaffordable, and abusive products should be penalized regardless of whether these products are offered in the assessment areas or anywhere in the country.

Need for deposit data: Better deposit data is needed for the service test. Currently, deposit data is available by branch but the data does not reveal the income level of the census tracts in which the depositors reside. The data does not therefore indicate the levels of deposits for LMI neighborhoods, which would be a critical measure of bank services on CRA service tests.

Terms and conditions: Terms and conditions that particularly benefit LMI consumers, even if they differ from terms and conditions for other income levels should be encouraged. For example, low dollar amounts (\$10) to open accounts and leniency regarding check systems can particularly benefit LMI consumers.

Assessment areas: The service test should have more AAs but less narrative for each AAs. The service test can focus on best AAs and worst AAs. Best and worst is defined to mean how well the institution performs in offering branches, deposit accounts, and consumer banking services to LMI people.

How to consider innovations: The qualitative analysis for the service test can focus on what innovations in best AAs can be applied to worst AAs.

Lending and Service Test: Assessment Areas

The great majority of loans and services must be covered on exams. For many large institutions, CRA exams presently scrutinize the minority of their activity, meaning that exams are not adequately considering if their lending and services are meeting community credit needs. Assessment areas for home mortgage lending, small business/small farm lending, and consumer lending should be drawn to include the geographical areas where an institution has a significant presence for a given loan category, either because it has a significant local market share⁶ or because that area generates a substantial share of the institution's activity, as well as areas surrounding branches. Assessment areas for deposit services should cover geographical areas surrounding branches. As such, a bank might have different assessment areas for home mortgage lending, small business/farm lending, and deposit services. Activities not within an assessment area – e.g., home mortgage lending in places where the institution lacks a significant presence, or internet deposit accounts of customers not near branches – should be fully considered in the aggregate.⁷

Assessment Areas and branch networks – Our proposal also preserves attention to the geographical areas where institutions have physical branch networks. This approach is particularly appropriate for regional or local institutions that do not do much lending beyond their branch network. In some cases, these banks would not meet the market share threshold

⁶ H.R. 1479, the Community Reinvestment Modernization Act of 2009, has a threshold of one half of one percent of the market. Either this threshold or another market share threshold should be carefully chosen based on empirical analysis that measures how much lending and service in various geographical areas would be covered by various thresholds.

⁷ Currently, some CRA exams conduct national comparisons of a bank's lending activity compared to all lenders, as a group, when a bank is a nationwide lender but lacks significant market share in metropolitan areas or rural counties. This approach is appropriate when lending is at a high volume but diffuse across many geographical areas.

mentioned above, but the geographical areas in which they have branches are nevertheless important to the banks' business strategies and should therefore be assessment areas.

Full scope exams must cover all lending and service of banks and include rural as well as urban areas. Currently, some large banks have more limited scope than full scope exams for their assessment areas. Limited scope exams are cursory and do not adequately assess if an institution is meeting needs in assessment areas, and have little if any effect on a CRA rating. The distinction between full and limited scope exams should be eliminated. All assessment areas should have full scope exams with lending and service tests contributing to the overall rating. Our suggestions below for reducing exam narrative can facilitate full scope status for all assessment areas. Importantly, this approach is intended to increase attention to rural areas and smaller metro areas that currently receive only limited CRA reviews.

Proportion of loans in assessment area criterion on CRA exam – CRA exams consider the proportion of a bank's loans in its assessment areas as a criterion on the lending test. Currently, affiliate loans are not counted on this criterion. Affiliate loans must be automatically counted in order to ensure that the exam has complete expectations about lending in assessment areas, taking into account the capacity of the entire institution. For example, if a bank issues 90 percent of its loans in the assessment areas and an affiliate offers 40 percent of loans in the assessment areas, the combined lending in the assessment areas could be less than a majority of loans depending on the loan volume of the affiliate. Just examining the lending volume of the bank distorts the true picture of entire institution's lending inside and outside the assessment areas.

Change exam focus to save resources, facilitate more assessment areas, and focus on where a bank's performance is above or below peer performance - Lending and service tests evaluate activities (lending and deposits) that are relatively easy to quantify. Therefore, these tests can accommodate several assessment areas, possibly a few hundred for the largest banks. Tables can compute performance measures for lending and service and list the assessment areas in descending order from the best to worst. Since institutions generally provide similar products and terms across markets, the exams do not have to repeat narrative for every assessment area but perhaps focus attention in describing performance in best and worst areas.

The Community Performance Context (CPC) report described below will also provide context for considering performance across assessment areas and weighting different types of loan products. For example, if a lender performs in an exemplary manner in providing home improvement loans in areas of the country with aging housing stock, the home improvement performance could compensate for mediocre or poor performance on other loan types (this type of weighting and compensatory approach occurs now so CPC reports can enhance their effectiveness). Another example of the importance of CPC reports is that average performance is adequate in a well-served geographical area but may not be adequate in an underserved area. The CPC reports will help identify the geographical areas that are underserved.

Overall, this approach to sorting performance in assessment areas is a method to evaluate more assessment areas in a less cumbersome and resource draining manner than is currently the case.

In addition, it focuses the analysis on where the bank’s performance is above or below its peers.⁸ This provides a clearer indication to all stakeholders of how a bank can reduce unevenness in performance.

Replacing the Investment Test with a Community Development Test and Related Reforms

Community Development Test

A new community development test should replace the current investment test and complement separate tests for general lending and services. The new CD test would include all CD activities primarily benefitting low- and moderate-income households and communities, including multifamily housing, commercial and economic development activities that revitalize low- and moderate-income areas, community service facilities, construction and rehabilitation of single-family homes, and support for nonprofit CD organizations such as CDFIs and CDCs. Qualitative factors should include responsiveness to local community performance context and national community development challenges, as well as leadership.

Treatment of CD activities under the current rule and exam procedures does not work well for all activities in all communities. The content of CD activities is as important as its volume. Dividing consideration of CD activities among the three tests places the form of an activity ahead of its function, and impedes the planning and analysis of CD activities that are responsive to local needs and national challenges. CD loans are considered on the lending test, where they are not required but generate only “extra credit”. CD loans tend to get little or inconsistent consideration, even though they often are disproportionately beneficial for communities, because the number and volume of CD loans tends to be small relative to standard home mortgage and small business lending. Meanwhile, the current investment test recognizes not only high value investments like LIHTCs, NMTCs, grants to nonprofit community developers and loan purchases from CDFIs, but also MBS purchases that are easy to make in volume but add little real CD value and would be more appropriately considered along with home mortgage lending.

CD loans would be moved from the current lending test. Purchases of home mortgages and small business/farm loans, including mortgage backed securities (MBS), which are now part of the

⁸ The following is a hypothetical example of how our proposal to sort geographical areas would work. One performance measure could be the percent of home mortgage loans to low- and moderate-income borrowers. In two metropolitan areas, Main Street Bank has the following performance:

East Coast metropolitan area - Main Street Bank - 15 percent of loans to low- and moderate-income borrowers; all lenders as a group, 25 percent; percentage point difference -10 percentage points.

Midwest metropolitan area - Main Street Bank - 35 percent; all lenders as a group, 20 percent; percentage point difference - +15 percentage points.

In this example, the Midwest metropolitan area is one of the areas with the best performance for Main Street Bank where Main Street Bank is above peer performance. The East Coast metropolitan area is one of the areas with worse performance where the bank is below peer performance.

investment test, should be considered along with direct home mortgage lending as part of the lending test, and not as part of the CD test, except those sold by CDFIs. CD services should include advice to nonprofit and public CD entities. Banks' partnership building activities with nonprofit and governmental entities should receive recognition. Whether an activity is conducted directly or through a CDFI or other entity at the local, state, regional or national level should not be important.

The content as well as the volume of CD activities should be considered together. The various kinds of activities should be considered (e.g., LIHTC investments, commercial revitalization loans, technical assistance to nonprofit and governmental CD entities.). Qualitative factors should include: responsiveness to local needs and national challenges, leadership and innovation, and the degree to which a market is underserved or a product is not otherwise broadly available. National challenges might include serving rural areas, preservation of affordable housing, financing for community service facilities such as health centers, charter schools and childcare centers, transit-oriented development, and energy efficiency. The responsiveness of banks to rural areas must be routinely considered on CRA exams and should be one of the national challenges that banks could be allowed to meet after they satisfy the CD needs of their assessment areas.

CRA exams sometimes benchmark CD investments against assets and other times Tier I capital., A consistent approach should be used in order to better compare institutions to each other.

Community Development Test Assessment Areas

On an interagency basis, regulators should develop "community performance context" reports for individual markets such as the fifty largest metropolitan areas and the balance of each state. All banks operating in a particular market could use the same community performance context report to inform their decisions prospectively about CRA-eligible activities that meet the needs of that market. Each report would focus on community needs and economic conditions in the market, such as levels of unemployment and housing affordability. Markets analyzed would include rural counties, smaller cities and large metro areas.

In developing the community performance context report, regulators would incorporate existing data (including consolidated plans, and qualified allocation plans for Low Income Housing Tax Credits, etc.) and provide an opportunity for public input. Such a system would better align CRA activities with community needs, improve transparency, and be more efficient than current practice, where each regulator creates an individual performance context for each bank in every market where the bank operates. Banks would remain responsible for shaping their CRA strategies based on their operating models, expertise and capacity. A period of transition from the current system to the new interagency community performance context approach would be expected.

The markets identified by regulators for community performance context (CPC) reports would become the assessment areas for purposes of the community development test (CD) only (Assessment areas for the lending and service tests would not change.) In other words, the metro areas and balance of each state analyzed by CPC reports would be CD assessment areas (AAs) if

the bank had branches anywhere in the state and/or large market share of loans in the state. For example, if a bank had a branch in Philadelphia, the entire state of Pennsylvania would be an AA for the CD test. This avoids the current practice of a bank CD project not receiving credit in rural Pennsylvania simply because the bank has a branch in Philadelphia but no other branches in the state.

The current approach for determining assessment areas for the investment test creates hyper-competition in some markets and creates CD financing "deserts" in other geographical areas. Although the content and context of CD activity are as important as its volume, it is not practical to perform a content review for each of the hundreds of AAs that the largest institutions serve. An exam with too many assessment areas may result in banks striving for certain numerical targets in each assessment area when in fact, the needs will not be as great in each AA or the opportunities may not be readily available in each AA. In contrast, non-traditional institutions with one or only a few branches but with a national presence have narrow assessment areas consisting of only a few geographical areas while they have large scale lending or other operations.

Fewer AAs for the CD test is practical and would make a full review of content and volume of CD activity possible for all AAs. Larger AAs would encourage significant activities, including in smaller communities. A rigorous community performance context will guide community development financing levels and types by identifying specific needs in AAs and available infrastructure in AAs. There will be fewer assessment areas for the community development test but CRA exams need to make sure diversity of needs are met. (For example, rural East Texas and the Rio Grande Valley have different demographics and needs.)

The scale of an institution's community development obligation should be commensurate with the scale of an institution's overall activities. A community development obligation should include geographical areas where the institution has branches and where an institution's market share of loans is disproportionately high compared to its market share elsewhere. Beyond these geographical areas, an institution's community development activities can meet needs elsewhere such as rural counties and smaller metropolitan areas.. An investment into a CDFI may help an institution meet its CRA obligations regardless of whether the CDFI operates in the institution's assessment area. CDFIs should receive the same regulatory treatment afforded to minority- and women-owned depository institutions.

Additional Recommended Reforms

Weights on CRA Exams

Qualified Mortgages: Loans that meet the definition of qualified mortgages in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 should be considered more favorably than other home loans on CRA exams. Since Congress judges that qualified mortgages are safer and sounder than other home loans and CRA requires safe and sound lending, the regulatory agencies would be implementing statutory requirements of both Dodd-Frank and CRA by treating loans in this manner.

Definition of Qualified Mortgage: A qualified mortgage in Dodd-Frank is defined as a mortgage that does not contain negative amortization or balloon payments. Income verification is required and the ability to repay is based on a fully amortizing schedule and payments for taxes and insurance. For adjustable rate loans, the ability to repay is based on the maximum rate during first five years of the loan. Moreover the loan will not exceed a debt-to-income ratio established by regulation and will provide enough income after debt payments to afford basic necessities. The term of the loan is 30 years and total points and fees of the loan will not exceed 3 percent of loan amount.

Originations Count More than Purchases: Loan originations should be weighed more heavily than loan purchases. Only original purchases of mortgages or mortgage-backed securities (MBS) would be considered as part of the lending test. Only original purchases of small business loans would be considered part of the lending test.

Community Development Test: The community development test should be weighed more heavily than the current investment test.

Underserved Communities on CRA Exams

Underserved Communities on CRA Exams – The American Community Investment Reform Act (HR 6334) requires CRA exams to assess an institution’s record in meeting the needs of “other traditionally underserved neighborhoods” in addition to low- and moderate-income communities. This requirement would ensure that rural areas, economically distressed communities, and underserved communities of color would be considered on CRA exams. The CRA statute is broad enough that passage of HR 6334 is not necessary for this approach to be considered in revised regulations. The agencies already have applied CRA to underserved and distressed rural middle-income areas, for example.

Impact on CRA exam for violations of FHA/ECOA – Should be rigorous and also flexible enough so that a CRA evaluation allows for failure in one or a few AAs or overall, depending on breadth, depth and duration of violations. Even if violations occur in one or a few AAs, if these violations continue for some time or are identified but not corrected, the CRA exam could fail the bank (This resembles the "three strikes and you're out" approach).

Affiliates

Mandatory inclusion of affiliates – Banking activities undertaken by affiliates must automatically be on CRA exams. In other words, if the affiliate is offering a product that a bank or its subsidiary can offer, the affiliate’s activity should be considered on the CRA exam. Mandatory inclusion of affiliates ensures that the total capacity of the institution and its affiliates is considered when assessing if the institution is adequately meeting the needs of the community and to avoid a regulatory arbitrage through which activity can avoid scrutiny merely because of the corporate entity in which it takes place.

Exams on a holding company level – Currently, CRA exams are conducted for each institution in a holding company in isolation. Mandatory inclusion of affiliates entails considering whether

CRA exams should be conducted on a holding company level with appropriate weights assigned to each institution, depending on their level of activity. Another alternative is summing the activities of each institution in each assessment area when conducting an exam on a holding company level.

Examiner training

Community groups must be involved in training examiners. This provides examiners with insights into perspectives of community groups regarding community needs and experiences in engaging banks in responding to those needs.

Improve community contacts. Community groups around the country report that they are rarely contacted when CRA exams being conducted.

Transparent means for commenting on exams and merger applications. It is difficult for community groups to figure out to whom in the agencies to send comments. For example, comments are to be sent to Deputy Comptrollers in the case of the Office of the Comptroller of the Currency. The Federal Reserve Board has an electronic form via <http://www.federalreserve.gov/feedback.cfm> for sending CRA comments that is hard to find and does not leave enough space for writing a substantive comment. The process for commenting would be vastly improved if the agencies published publicly available lists of officials and examiners at each agency to whom to send comments along with the current announcements of quarterly CRA exams and merger applications.

Consistent analysis, examination tables, and performance measures – Currently, exams exhibit significant inconsistencies across and within agencies. CRA ratings and enforcement are diminished especially when similarly situated institutions receive different examinations. Performance measures need to be as consistent as possible. For example, CRA exams have contained ratios of qualified investments to assets or Tier I capital. One of these ratios should be chosen and ranges should be developed that correspond to gradations of performance. Another example is that one of the agencies uses market share comparisons on the lending test while the others typically compare percentages of loans to low- and moderate-income borrowers made by the bank being examined to all lenders, as a group. Both measures have value; either both or one should be consistently used.

Consistent treatment for loans, investments, services – Despite the development of detailed interagency Questions and Answers, different examiners treat activities such as letters of credit differently. Sometimes the activity does not receive any favorable CRA consideration or the extent of favorable consideration varies.

Training for examiners regarding affordable and sustainable loans, services, and investments – Careful qualitative judgments need to be made as to how affordable and sustainable various loans, investments, and services are. Appropriate weight should then be assigned to various loans, investments, and services depending on their affordability and sustainability. Examiners are uneven in their abilities to make these judgments.

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