AMERICAN BANKER

BankThink Overhaul CRA? Why not eliminate it?

Diego Zuluaga

December 3, 2018

Sen. Bill Proxmire was no spendthrift. The long-serving Wisconsin lawmaker, who replaced Joe McCarthy and remained in office until 1989, was notorious for taking no campaign donations, refusing reimbursement for business travel and voting against pork-barrel projects in his own state.

Yet the 1977 Community Reinvestment Act, Proxmire's signature legislative achievement, is no example of efficiency. More than 40 years after its passage, policymakers confront a much-changed U.S. banking landscape — one with which CRA is increasingly incompatible.

CRA mandates that most depository institutions serve the credit needs of the communities where they take deposits. Who could oppose such a mandate? After all, it is undeniable that banks exist to serve their customers. If they did not add value, their costs would exceed their revenues and they would eventually go out of business. So, as CRA intends, banks must serve their communities.

But Proxmire's CRA has gone much further than that.

For 41 years, it has instructed bank regulators — the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corp. — to assess banks on their CRA performance. How to measure whether banks are serving their communities was never clear, however, and it has evolved over time. CRA ratings initially focused on banks' efforts to bring credit to the places where they took deposits. From the 1990s onwards, assessments have targeted results — that is, how much lenders actually do in the places where they have offices, branches and ATMs.

CRA focuses on loans to "low- and moderate-income" communities. The aim is to encourage credit extension to the less well-off and minorities, communities historically underserved by the financial system.

How do regulators encourage such lending? CRA does not provide for sanctions, fines or charter withdrawals in the event of underperformance. But it does empower regulators to block bank expansions, including new offices and, critically, mergers. Because CRA ratings are public, activist groups can use them to extract lending commitments from depository institutions, often using heavy-handed tactics. This quid pro quo between banks and community groups was the norm in the run-up to the financial crisis. Between 1992 and 2007, banks committed $4.6 trillion in CRA loans.

Did CRA contribute to the 2008 crash? That is a matter of dispute, though activists did flaunt their ability to extract lenient loan terms, including low down payments and interest-only mortgages, from eager banks during the boom times. At a minimum, CRA loans provided an

enthusiastic, and ultimately misguided, drive for more housing loans with the useful cover of "community investment."

Now the OCC is reviewing the 41-year-old statute. That is a laudable effort, as U.S. banking has changed beyond recognition since 1977. Where tiny unit banks used to be the norm, mainly due to government bans on branching, large and diversified institutions have taken up a growing share of deposits and assets. At last count, the FDIC regulated 4,918 banks, down from more than 14,000 in the 1980s. In addition, marketplace and online lenders, which do not take deposits, account for a growing portion of the market. A recent study found that 60% of their growth resulted from greater regulation of banks, while technological innovation accounted for another 30%.

CRA may have made sense in a world of limited bank competition, where redlining of poor and minority communities was a well-documented phenomenon. But more recently, CRA lending has come into conflict with financial stability, with studies showing that banks extended riskier loans in advance of CRA assessments, presumably to impress their regulator. CRA-timed risk-taking compromised bank soundness and may in some cases have left taxpayers exposed.

How can CRA's goals best be achieved in the 21st century? Anti-discrimination laws, such as the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act, can better tackle the unfair or abusive treatment of vulnerable groups. While these statutes impose compliance costs of their own, they are better targeted than CRA as they consider evidence case by case and carry penalties for violators.

Moreover, whether banks could lend more to low-income areas without taking undue risks is debatable. The financial crisis illustrated that, for many vulnerable households, the problem was not so much a dearth of mortgage credit as its all-too-easy availability. The result was millions of foreclosures when house prices began to decline. Thus, the very philosophy that underpins CRA may be inappropriate four decades after its passage, making congressional repeal of the act the best path forward.

Even if CRA remains in place, there are more efficient ways for banks to discharge their statutory obligations. One would be a market for CRA loans, whereby banks could sell their obligations to lenders better placed to serve vulnerable communities. In addition to promoting competition and innovation in CRA delivery, this system has the attractive feature of showing the cost to society of foregoing other lending opportunities.

The purpose of the Community Reinvestment Act was to bring the opportunities of U.S. credit markets to all households. As policymakers review the act, they must ensure that regulation serves the present and future needs of depositors and taxpayers. Clinging to an outdated picture of U.S. banking will neither aid innovation nor safeguard bank balance sheets.

Diego Zuluaga is a policy analyst at the Cato Institute's Center for Monetary and Financial Alternatives.