The Levy Economics Institute of Bard College

LEVY INSTITUTE

Public Policy Brief

HIGHLIGHTS

No. 68A, 2002

OPTIMAL CRA REFORM

Balancing Government Regulation and Market Forces

KENNETH H. THOMAS

The Community Reinvestment Act of 1977 (CRA) is proof that capitalism can have a corporate conscience without degrading into socialism or gambling on the other extreme of completely unregulated markets. CRA is arguably a perfect example of the correct balance between government and market regulation in a capitalist economy. Too much regulation is as bad as too much deregulation, as seen in the savings and loan crisis and, more recently, Enron. Somewhere between regulated and unregulated markets is the ideal point, or "fair" market representing the optimum balance between consumer and industry interests. This brief presents the first comprehensive analysis of public comments on the proposed reforms and concludes with specific recommendations that will lead to optimal CRA reform.

There are many reasons why CRA is an example of a fair market regulation. By providing credit access to all, the law gives everyone an equal chance at (but no guarantee they will get) their share of the American Dream. It is needs-, not race-based, with the focus on the most needy low- and moderate-income (LMI) groups, representing 40 percent of the U.S. population. It does not require banks to make bad loans or lose money. Although the law requires banks to pay a reasonable compliance cost, there is little to no cost to taxpayers, who get something in return for federal subsidies to the banking industry. The law has more bark than bite in terms of actual enforcement and is therefore not overly intrusive to business. Finally, the CRA relies more on the positive power of disclosure in the market than on regulatory brute force. It is reformed periodically so that it remains responsive to both consumer and industry interests.

The rules and regulations implementing CRA as developed, applied, and enforced by the federal bank and thrift regulators are being

The full text of this paper is published as Levy Institute Public Policy Brief No. 68, available at www.levy.org.

ISSN 1094-5229 ISBN 1-931493-12-X

reformed this year as part of a mandatory review of this law. Their last major reform, in 1995, resulted in what was called the "new CRA," and banks and thrifts have operated under those rules and regulations since that time. While most of the last reform effort was successful in terms of expanding access to credit for LMI people and areas, much remains to be done to make this good regulation even better. CRA's success has been in its simplicity, something somewhat forgotten during the 1993–95 reform process, which created separate investment and service tests that effectively diluted the key lending test by 50 percent. Good public policy in CRA must be refocused on LMI lending, the purpose of the 1977 law.

The revisions now being drafted by the regulators are based on their review of approximately 400 public comments received in October 2001; the revisions should be released sometime during the second half of 2002. The future of CRA depends upon the direction of these reforms. To create optimal public policy, bank and thrift regulators, under the direction and influence of Congress and the Bush Administration, must reach the ideal balance between competing consumer and industry interests.

The banking industry's priority on CRA reform varies by institution size, as small and large retail banks are evaluated under different standards. Many big banks are rightfully asking that the law be returned to its LMI lending roots by abolishing the investment and, to a lesser extent, the service test, or at least making them optional as is currently the case for small banks. Small banks want to increase the current $250 million cutoff size for a streamlined exam, which now covers about 80 percent of all banks and thrifts. A reasonable approach is to double the cutoff to $500 million, which would include 90 percent of the industry, and free up some $50 million in CRA regulatory costs that could be reinvested in the community.

Community groups in general would like to keep everything in the existing CRA regulations but expand both the enforcement and scope of the law. They are correct in asking for a fix to the rampant grade inflation problem and an expansion of CRA at least to credit unions, as the proportion of home purchase loans made by CRA-covered institutions continues to fall. Their attempts to hold on to the nonlending tests are not only unrealistic but also somewhat self-serving, as some groups have financial incentives to maintain the investment test (e.g., bank contributions to them count as qualified CRA investments). Community groups are also flat-out wrong to ask that CRA be made race-based,something that could jeopardize the future of this needs-based law.

Following is a summary of the most important optimal reform recommendations proposed in this brief, organized by type of CRA exam:

1. Large Retail Bank Exam: Eliminate separate investment and service tests and incorporate into an expanded lending test, which results in a streamlined large-bank exam with one rather than three tests (a 67 percent reduction); 10 rather than 15 performance criteria (a 33 percent reduction); one rather than three performance ratings matrices (a 67 percent reduction); and 50 rather than 70 individual rating matrix cells (a 29 percent reduction).
2. Small Retail Bank Exam: Double small bank cutoff from $250 to $500 million.
3. Community Development Exam: Allow credit for all LMI-related community development activities outside of assessment area, as long as LMI credit needs within it have been met.
4. Strategic Plan: Eliminate this option since only 0.1 percent of the industry has adopted it.

Irrespective of the type of exam, it is imperative that the CRA return to its original focus on LMI lending. Optimal reform also hinges on reduction of grade inflation through a joint regulatory compliance function; on expansion of CRA to, at the least, credit unions; the addition of a fifth "good" or High Satisfactory rating; a return to more frequent, tiered exam schedules based on the institution's last CRA rating; mandatory rather than optional CRA treatment of affiliates; the use of specialized compliance examiners and exams; improvement of the quality and amount of disclosure in public performance evaluations; a requirement that both acquirer and acquiree in bank mergers have passing CRA ratings; and provision of reduced credit for purchased (as opposed to originated) loans and for purchased mortgage-backed securities.

It is more important than ever that the public policy deliberation on CRA reform be conducted with a full view of the potential conflict and constraints associated with community groups, the regulators,and the banking industry. Many of these issues did not apply at the time of the last reform process, but they are most relevant today. It is respectfully suggested that the reform recommendations in this brief,

especially those identified above, are optimal in the sense that they represent an objective, balanced perspective of both community and industry interests with full recognition of all relevant conflicts and constraints.

References

Association of Community Organizations for Reform Now (ACORN). 2000. "Minority and Low Income Homeowners More Likely to Receive High Interest Mortgages." Press release for Separate and Unequal: Predatory Lending in America. November 2.

Blackwell, Rob, and Rob Garver. 2002. "OTS Likes One-Exam Model, Cuts Examiners." American Banker, April 2:1.

Federal Deposit Insurance Corporation. 2002. "Reducing Burden on Banks and the Public." Financial Institutions Letter 36-2002, April 24.

Federal Reserve Bank of San Francisco. 2002. "A Guide to Community Development Investments." Community Investments, March.

Gamboa, John, and John Taylor. 2001. "CRA Element Should Be Part of Any Insurance Bailout." American Banker, October 4: 7.

Garver, Rob. 2002. "Gilleran Explains OTS Cutbacks." American Banker, April 12:1.

Gramlich, Edward. 2000. "Subprime vs. Predatory Lending." National Mortgage News, May 1: 4.

Greenspan, Alan. 1999. Comments at Conference on Business Access to Capital and Credit. Federal Reserve System, Arlington, Virginia. March 9.

Haag, Susan White. 2000. Community Reinvestment and Cities: A Literature Review of CRA's Impact and Future. Washington, D.C.: The Brookings Institution, Center on Urban and Metropolitan Policy.

Hall, John, and Timothy Yeager. 2002. "Community Ties." The Regional Economist, April.

Heller, Michelle. 2002. "LaFalce Rips OTS Exam Plan as 'A Complete Abrogation.'" American Banker, April 4:1.

———. 2000. "Tanoue: Consider Dropping Investment from CRA Exam." American Banker, June 20: 6.

Kellner, Tomas. 2001. "Insider Enrichment Act." Forbes, December 10: 113

Litan, Robert E., Nicholas P. Retsinas, et al. 2000. The Community Reinvestment Act after Financial Modernization: A Baseline Report. Washington, D.C.: U.S. Department of the Treasury. April.

Mandaro, Laura. 2001. "Wamu Primed for More Subprime." American Banker, August 20:1.

Metzger, J. 1999. Social Capitalism in American Cities: Financial Institutions and Community Development. Dissertation, Columbia University.

Muñoz, Carlos Jr. 2000. "California Is Now a Majority Minority State: Politics Must Change with Demography." The Progressive Media Project, www.progressive.org website, September 28.

National Community Reinvestment Coalition. 2002. "CRA Modernization Bill Update." Reinvestment Works. Spring: 4.

———. 2000. Testimony before House Committee on Banking and Financial Services, Washington, D.C. May 24.

Office of Inspector General, Office of the Comptroller of the Currency, U.S. Department of the Treasury. 1998. The Office of the Comptroller of the Currency Needs to Improve Its Implementation of the Community Reinvestment Act Small Bank Performance Standards. May 28.

Office of Inspector General, Office of Thrift Supervision, U.S. Department of the Treasury. 2001. Office of Thrift Supervision's Community Reinvestment Act Performance Evaluations. OIG-02-026. December 21.

"Proposed Rules." 2001. Federal Register, July 19: 37602–08.

Schmitt, Eric. 2001. "Whites in Minority in Largest Cities, the Census Shows." New York Times, April 30:1.

Thomas, Kenneth. 2002a. "CRA's 25th Anniversary: The Past, Present, and Future." Working Paper No. 346. Annandale-on-Hudson, N.Y.: The Levy Economics Institute.

———. 2002b. Letter to the Editor on "Reforming Reinvestment." Forbes, January 7.

———. 2001a. "CRA Policy Must Not Consider Just Activist's View." American Banker, February 9:12.

———. 2001b. "Subprime Industry Needs Single Voice to Help Defend Its Image." American Banker, March 30: 18.

———. 1998. The CRA Handbook. New York: McGraw-Hill.

———. 1994. "Public Good Takes a Back Seat in Superregulator Debate." American Banker, March 8: 20.

———. 1993. Community Reinvestment Performance. Chicago: Probus Publishing.

The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System. 2002. Cambridge, Mass.: Joint Center for Housing Studies, Harvard University.

U.S. Department of Housing and Urban Development and U.S. Department of the Treasury. 2000. Curbing Predatory Home Mortgage Lending: A Joint Report. June.

U.S. General Accounting Office. 1995. Community Reinvestment Act: Challenges Remain to Successfully Implement CRA. GAO/GGD-96-23. November.

Whalen, Gary. 2001. "The Impact of the Growth of Large, Multistate Banking Organizations on Community Bank Profitability." Economic and Policy Analysis Working Paper No. 2001-5. Washington, D.C.: Office of the Comptroller of the Currency. December.

About the Author

Kenneth H. Thomas is a lecturer in finance at the Wharton School of the University of Pennsylvania. Since 1969, Thomas has served as a consultant to hundreds of banks and thrifts, advised federal bank regulators, and testified several times before Congress on the Community Reinvestment Act (CRA) and related bank regulatory and public policy issues. He speaks and writes regularly on the banking and financial services industries. Many of the recommendations that appear in his book Community Reinvestment Performance (Probus, 1993), were implemented in the 1995 CRA reforms. His most recent book, The CRA Handbook (McGraw-Hill, 1998), contains a comprehensive evaluation of CRA exams, including a new technique for evaluating and quantifying CRA "grade inflation." Thomas received a B.S.B.A. in finance from the University of Florida, an M.B.A. in finance from the University of Miami, and M.A. and Ph.D. degrees in finance from the Wharton School. He can be reached via e-mail at KHThomas@wharton.upenn.edu or KHT@CRAHandbook.com.

The Levy Economics Institute of Bard College
Blithewood
PO Box 5000
Annandale-on-Hudson, New York 12504-5000

Nonprofit Organization
U.S. Postage Paid
Annandale-on-Hudson, NY
Permit No. 12

Address Service Requested

Recent Public Policy Briefs

Financing Long-Term Care
Replacing a Welfare Model with an Insurance Model
Walter M. Cadette
No. 59,2000 (Highlights, No. 59A)

A Dual Mandate for the Federal Reserve
The Pursuit of Price Stability and Full Employment
Willem Thorbecke
No. 60,2000 (Highlights, No. 60A)

Whither the Welfare State?
The Macroeconomics of Social Policy
Jamee K. Moudud and Ajit Zacharias
No. 61,2000 (Highlights, No. 61A)

Is There a Skills Crisis?
Trends in Job Skill Requirements, Technology, and Wage Inequality in the United States
Michael J. Handel
No. 62,2000 (Highlights, No. 62A)

The Future of the Euro
Is There an Alternative to the Stability and Growth Pact?
Philip Arestis, Kevin McCauley, and Malcolm Sawyer
No. 63,2001 (Highlights, No. 63A)

Campaign Contributions, Policy Decisions, and Election Outcomes
A Study of the Effects of Campaign Finance Reform
Christopher Magee
No. 64,2001 (Highlights, No. 64A)

Easy Money through the Back Door
The Markets vs. the ECB
Jörg Bibow
No. 65,2001 (Highlights, No. 65A)

Racial Wealth Disparities
Is the Gap Closing?
Edward N. Wolff
No. 66,2001 (Highlights, No. 66A)

The Economic Consequences of German Unification
The Impact of Misguided Macroeconomic Policies
Jörg Bibow
No. 67, 2001 (Highlights, No. 67A)

To order Levy Institute publications, contact us by mail, phone, fax, e-mail, or the Internet.
Briefs are published in full-text and highlights versions and are available on our website.

The Levy Economics Institute of Bard College
Blithewood
PO Box 5000
Annandale-on-Hudson, New York 12504-5000

Phone: 845-758-7700, 202-887-8464 (in Washington, D.C.)
Fax: 845-758-1149 E-mail: info@levy.org Website: www.levy.org