Financial Services Management

FRB Community Reinvestment Act Regulation

Cite

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Websites:

https://www.federalreserve.gov/aboutthefed/boardmeetings/files/cra-fr-notice-20200921.pdf

Impact Assessment

- Odds increase for eventual agreement on an inter-agency CRA standard, increasing efficiency and reducing regulatory-arbitrage opportunities.
- Effective community service may also increase.
- Internet and other novel charters would come under tougher CRA standards.
- Assessment areas would be made considerably more flexible, affording CRA credit for activities beyond a branch-designated area in ways that may increase financial services in banking "deserts," rural areas, Indian Country, and other under-served regions.
- Minority- and women-owned banks would gain CRA advantages of their own as well as higher odds of investment or other support from other banking organizations.
- Greater emphasis could be placed on loan origination and retention, not securitization. This could significantly alter bank single- and multi-family lending practices.
- Many new activities would count as community development, encouraging engagement, innovation, and financing.
- Innovative deposit and small-dollar loan programs could also receive CRA credit and thus become more significant.

Overview

Following opposition to the OCC's CRA rewrite,[1] the FRB has proposed an initial construct that takes some elements of the OCC's approach and adds further and in some cases different provisions to craft what the Fed hopes will become an inter-agency CRA construct in 2021. An extremely long ANPR seeking views on 99 questions, the Fed's

[1] See *Client Report* **CRA28**, May 26, 2020.

proposal is clearly an initial foray into a new CRA framework, not a penultimate policy statement. However, much in it has so much specificity as to suggest that Board thinking is well along to finalizing a new CRA standard in 2021 that might not only increase community-focused finance, but also allay growing political pressure on the central bank to address racial inequity and economic inequality. Given the importance of CRA ratings to achieving strategic objectives, this new CRA construct could both increase financial inclusion and spur innovation as well as provide banks with a more transparent and certain supervisory construct. It could, however, also require considerably more data and governance by banking organizations.

Impact

As the Board noted when releasing this ANPR, recent events have placed new emphasis on increasing financial inclusion, especially for the racial and ethnic groups that have been historically under-served by the financial industry. However, the Board's proposal, like current CRA rules, applies only to regulated banking organizations; other companies engaged in like-kind financial services are exempt and thus may not engage in low-and moderate income (LMI) and minority focused lending, investment or other community-focused financial services. The Trump Administration's recommendations for CRA reform[2] included assessing whether nonbank mortgage lenders are meeting the credit needs of LMI communities. Sen. Elizabeth Warren (D-MA) and other Democrats have advanced legislation expanding CRA; if Democrats gain additional power in 2021, these initiatives will gain far greater force. As a result, the final banking framework could have significant impact not only on banks, but also on nonbank providers of certain retail financial services.

Perhaps the most controversial aspect of the OCC's rule is its decision to discount branch-based retail lending in order to reflect changing retail-delivery channels. The FRB has decided to retain the branch-based assessment construct but also to provide supplementary measurement criteria designed to capture retail services, including deposit-taking, and reflect lending and investment outside a branch-specific assessment area. Many measurement criteria here and throughout the ANPR are based on benchmarks the Board thinks provide greater certainty and less burden, as well as creating a strong platform for expanding community finance without abandoning traditional markets. However, the benchmarks and thresholds might also lead to false comparisons that under- or over-count activities or fail adequately to recognize qualitative actions. Various adjustments are thus outlined to possible benchmarking on which comment is sought. These benchmarks and then the thresholds based on them by which banks would be measured may create significant complexity as well as new data-gathering requirements not just for the Fed, but also large banking organizations. If benchmarks and thresholds are well-designed, they could ensure transparency, comparability, and reasonably rating certainty; if not, then significant distortions would ensue.

The OCC's rule also does not give credit to the extent some think appropriate for deposit services such as offering low-cost transaction accounts or remittance services. The Board instead is proposing a retail-services subtest for CRA measurement that could include a prong specifically capturing these offerings. While adding complexity, this approach significantly broadens CRA's focus beyond traditional measures to capture

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2 See *Client Report* **CRA20**, April 3, 2018.

services many believe essential to safeguarding income and increasing wealth. This approach would also enhance recognition of innovative fintech products not directly tied to lending.

The OCC's final rule sought to address CRA challenges resulting from Internet-only banks with few if any physical locations by using a deposit-based assessment approach. The FRB is open to this, but notes the data challenges that in fact led the OCC to postpone finalizing this aspect of its rule in detail while data are gathered. The Fed fears for example that an ill-crafted deposit-taking assessment area could lead to undue CRA credit for certain areas – i.e., CRA "hot spots" – or overlook LMI communities because of undue data dispersion across a wide, but shallow, data field. The Fed is considering variations on the OCC's approach along with an alternative to deposit-based areas that are also or even solely lending-based.

Among the most significant revisions detailed in the ANPR is a revised approach to measuring community-development financial services. As with the retail test, these are in part intended to reflect new options and prior experience. For example, one longstanding criticism has been that the focus on investments for community-development purposes omits loans that might well prove advantageous for some development purposes. Another significant change would revise reliance on yearly snapshots to judge performance to reflect eligible loans and investments still held on the bank's balance sheet. As with the retail test, this increases CRA attention to actual capital at risk, not CRA-advantageous secondary-market or agent activities, perhaps creating a CRA disincentive for multifamily loan originations aimed at affordable housing sold to Fannie Mae and Freddie Mac.

What's Next

This ANPR was approved unanimously by the Board on September 21.[3] It is set for a 120-day comment period following *Federal Register* publication.

One of the Board's goals with this ANPR is to re-engage with the OCC and FDIC to craft a set of common inter-agency CRA standards. Although the Fed emphatically differed with several aspects of the OCC's final rule, there are also many common areas between it and the FRB's initial suggestions. The OCC's rule is effective on October 1 but does not require compliance for large banks until January 1 of 2023 or 2024 based on bank size. Thus, there is considerable time for compromise by the FRB, OCC, or both to reach a common standard before federally-chartered banks come under discrete CRA rules. The FDIC appears to have decided to consider its CRA standards once the Fed's advance.

Analysis

In addition to the many requests for views summarized below, questions posed by the Board include:

- the need to address other CRA-modernization objectives; and

[3] See *Client Report* **CRA29**, September 21, 2020.

- how best to address ongoing systemic inequity in minority credit access.

A. Assessment Areas

1. Framework

The Fed is considering revising definitions here to reflect many changes in bank service delivery and to retain CRA's relationship to fair-lending requirements. The Board thus proposes continuing to delineate assessment areas where banks have a physical presence and seeks feedback on options to tailor assessment areas around branches, loan production offices, and deposit-taking ATMs based on bank size, business model, and capacity. Assessment areas within a political subdivision would continue to be allowed as long as there is no evidence of redlining and whole census tracts are considered only by smaller banks. Both large and small banks would still be required to delineate assessment areas to include the geographies in which banks have their main office and branches, as well as the surrounding geographies in which the bank has originated or, in some cases, purchased a "substantial portion" of its loans. Assessment areas could not extend substantially beyond an MSA or beyond a state boundary unless the assessment area is located in a multi-state MSA.

However, the Board is also considering whether assessment areas should be expanded to include loan production offices evaluated based on bank business models, capacity, and constraints, as well as community needs. The Fed is also proposing to give banks the option of delineating facility-based assessment areas around deposit-taking ATMs, but they would not be required to do so unless, the Board suggests, the ATM is a significant deposit facility.

2. Large-Bank Assessment Areas

The Board is also exploring alternative deposit-based and lending-based ways to delineate additional assessment areas for large banks with extensive deposit-taking and lending activities not necessarily centered on facilities (e.g., via mobile-banking channels). This approach would likely govern only internet banks that do not have physical locations and banks that partner with online lenders that do not have physical lending locations and perhaps also to hybrid banks that have traditional branch-based assessment areas but also conduct a substantial majority of lending and deposit-taking beyond their traditional assessment areas. The Board notes numerous challenges to doing so and proposes various options if these might be resolved if the risk of CRA hot spots and those to LMI communities are resolved. Areas might be based on loan concentrations outside branch assessment areas or on other options which the Fed thinks may be more viable due to existing data sources (e.g., HMDA) but nonetheless fears could permit neglect of LMI communities. A detailed discussion of various Fed estimates of how these options would work is provided.

3. *Nationwide Assessment Areas*

The Fed is also considering whether to allow internet banks to delineate nationwide assessment areas based "holistically" on the bank's overall business activity. To do this, new performance tests and definitions would be required, with the Fed thus seeking comment on these and other questions related to any such approach.

4. *Request for Comment*

Questions on assessment areas also include:

- how best to ensure no illegal discrimination or LMI-community exclusion;
- clarification of the small-bank standard;
- the benefits of tailoring the facility-based option on bank size so that larger banks must generally serve entire continuous political subdivisions;
- the latitude proposed for LPOs and deposit-taking ATMs; and
- whether new deposit- or lending-based tests should apply only to banks with no physical presence or to other large banks.

B. New CRA Construct

1. *Framework*

The Board is proposing a revised CRA evaluation framework that would consist of two separate tests: a Retail Test and a Community Development Test. There would also be four subtests for retail lending, retail services, community development financing, and community development services. Small retail banks could choose to be evaluated only for retail lending; larger banks would come under all four subtests, with specific conclusions provided for each subtest in each bank assessment area. Size tests would be revised so that small banks (now those below $326 million) are those below $750 million or $1 billion, with no intermediate-size category so that all large banks are those above the small-bank ceiling. Small banks would also be evaluated only qualitatively, although they could opt into any of the metrics measures (see below). The Board is also considering whether small banks could opt into other subtests for qualitative evaluation likely to improve their scores.

The Board also proposes to tailor CRA rules for wholesale or limited-purpose banks; these would come under only the community-development subtest which would be done differently than for retail banks. As with all banks, they could choose to be evaluated under a qualitative strategic plan.

2. *Retail Subtests*

The ANPR includes extensive detail on each proposed subtest. Key retail-subtest issues include:

- the benefits of allowing large retail banks to opt into a retail services subtest;
- the details of each of the metrics-based approaches. The approach emphasizes service to LMI communities, small businesses, and small farms;
- credit for both originated and purchased loans;
- the need to calculate different types of loans separately from aggregates and/or to lump all loans in one category (e.g., home-purchase and refi loans) into a single category;
- using credit-reporting company data to avoid the need for new data-gathering and reporting requirements;
- the benefits of an online portal showing benchmarks against which a bank could measure itself;
- the way in which presumptions of satisfactory performance are set and the authority examiners would be granted to rebut them in cases of possible discrimination or other illegal credit practices. Presumptions in one test or assessment area would not bar an overall downgrade;
- qualitative criteria for variations from benchmarking (e.g., instances in which more loans would be risky), cases in which performance exceeds expectations for support to minority depository institutions, women-owned financial institutions, or low-income credit unions;
- a greater focus on the nature of deposit products in the retail services subtest the data necessary to do so;
- continuing attention to branch locations along with greater credit for other retail services. Extra credit would be granted for branches in banking deserts;
- credit for retail-product delivery services;
- percentages to determine significant mortgage, small-business, and small-farm lending and consumer-lending thresholds for large banks. The thresholds at which small loans are determined is also set out for comment, with the Board weighing whether just to increase current thresholds to reflect inflation (which would lead to large loan limits) or retain them as is to enhance the focus on truly small entities;
- how best to recognize non-securitized loans purchased from other lenders. The Board for example is considering CRA credit only for mortgages purchased directly from an originating lender or other ways to bar loan churning;
- consumer-loan evaluation standards; and
- ways to increase credit in Indian country.

Views are also sought on:

- making current rules the small-bank default option;
- the need to evaluate all large retail banks under all subtests;
- subtest metrics;
- the need for standard benchmarks;
- the risk that satisfactory presumptions could be set too low in communities under-served by all lenders;

- expanded services suitable for ratings above those set by benchmarks;
- the need for the very largest banks to provide a strategic statement ahead of CRA examinations detailing their business strategy for offerings aimed at LMI and under-served communities;
- how best to measure non-branch retail services;
- if banks should get credit for delivering services to LMI communities for branches in moderate- or upper-income communities;
- the need for large-bank statements on deposit-product offerings and the benefits of making public any such statements;
- how best to way to deliver services versus deposit products;
- a specific test related to deposit products (e.g., low-cost transaction accounts), remittance services;
- appropriate large-bank lending tests for each assessment area; and
- how best to judge consumer loans.

3. *Community Development Test*

This would apply only to large retail, wholesale, and limited-purpose banks. Each of the subtests discussed below would be evaluated in each assessment area.

a. Community Development Financing Services Subtest

This would be a quantitative assessment of community development financing activities using both a "community development financing metric" and qualitative "responsiveness and impact" criteria to capture meaningful small-dollar activities. For retail banks, the metric would measure the ratio of the dollar amount of a retail bank's qualifying community development financing activities to its deposits within each assessment area along with those in areas in which a bank is covered by an assessment area. Assessment would be based on new financing services as well as those held on balance sheet to encourage "patient" capital regardless of whether provided as loans or investments.

The request for feedback includes:

- combining loans and investments in a single subtest;
- measurement metrics; and
- whether the Board should develop "impact scores" to judge qualitative performance.

An array of options is under consideration for wholesale and limited-purpose banks including using assets in the denominator or assessing only qualifying loans and investments without reference to deposits or assets. Comment is sought on these alternatives as well as on using a "financial capacity" test.

The Fed could also create one local and one national benchmark for each assessment area by which to compare performance under this subtest along with thresholds against which performance judged by these benchmarks would be judged. Questions on how to do so and what data are needed are also posed. Once benchmarks are set, banks would be judged based on thresholds within these benchmarks. These thresholds are at least as analytically challenging as the benchmarks, and many questions on each is thus posed.

b. Community Development Services Subtest

Community development services now generally include activities such as service on boards of directors for community development organizations or on loan committees for CDFIs, financial literacy activities targeting LMI individuals, and technical assistance for small businesses. The ANPR suggests expanding these to include volunteer service, community participation in development counting volunteer activities with a broadly-defined community-development focus in rural areas, and financial literacy and without regard to income level. Community development could also be expanded to encompass arrangements with CDFIs, minority depository institutions, low-income credit unions, and women-owned banks along with an illustrative list of eligible activities that give minority- and women-owned banks certain CRA privileges. A process for crediting activities in a surrounding state or region outside an assessment area is also outlined along with a pre-clearance process. Issues on which comment is sought include:

- how to treat affordable housing benefiting from a wide array of relevant subsidies as well as targeted housing that does not benefit from a government subsidy without encouraging gentrification. A new approach to pro-rata credit for mixed-income communities is also under consideration;
- the benefits of including housing with renewable energy, that is close to transit or that meets other social-policy objectives;
- how to address multi-family MBS;
- how best to define community services to expand CRA's reach and maintain its LMI focus. Expanding programs to cover the disabled and certain students is also possible;
- an expanded approach to economic development. New and higher thresholds for defining small-business and small-farm eligibility are also laid out;
- whether engagement with minority depository institutions and others cited in the ANPR should be necessary to earn an "outstanding" rating; and
- if recognition of out-of-area activities effectively addresses banking "deserts" and if, to do so, "designated areas of need" should be identified by the Board for CRA credit outside a branch assessment area.

This criterion would be primarily a qualitative subtest, but the Fed is also seeking comment on quantitative metrics (e.g., number of hours spent or persons served). An impact score might also be deployed.

C. Strategic Plans

Banks may now file strategic plans and seek public comment on them instead of coming under all the CRA requirements but very, very few companies have done so and most of those that have are non-traditional charters. The Board is considering several procedural improvements to strategic planning along with:

- greater assessment-area flexibility and measurement metrics;
- more plan-goal flexibility; and
- streamlined approval based on electronic templates.

Questions are posed on all of these options.

D. Ratings

The revised ratings schedule would be based on local-community performance judged by a weighted average of assessment areas without any consideration of full- or limited-scope areas. The same ratings would be used for banks of all sizes although large banks also come under the revised community-development activities standards outside branch-specific assessment areas. Ratings weight applied to each assessment area would average the percentage of a bank's deposits from that assessment area and the percentage of dollars of loans in that assessment area. Qualitative examiner judgments would grant rating enhancements.

Fair lending and illegal credit practices would remain factors in all ratings, but the Fed is considering expressly adding to them violations of various laws governing service members and UDAP. Small banks could remain under the current framework.

Questions here cover matters such as:

- whether this ratings construct is sufficiently transparent;
- how best to rate outside-area activities;
- what additional illegal activities should be sanctioned in CRA ratings.

E. Data Collection and Reporting

Reflecting all the changes above, the Board notes the need for extensive changes on these criteria, seeking comment on most of them focused in particular on the extent to which greater precision and comparability sufficiently offset additional regulatory burden.

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