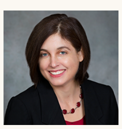
Bank Director

LOGIN

04/10/2024

A CRA OVERHAUL SHAKES THE INDUSTRY

Regulators finalized a much-needed modernization of the Community Reinvestment Act, only to be met with resistance and confusion.



NAOMI SNYDER

EDITOR-IN-CHIEF

SHARE THIS ARTICLE

Green Dot Bank. Morgan Stanley Bank. SoFi Bank. They're all based in Utah, a bank-friendly place to do business. **But the Community Reinvestment Act is designed to ensure they serve low- and moderate-income neighborhoods near their physical locations.** That's a bit odd, since those banks have almost no branches and are mostly nationwide.

Until now, regulators hadn't made significant changes to the CRA's rules since 1995, despite the rise of branchless banks and mobile and internet banking in the decades since. Almost everyone — financial institutions, lawmakers, community groups — agree the CRA needed modernization. Unfortunately, that's where the agreement ends.

After years of wrangling and disagreement over what the anti-redlining rule should look like, the federal banking agencies came together and published a final rule last fall, only to have local and national industry associations such as the American Bankers Association and Independent Community Bankers of America file a lawsuit against it. The 1,480-page final rule completely rewrites the CRA manual for banks and thrifts above $2 billion in assets, sparking confusion around a law that's deeply ingrained in banking's DNA. Although the law hadn't aged well, some horrified onlookers haven't rejoiced at its facelift, either.

Critics say the overhaul is overly complex and burdensome, and could harm low-income communities. **"The final rule is the most complicated and convoluted regulation in the history of American banking,"** says Kenneth Thomas, CEO of Community Development Fund Advisors, which manages a CRA fund where banks can invest. "CRA only needed a tune-up. It did not need a total overhaul."

Advocates and the industry's primary regulators — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp. and the Federal Reserve — say the rule will adapt to changes in the banking industry, address inequities in access to credit and provide greater clarity to help banks achieve higher CRA ratings. "For most banks, this is going to result in a better landscape for them to invest that will help a lot of communities," says David Dworkin, the CEO of the National Housing Conference, a coalition of affordable housing nonprofits and lenders.

Banks Lend Billions to Underserved Communities

A lot of the fuss over the rule is a result of its importance: There's a lot of money involved, and the stakes are high for community activists, fair-housing advocates and banks. According to the associations' lawsuit, banks in 2022 provided $227 billion in capital to low- and moderate-income communities in the form of mortgages and small business loans, and an additional $151 billion in community development loans.

Prudential regulators publish CRA ratings such as "outstanding" or "needs improvement," based on each bank's lending and community development activities in their geographic communities. The ratings help tip the scale in favor of affordable housing and low-income neighborhoods when banks would make a better risk-adjusted return serving wealthier neighborhoods and bigger businesses, Dworkin says.

Failing to achieve a satisfactory or outstanding rating on a CRA exam comes with consequences. **Regulators can deny strategic opportunities such as new branches and acquisitions.** "You can't do anything," Thomas says."Plus, you get the reputational risk of being branded a failing CRA bank, which means you're not meeting your community's needs."

Banks and thrifts must comply with most of the provisions such as data collection and new tests by Jan. 1, 2026. By most accounts, banks will need the time. "That's within a three-year planning horizon, and we've got to address it," says Don Musso, CEO of the consulting firm FinPro.

A New Series of Tests

Regulators did attempt to reduce the compliance burden on the smallest institutions. Banks below $600 million in assets can opt to stay with the old rule's assessment areas and standards, although they will have to understand the rule's impact and prepare if they plan to go over that asset mark in the next few years. Regulators will evaluate what they term intermediate banks from $600 million to $2 billion based on a retail lending test and either the current community development test or, at the bank's option, a new community development financing test.

Banks above $2 billion in assets are characterized as large per the CRA, and they will have the greatest number of assessment areas. Regulators will use four performance tests to evaluate those banks: **the retail lending test, the retail services and products test, the community development financing test and the community development services test.**

Under the retail lending test, regulators will continue to evaluate a large bank based on its facility-based assessment areas but instead of carving out partial counties, an institution will have to designate whole counties, metropolitan divisions or metropolitan statistical areas. In addition, unless a large bank conducts more than 80% of its lending in its facility-based assessment area, the institution will be subject to another retail test as well. The bank will have to create new retail lending assessment areas for each location where it did at least 150 closed-end home mortgage loans or at least 400 small business loans in each of the prior two calendar years.

Regulators will use the retail lending test to evaluate a bank according to how well it serves low-and moderate-income individuals, small businesses, small farms and low-and moderate-income census tracts, and the bank will get credit for community development activities nationwide. The agencies also increased the size of a small business and a small farm from the prior rules, which capped revenue at $1 million, to $5 million in gross annual revenue or less.

In addition, regulators will evaluate banks above $10 billion in assets based on branch availability, services and digital delivery systems. The regulation also introduces a metric for banks above $10 billion to assess their community development investments relative to deposits. **The point is to encourage investments such as the federal low-income housing tax credit and the new market tax credit, according to the final rule.**

Aside from potentially creating new assessment areas for banks that lend outside a facility- or branch-based geographic area, the rule adds several ways to grade banks that hadn't been done before. For example, the final rule says banks above $2 billion will have their deposit products evaluated under a new retail services and products test with a more explicit focus on financial inclusion. The rule states this will count only as a positive toward a rating for a bank, not a negative. That includes an evaluation of how deposit products impact low- and moderate-income households, such as whether the bank offers an account with no overdraft or nonsufficient funds fees.

The final rule also introduces new peer benchmarks for $2 billion-plus banks, looking at both a bank's branch network and loan originations against its peers in retail assessment areas. Banks will have to talk to their regulators and study forthcoming regulator FAQs to answer questions and get peer group data.

The Longest Rulemaking Ever

FDIC Vice Chairman Travis Hill, who voted against the rule, objected in part to its length, calling it "by far the longest rulemaking the FDIC has ever issued."

Thomas of Community Development Fund Advisors says the update is so complex that complying will require banks to employ plenty of outside expertise. "The consultants love it," he says. "The lawyers love it, because this is going to put a lot of their kids through college. But the point is, is this what we need for CRA?"

Costs of compliance are hard to pin down, and they will vary by bank. Wes Burns, executive vice president of community and economic development at St. Louis-based Midwest BankCentre, is one of those bankers figuring out how the new rules apply. "It's early," he says. "With 1,500 pages, there's meaningful data on every one of those pages." He anticipates the $2.8 billion bank will have to hire more full-time personnel to comply and will use outside advisors to help, but he doesn't know how many that will be and at what cost.

Based on a survey of their members, the banking associations' lawsuit says the industry-wide cost of compliance would exceed $600 million in the first year. It's a figure the groups say isn't justified in a cost-benefit analysis, which they accuse the agencies of failing to do adequately. "The agencies do not attempt to quantify any purported increase in credit or lending to low- and moderate-income borrowers that is expected to result from their promulgation," the lawsuit says. "Not only must banks develop and test new computer programs and data collection capabilities, but they must also conduct program planning and analyses, upgrade vendor relationships, hire more compliance personnel and conduct extensive staff training."

The lawsuit states further that **"some banks will seek to minimize the direct costs caused by the Final Rules by curtailing lending to avoid triggering new assessment areas."** Others will be forced to scuttle plans to expand for fear of additional CRA assessment areas, potentially reducing investments in low- and moderate-income neighborhoods. Federal Reserve Governor Michelle Bowman and the FDIC's Hill also expressed concern in statements that banks would avoid lending in new areas to bypass additional scrutiny.

A More Transparent CRA

However, not all bankers think they'll have to cut back on lending. Midwest BankCentre's Burns doesn't think it likely that the new rule would force the bank to reduce lending outside its footprint. Most of its lending is inside the St. Louis region. He thinks the agencies have been transparent about the rulemaking and have given banks more than two years to implement it. **"This touches all corners of banking," he says. "There is no negative lens that we look at CRA through."**

For John Geiringer, a partner at the law firm Barack Ferrazzano Kirschbaum & Nagelberg, regulators have made some of their expectations clearer than under the legacy CRA rule. "The key that I keep hearing from clients about any new rule is if there are bright line tests, if there are clear expectations, if the rules of the road are understandable, banks will follow it," he says.

Dworkin of the National Housing Conference compares navigating the previous CRA rule to playing a Super Bowl with players who don't know the rules. **In the past, no bank was quite sure how a certain investment or loan would be credited for CRA ratings.** "[Regulators] believed that if you kept a rule opaque, banks would strive to do more than was required in order to ensure they made it," Dworkin says. "And what they didn't understand is that within every bank, there are silos that compete against each other for allocations of capital. And the actual impact of having an opaque rule was that the people making the investments we want to see made were undercut when arguing for their projects."

Dworkin also thinks the new rule encourages more lending in underserved areas. For example, branchless banks tend to locate in a single geography such as Utah or Delaware that is bank-friendly, which means their CRA investments are heavily concentrated in those areas. Meanwhile, some rural or indigenous areas struggled to get any loans or investment at all. Lael Brainard, the then-Federal Reserve Governor who took the lead on developing the new CRA rule for the Fed, visited the Pine Ridge Reservation in South Dakota several years ago and found no banks had been part of a major redevelopment project there. **Only one bank considered the Oglala Lakota reservation as part of its CRA geographic assessment area.**

The new rule also allows banks to get credit for investments in minority depository institutions and community development financial institutions. "I think that the net impact of this new regulation is that banks will be better able to understand their compliance requirements, and communities will see more investment where there hasn't been as much in the past," Dworkin says.

The updated CRA also goes a step further in transparency, requiring prudential agencies to publish a large bank's mortgage loan distribution by income, race and ethnicity in each of its assessment areas. Those distributions will be derived from data that banks already collect under the Home Mortgage Disclosure Act.

Fair Lending Concerns

The data requirements have raised concerns that regulators may be pulling from a variety of sources to scrutinize banks for fair lending violations. Although the CRA is a different law than the those that forbid discrimination against borrowers based on race, ethnicity or sex — and in fact, **the CRA says**

nothing about race or sex — the laws often go hand in hand. For example, regulators can downgrade a bank's CRA rating when bringing a fair lending enforcement action against a bank, according to Alston & Bird Partner Cliff Stanford.

Jonice Gray, chair of the consumer financial services practice at the law firm Paul Hastings, says regulators focused on fair lending compliance start by looking at a bank's mortgage data and decide if they need to probe further, peeling back the layers as if the data were an onion. "Do you have statistically significant disparities in penetration in these markets against your peers?" she says. "Who are you marketing to? Where is the marketing going? Who's on the marketing collateral? Only white people? Are there minorities? Are women represented?"

Regulators have been particularly focused on investigating banks for violations of laws prohibiting discrimination. "Right now in fair lending there is an unprecedented amount of attention on redlining in particular," she says.

And new rules promise to increase the amount of data regulators are collecting. "They provide a lot more opportunity for institutions to be scrutinized," she says. For instance, the Consumer Financial Protection Bureau finalized a rule last year that requires most small business lenders, including credit unions and fintechs, to start reporting small business borrower demographics including race, sex, ethnicity, geographic location, credit pricing and the outcome of small business loan applications, similar to the data banks already report for home mortgage loans. **The so-called 1071 rule is named after its position inside the Dodd-Frank Act of 2010.** [*Bank Director* magazine described that rule in detail in its fourth quarter 2023 issue.]

Regulators did have the 1071 rule in mind when they finalized the CRA rule. In fact, the final CRA rule explicitly states that the agencies expect to analyze banks for CRA purposes based on data coming from the 1071 rule.

The 1071 rule goes into effect in October of this year for lenders who originated at least 2,500 small business loans in each of the prior two years, with smaller institutions complying in later years. But a federal judge in the Eastern District of Kentucky granted a motion late last year to delay the rule pending the outcome of another lawsuit challenging the CFPB's funding.

A Court Battle Against Regulations Heats Up

That's part of multiple challenges coming from trade associations trying to leverage President Donald Trump's appointees on the bench to defang federal banking regulators.

The trade associations also are picking favorable court jurisdictions, says Gray. For example, the trades filed their CRA challenge in the Northern District of Texas in Amarillo, where appeals go to the Fifth Circuit. **"This is a very favorable jurisdiction to more broadly litigate issues that relate to potential agency overreach," she says.** "We're already seeing an unprecedented number of challenges. And I think that's due in part to where we're situated with respect to regulatory agendas, but also where we're situated with respect to the composition of the judiciary."

The ICBA declined to comment on its court case, and the ABA didn't return a request for comment. All three federal prudential banking agencies also declined to comment for this article.

Despite the legal challenges, many senior bank executives and directors aren't too concerned about the CRA. In Bank Director's 2024 Risk Survey, **49% think the CRA update would make it slightly harder to comply, and 35% expect no effect.** "Banks are used to the notion of reaching out to the underbanked and the unbanked and connecting with low- and moderate-income areas," Geiringer says. "It's already in their DNA."

Still, Stanford says at the end of the day, every bank and its CRA officer will need to understand the rule in detail. "It is an extremely long and really quite complicated rule," he says. Banks will have to project how the rules could impact them a few years down the road, and the rule can be more complex based on size and business model. Geiringer says boards should establish a tone of compliance from the top. “I think part of it is also engaging with your regulators every step of the way and having good transparent discussions with them about how you intend to comport with the rule to get their feedback.”

And if banks fail to prepare for the new rules, they might see the consequences from a below-satisfactory rating. Based on changes to the retail lending test alone, nearly 10% of banks would be rated “needs to improve” based on 2018-2020 data, compared to 1% under the prior regulation, according to Fed Governor Bowman, who voted against the rule.

Gray suggests getting prepared for another reason. If a bank figures out how it will perform on a CRA exam before the regulators do, bank leaders can figure out why and do something about it if necessary. **She suggests banks “lean into the story” of what their data says, rather than “waiting to get whacked.”**

NAOMI SNYDER

EDITOR-IN-CHIEF

Editor-in-Chief Naomi Snyder is in charge of the editorial coverage at Bank Director. She oversees the magazine and the editorial team’s efforts on the Bank Director website, newsletter and special projects. She has more than two decades of experience in business journalism and spent 15 years as a newspaper reporter. She has a master’s degree in journalism from the University of Illinois and a bachelor’s degree from the University of Michigan.

SHARE THIS ARTICLE