Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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On Tuesday, the banking agencies will release the final version of their 679-page proposal to rewrite the Community Reinvestment Act. Regrettably, much of the proposal reflected the worst of false-science staff seeking complex new models defining subjective goals combined with certainty-loving compliance officers and lawyers who just want to be told the number they need to hit, not if the number makes any sense. Unsurprisingly, there were hundreds of comment letters in which banks generally said the agencies should ease up and community groups urged still more stringent standards. But the story doesn't end with this unremarkable line-up– in just the last few months, two major bank trade associations and one often-virulently anti-bank advocacy group agreed on one crucial thing: anything close to what the agencies proposed won't work.

There are of course sharp differences between what banks and public advocates want in a new CRA rule, but what unites them is the over-arching understanding that the new approach is a cumbersome exercise remote from the reality confronting both banks and borrowers in the least-served urban and rural communities. Banks complain – often with good reason as I showed in my book on economic inequality – that risk-based capital rules over-estimate the risk of lending to many community-focused borrowers. The new capital proposals would ameliorate some of this in their "enhanced" risk weightings, but these weightings actually don't count for much of anything since the proposed "higher-of" standards applies current, higher weightings.

The agencies in fact acknowledge as much when it comes to low-and-moderate-income mortgage borrowers, but fixing the rules only for these important customers will still lead small business, retail customers, and much else ill-served. So, the banking trades are right: finalizing new CRA standards without understanding the capital-driven business reality that governs them will do little for anyone but the aforementioned weed-dwellers. They'll have lots more to oversee even though communities won't get more with which to counter structural inequality.

And, the advocacy group Better Markets is also right when it comes to one of its most fundamental points: the 1977 Act was intended to end redlining, i.e., refusing to lend to certain communities no matter how much funding the bank extracts from them. As its letter goes on to say, the more the rule focuses on redlining, the simpler, more effective, and accountable it would prove.

Redlining in essence is failing to lend to or invest in ways that properly represent the demographic and economic composition of a community – in short, refusing to do business with customers not because they are unprofitable, but because discriminatory action or inaction deems them undesirable.

Another on-point Better Markets argument backing up its simplicity suggestions is the fact that redlining as we have come to define it also occurs if a bank does business with consumers in ways that put consumers at more risk than more sophisticated or profitable consumers via predatory

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lending, abusive fees, or other pricing decisions taking advantage of vulnerable or even desperate customers. As the letter says, CRA penalties should add to all the other ones directed at these violations to ensure that community well-being is not dependent only on effective anti-discrimination and consumer-protection enforcement – it's not just how much banks lend – it's also how banks lend.

However, neither the banking trade associations nor community advocates raise a still more fundamental problem with the complex new CRA construct: the 1977 rationale no longer applies to banking as it has become. Cramming ever more complex standards into contortions designed to achieve the law's worthy objective almost fifty years later is a doomed exercise that does nothing for needy communities.

The Community Reinvestment Act of 1977 is founded on Congress's then-correct conclusion that banking charters are a public gift that requires companies which receive them to return the favor and serve the public good. This public-gift rationale also underpins the corpus of bank regulation, supervision, and resolution standards.

And, it's not wrong on its face. Banks have access to the discount window, other Fed facilities, FDIC insurance, the payment system, and other benefits that warrant not just all these safeguards, but also the additional duty of serving customers whose need is great even though their profit is scant. This made a lot of sense in 1977 when banks received manifold public gifts in monopoly markets.

But it makes much, much less sense now when MMFs have trillions of Fed backing, nonbanks have access to the payment system and FDIC insurance, and Fed backstops prop up finance as a whole, not just regulated banks. CRA standards that turn banks of all sizes into public utilities will be one more costly reason regulated banks are pushed to the perimeter of sound, equitable, and sustainable financial services essential to ending redlining in the broad sense in which it is best understood.

Yes, the biggest banks just notched record earnings, but most still barely earn more than their cost of capital and many have market capitalization well below book value. Money is increasingly being made by servicing nonbanks with the infrastructure banks have built, not the privileges they once exclusively enjoyed. And, while big banks may swim in the money, regional and smaller banks are struggling under the burden of rising rates, low-return portfolios, and customers willing and able to head to nonbanks such as MMFs that enjoy privileges akin to those that once distinguished banks and warranted CRA's public-good mandate.

It seems all too likely that the final CRA rule will not reflect the banking industry's new business climate, Better Market's focus on targeted standards with stiff and credible enforcement, or the broader transformation of U.S. banking into a business that shares its public gifts with many competitors exempt from any mandate also to do the public good. Hundreds of pages of new CRA rules are thus unlikely to do better for vulnerable communities than the hundreds of pages they replace that failed to make a material difference in credit availability for under-served communities.