GSE Activity Report

Tuesday, April 3, 2018

Strange But True: Treasury Proposes Tougher, Clearer CRA

Summary

Despite an immediate burst of rhetoric to the contrary, Treasury today released an astonishingly-progressive set of recommendations to reform implementation of the Community Reinvestment Act (CRA). If these are taken up by the federal banking agencies – and they will be – banks would do more for their communities and thus rely a lot less on FHA/GSE lending to show they care even when they really don't. The bank mortgage-origination share for FHA and the GSEs is thus likely to drop still lower.

Impact

The CRA is a 1977 law requiring insured depositories to demonstrate that they provide lending (and in more recent years also other services) to the communities from which they draw deposits. Enacted at a time when redlining was widespread, the law is intended to make it considerably more difficult for banks to draw deposits from LMI communities and lend them out in prosperous, white suburbs. Although strongly progressive in intent, the law is also effectively toothless except – and this is an important exception – when a bank or holding company wants to expand. Then, its CRA record – always public and thus also a source of reputational risk – can tie up a deal in knots. Banks thus generally do the best they can to score as well as possible under CRA without in fact changing their business plans to any meaningful degree. That the vast majority of banks have long had favorable CRA scores testifies to how well this balancing act is generally accomplished.

How do banks mesh CRA's demands and their business-plan requirements? It's not at all hard because the banking agencies have long favored mortgage lending as a CRA contributor and do not differentiate between mortgages on portfolio or for which a bank is otherwise directly at risk versus all those sold to Ginnie and the GSEs. Unsurprisingly, mortgages along with activities eligible for low-income housing tax credits, thus comprise the bulk of CRA activities.

The implementing rules for the 1977 law also pay no heed to how banking has in fact changed over the decades. Back then, banks of course did the vast majority of their business through physical branches; the rules thus measure a bank's performance only with regard to the geographies surrounding home offices, branches, and ATMs. As branching has declined and digital channels replaced traditional intermediation, the boundaries within which bank performance is judged have thus become increasingly irrelevant to actual amounts of real community reinvestment.

Treasury's recommendations take on both of these problems, building on a recent GAO report urging comparable reforms. First, bank mortgage and LITC activities would be downplayed in comparison to

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many other types of loans (e.g., small business) and services (e.g., multi-family investment, financial education). Second, assessment areas would be expanded to a banking organization's entire service footprint, not just its physical locations. In addition, innovative services would be more easily approved as CRA-eligible, long-term debt such as portfolio mortgages would be favored, stress tests would need to be more merciful to certain CRA activities, and banks could no longer cherry-pick among affiliates to enhance CRA performance. For good measure, Treasury tells the banking agencies to study the benefits of bringing non-banks into the CRA ambit. This would of course take statutory change, but Treasury is not only open to this, but seems indeed to recommend it due to the growing replacement by banks with non-banks in both mortgage and small-business finance.

This is a remarkable approach from a Trump Administration generally more inclined to slash and burn regulations than to enhance them. Consumer and community groups will in fact find things to loathe in this plan – for example, it supports recent OCC actions to end the practice of downgrading or even double-downgrading banks (e.g., Wells) for consumer-law violations with no clear nexus to community reinvestment. Faster application turn-arounds and changes to CRA examinations will also surely get skeptical, if not damning, reviews from progressive and Democratic groups.

Outlook

Regardless of the politics to come, the banking agencies will cautiously tread where Treasury now directs them. Reflecting ongoing transitions at the federal agencies – most notably continuation of Marty Gruenberg as FDIC chairman for now – the agencies plan only an advance notice of proposed rulemaking as a first step to acting on Treasury's recommendations. Nonetheless, the industry is hearing them loud and clear and will, we believe, begin to reflect the changing nature of mortgage lending in forward-looking business plans.

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