New Community Reinvestment Act regulation: What have been the effects?

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Effective January 1, 1996, the federal financial supervisory agencies (agencies) implemented their new Community Reinvestment Act (CRA) regulation.[1] Initially, examiners will use the revised regulation to review CRA performance at smaller institutions. Beginning on July 1, 1997, the new regulation will also be applied to larger institutions.

The newly introduced regulation replaces the "process oriented" approach previously used to evaluate an institution's CRA performance with a more objective, performance based approach. The intent of this change is to reduce regulatory burden on depository institutions and to make CRA regulation more effective.

This article reports on the move to the new CRA regulation and early results from its implementation. It starts with a brief history of events leading to the adoption of the new regulation. Next, it points out the goals the agencies sought to accomplish in revising their regulation and indicates how CRA regulation has been changed to accomplish these goals. It then examines early experience with the new regulation to see if the goals were achieved. The article ends with summary remarks and conclusions.

A brief history of CRA and its regulation

The CRA was passed in 1977 amid concerns about community-oriented lending.[2] Proponents of the law believed that financial institutions failed to take advantage of profitable lending opportunities in inner-city neighborhoods. They believed that institutions took deposits from these neighborhoods and lent them elsewhere, accelerating economic decay of poorer neighborhoods and inhibiting their revitalization.[3] Acknowledging these concerns, Congress passed the CRA.

The CRA required the agencies to use their supervisory authority to encourage institutions to help meet the credit needs of their communities consistent with "safe and sound" operation. The law mandated that the agencies assess an institution's record of meeting community credit needs and take that record into account in evaluating its applications for deposit facilities, e.g., charter, branch, deposit insurance, office relocation, merger, or acquisition applications. Specifics on how this assessment was to be done were left to the discretion of the agencies.

The agencies, in their regulations, settled on a qualitative assessment approach. An important concern raised during Congressional debate on CRA was its potential for leading to credit allocation.[4] Largely because of this, the agencies specifically avoided adopting regulations whose effect might be to interfere with credit flows or allocate credit. Instead, they opted for a regulatory approach that permitted institutions wide latitude in the ways they ascertained and met credit needs in their communities. Under this approach, the agencies examined institutions for their technical compliance with the CRA regulation and qualitatively evaluated their record in helping meet community credit needs.[5] This qualitative review looked at the lending process, evaluating the systems, programs, and procedures used by institutions to ascertain community credit needs and market

[1] *The federal supervisory agencies include the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.*

[2] *Although the law is often thought of as addressing the problem of "redlining" and unmet mortgage credit needs in depressed areas, its proponents meant the law to apply to the wider range of credit needs, e.g., small business, consumer, etc., in these areas. For a discussion of this point, see Warren L. Dennis,* ***The Community Reinvestment Act of 1977: Its Legislative History and Its Impact on Applications For Changes In Structure Made by Depository Insti-***

tutions To The Four Federal Financial Supervisory Agencies, Krannet Graduate School of Management, Purdue University, 1978, pp.22-25.

[3] *Glenn Canner and Joe M. Cleaver, "The Community Reinvestment Act: A progress Report,* ***Federal Reserve Bulletin,*** *(Washington, D.C., Board of Governors), February 1980, p.87. Also Dennis,* ***Community Reinvestment Act of 1977****, pp.13-16.*

[4] *For example, see* ***Community Credit Needs,*** *Hearings Before the Committee on Banking, Housing, and Urban Affairs, United State Senate, Ninety-fifth Congress, First Session on S.406,(U. S. Government Printing Office: 1977), pp 315, 324.*

[5] *Griffith L. Garwood and Delores S. Smith, "The Community Reinvestment Act: Evolution and Current Issues,"* ***Federal Reserve Bulletin****, (Washington, D.C. Board of Governor) April 1993, p 252.*

[6] *The review also encompassed looking at an institution's geographic lending patterns, assessing its community development lending, and looking for discrimination in its lending.*

[7] *He also asked the agencies to provide for more effective sanctions against institutions with poor CRA records. This was an outgrowth of public concern that institutions with poor*

their credit and financial services to the community.[6]

Under the regulations adopted by the agencies, it was important that institutions document their actions to identify and meet credit needs in order to substantiate their CRA efforts to examiners. This emphasis on documentation led many institutions to complain that the CRA examination process encouraged them to generate excessive paperwork on the process they used to identify community credit needs and to market to those needs. They argued that over emphasis on process and documentation hampered their lending. They also argued that costs associated with documenting their CRA efforts raised their operating expense and put them at a competitive disadvantage to other financial service providers that did not fall within the scope of CRA.

There were other complaints as well. Institutions and community groups expressed concern that examiners were inconsistent in their CRA evaluations from examination to examination and from agency to agency. For institutions, these inconsistencies led to confusion and uncertainty about actions they needed to take in order to receive satisfactory CRA examination ratings. For community groups, inconsistencies were taken as failure by the agencies to hold institutions accountable for meeting community credit needs.

Noting these concerns, President Clinton, in July 1993, asked the agencies to revise their CRA regulation. Among other things, he asked the agencies to focus CRA examinations on results rather than process and paperwork, reduce CRA compliance costs, and make examinations more consistent.[7]

In response, the agencies rewrote their CRA regulations and, after considerable public comment, adopted new regulations in April 1995. As previously noted, the regulations became effective on January 1 of this year for small institutions, those with total assets of less than $250 million that are not subsidiaries of larger companies (total bank and thrifts assets of $1 billion or more) and those choosing to be assessed under the new regulations. Large institutions become subject to the new regulations on July 1, 1997.

Agency goals and changes to CRA regulation

In their new regulations, the agencies sought to lessen the burden associated with CRA regulation, to make CRA assessment more reflective of actual performance, and to achieve greater consistency in CRA examinations. To do this, the agencies re-wrote their CRA regulations, focusing their assessment methodology on loan, service, and investment results. These assessments are to take into account information about economic conditions and demographic factors within the community being served and the size, business purpose, and condition of lending institutions (See the Appendix for a more detailed discussion of these matters).

Box 1 summarizes the old and new regulation and shows the shift in the agencies' assessment methodology. Under the old CRA regulation, institutions were judged on five performance categories encompassing 12 assessment factors. Two performance categories, geographic distribution and community development, were results based and considered an institution's lending record. Two others, ascertainment and marketing, focused on established policies and procedures to ensure that an institution was serving the credit needs of its community. The final category, discrimination, assessed compliance with anti-discrimination laws and regulations and dealt with fair lending matters that fell within the scope of the Equal Credit Opportunity Act, Fair Housing Act, and the Home Mortgage Disclosure Act.

The revised regulation evaluates an institution's CRA record in terms of its lending performance and uses three tests—lending, service, and investment—all of which are results based. The lending test looks at the amount and the geographic distribution of an institution's lending. Special attention is given to its lending to low- to moderate-income geographies and low- to moderate-income borrowers and to small business and farm borrowers. The service test considers the extent, range, and innovativeness of an institution's financial services delivered to low- to moderate-income individuals and geographies. The investment test takes into account the amount and extent of an institution's community development investments that benefit low- to moderate-income individuals and geographies.

In addition to changes in assessment methodology, the agencies also made accompanying revisions to other parts of their CRA regulation. For example, they gave institutions more flexibility in defining assessment areas. They made their public performance evaluations more concise and performance oriented. They reshaped the examination process, making it less intrusive and more focused on lending done, services provided, and development investments made within the community.

The agencies said these and other changes address many of the criticisms aimed at the old regulation. They stated their new approach to CRA regulation will be less burdensome, more consistent, and more accurately portray CRA performance than the old regulation.

Has the new CRA regulation achieved its objectives?

The new regulation became effective for small institutions on January 1, 1996. Since that time, the agencies have examined more than 400 institutions nationwide and gained experience with the new CRA regulation. Although it may be too early to judge the success of the new regulation in meeting the objectives set forth by the agencies, enough experience has been gained to form some initial impressions about its effects on such matters as on compliance costs and performance assessments.

To see how well cost and assessment objectives have been met, the Federal Reserve Bank of Kansas City surveyed by telephone 38 Tenth District member banks examined under the new regulation. These institutions received examination ratings during the first half of 1996 under the new regulation and were examined at least once under the old regulation. Also, for comparability purposes, institutions surveyed had both examinations done by the same federal banking agency.

The survey consisted of four questions. Three questions focused on regulatory burden. The remaining question asked bankers about their thoughts on the performance evaluations they received under the new regulation. Wherever possible, the survey questions were posed to the individual responsible for CRA administration at the bank surveyed. Those interviewed were asked to compare their bank's first examination experience under the new CRA regulation with that from its last examination under the old regulation.

Summarized below are the responses received from the survey. It is important to keep in mind that the responses reflect first time experiences by bankers with the new regulation. Thus, the information presented may not totally represent what may become typical experience under the regulation once it has been in place for a time. For example, one respondent to the surveyed noted: "Although the first examination did not significantly reduce burden, [I] attribute that to a learning curve and believe that from here on in it will be easier."

community lending records could escape CRA regulatory sanctions if they did not file expansion applications. The agencies, after some study, found that the CRA limited their enforcement primarily to an applications context and did not provide for sanctions outside this arena.

Box 1: Community Reinvestment Act regulation prior to January 1996

Technical Requirements

Public Notice posted in lobby

Documentation of annual board action adopting CRA statement

CRA Public File which includes:

CRA Performance Evaluation
Map of delineated community
CRA Statement - adopted annually by the board
HMDA data (if applicable)
Written comments from the public

CRA Performance Evaluation Criteria

Performance categories	Assessment factors for each performance category
Ascertainment of community credit needs	Activities to ascertain community credit needs and to communicate available credit services Board of directors role in formulating policies and reviewing institution's CRA performance
Marketing and types of credit offered and extended	Marketing and special credit-related programs to let community know about available credit services Housing, small business, small agriculture loans originated or purchased within the community Institution's participation in government or subsidized program for housing, small business, small farms
Geographic distribution of credit activities and record of opening and closing branches	Geographic distribution of institution's credit extensions, applications, and denials Institution's record of opening and closing branches
Discrimination and other illegal credit practices	Practices intended to discourage credit applications for credit offered Evidence of discriminatory or other illegal credit practices
Community development	Institution's participation in local community development and redevelopment programs Impediments to institution's ability to meet credit needs—financial condition, size, legal impediments, local economic conditions, etc. Other factors that may keep the institution from helping meet the communities' credit needs.

Box 1: Community Reinvestment Act regulation beginning January 1996 (continued)

Technical Requirements

Public Notice posted in lobby

Public File which includes:

- CRA Performance Evaluation
- Branch and service information
- Map of Assessment Area
- HMDA data (if applicable)
- Loan data information (Large banks)
- Description of efforts to improve performance (if rated less than satisfactory)
- Written comment from the public

CRA Performance Evaluation Criteria

Performance tests	Performance standards
Large bank: Lending test	Number and amount of loans in assessment area
	Geographic distribution of loans
	Distribution of loans based on borrower characteristics
	Community development loans
	Innovative or flexible lending practices
Investment test	Dollar amount of qualified investments
	Innovativeness and complexity of qualified investments
	Responsiveness to credit and community development needs
	Degree to which investments are not provided by private investors
	Benefits to assessment area
Service test	Distribution of branches and record of opening and closing branches
	Availability and effectiveness of alternative systems for delivering bank services to low- to moderate-income people and geographies
	Range of services provided
	Extent of community development services provided
	Innovativeness and responsiveness of community development services
Small bank: Lending test	Loan to deposit ratio
	Percentage of loans in the bank's assessment area
	Record of lending to borrowers of different incomes and businesses and farms of different sizes
	Geographic distribution of loans
	Action taken in response to CRA complaints
Wholesale or limited purpose bank: Community development test	Number and amount of community development loans, qualified investments, or community development services
	Use of innovative or complex investments, community development loans or services and extent they are not routinely provided by private investors
Strategic plan	Responsiveness to credit and community development needs
	Achievement of strategic plan goals

Table 1

The new CRA regulation's effect on banks' regulatory burden

For your institution, the new CRA regulation has:	Percent yes	Percent no	Percent same
Reduced documentation collected	81.5	5.3	13.2
Reduced staff time devoted to CRA administrative matters	71.1	10.5	18.4
Reduced staff time responding to examiner requests	63.2	18.4	18.4
Reduced data collection by your institution	50.0	15.8	34.2
Reduced examiner time spent in the bank	36.8	13.2	50.0

Effects on burden and compliance costs

One important reason for revising the CRA regulation was to reduce regulatory burden. In the past, complaints pertaining to CRA regulation often centered on burdens associated with paperwork costs in documenting CRA efforts, staff time devoted to CRA administration, staff effort required to respond to examiner requests, and examiner time spent on-site. Survey questions asked about each of these matters.

Besides ongoing burdens associated with the regulation, institutions often incur short-run, start-up costs implementing new and changed regulations. These costs represent an added regulatory burden. Because of this, respondents were asked whether their banks had experienced any added cost in complying with the new regulation. Additionally, because the new regulation may reduce some burdens and add to others, the survey asked bankers their opinions on the change in overall regulatory burden under the new regulation.

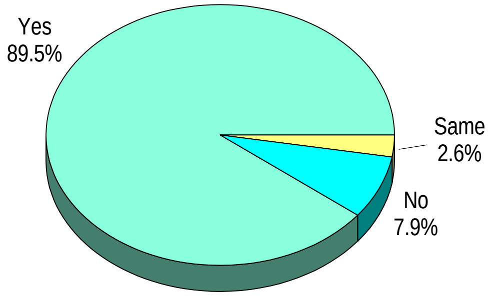
Table 1 summarizes banker opinions regarding documentation, staff, and examination burdens associated with the new regulation relative to its predecessor. For a vast majority of respondents, the new CRA regulation reduced their banks' CRA documentation burden and staff time administering CRA. Fewer, but still a majority, said the new regulation reduced their data collection effort and reduced staff time responding to examiner requests. Far fewer said the new CRA regulation resulted in less examiner time spent in the bank. Instead, a greater proportion responded that on-site examiner time was about the same as it was before the regulatory change.

In addition to these changes in on-going burden, the survey asked about start-up costs associated with coming into compliance with the new regulation. With respect to these costs, approximately 40 percent of respondents indicated their banks incurred some additional expense implementing the new CRA regulation. These costs were often associated with information management system changes, staff training, and CRA administrative changes to comply with the regulation. In some instances, however, added costs resulted from extra measures or initiatives taken by bank management to meet the bank's business needs. For example, one banker noted: "The bank chooses for its own business reasons to keep tracking the geographic distribution of loans." Another noted that "While the bank has enhanced mapping software, which is more work, the work will offer a return in regard to marketing to segments of the community." Thus, in cases such as these, qualitative benefits helped offset added expense.

Although implementation cost added to burden, 90 percent of the respondents said that the overall regulatory burden associated with CRA regulation for their banks was reduced (see Figure 1). Only about 8 percent saw it as increasing burden.

Figure 1

Has the new CRA regulation resulted in less burden for your bank?



The public performance evaluation under the new regulation is more concise, documenting an institution's lending, service offerings, and investment performance. It also includes a community description and a bank profile that help place the bank's performance in context of its operating environment and financial position.

The survey asked whether the public performance evaluation under the new regulation was more relevant or reflective of the bank's CRA record. Almost 80 percent of respondents said the new evaluations gave a better picture of their bank's CRA performance (see Figure 2). Additionally, bankers commented they thought the new evaluations "were more meaningful," "easier to understand, more concise, and to the point," "easier to read and better for the layman," and "more in line with what the bank does."

Not all comments, however, were favorable. For example one banker stated the "Public performance evaluation is not as relevant or reflective of the bank's record. Since it [the evaluation] does not have as much information, it is not as useful to the public."

Effects on public performance evaluations

The public performance evaluation summarizes aspects of a bank's CRA performance. Public performance evaluations are the public's primary information source for the agencies' assessment of banks' CRA performance and for data on the consistency of the examination process. Members of the public, however, complained that public performance evaluations were of limited use because they didn't include adequate information to easily judge an institution's actual lending performance and to judge examination consistency.[8]

Under the old regulation, the public performance evaluation was a lengthy document that provided information on the reasonableness of a bank's community delineation, substantive violations of Regulation BB, and summarized performance under each assessment factor. The performance evaluation also included supporting documentation for the bank's CRA rating.

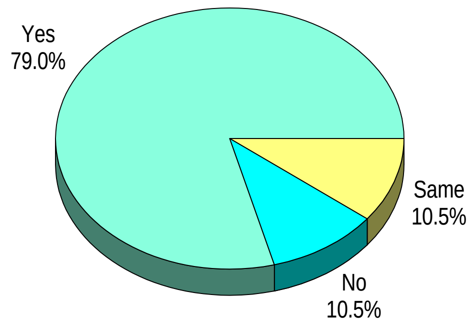
Conclusions

The agencies revised their CRA regulations to address complaints about burden, relevancy, and consistency. Their new CRA regulations became effective for smaller institutions January 1, 1996. A survey of Tenth District member banks examined under the new regulation indicates that the agencies, for the most

[8] *U.S. General Accounting Office,* ***Community Reinvestment Act: Challenges Remain to Successfully Implement CRA****, 11/28/95, GAO/GGD.*

Figure 2

Is the public performance evaluation under the new regulation more reflective of a bank's CRA performance?



part, accomplished many of the objectives they sought to achieve. A vast majority said that the new regulation reduced documentation and staff burdens. A good number experienced some increase in operating cost in order to implement the change in regulation. However, even after doing so, most of those surveyed responded that the new approach reduced their overall CRA regulatory burden.

In addition to reducing burden, a large majority of those surveyed indicated public performance evaluations under the new regulation better reflected the CRA performance of their banks. In their comments, they also stated the new public performance evaluation is more concise and easier to read and may be a better tool for the public to use in judging an institution's CRA performance.

From this, it appears the agencies have succeeded in meeting their objectives of making CRA regulation less burdensome and assessments under the regulation more meaningful, at least for small institutions. On July 1, 1997, the new regulation becomes effective for large institutions. These institutions have voiced concern about the data collection requirement under the new regulation. Therefore, any final judgement on the success of the agencies in streamlining CRA regulation must remain open until experience is gained with large institutions.

Appendix: New Community Reinvestment Act regulation and examination emphasis

Description of new requirements

The revised CRA regulation gives institutions greater flexibility in choosing evaluation methods that are consistent with their size and business strategy. The regulation lets institutions with assets less than $250 million choose a streamlined examination focused on their lending record or, alternatively, their lending, service, and investment records. The regulation also lets all institutions map their own destinies by permitting them to adopt a strategic plan. The strategic plan option gives institutions the flexibility to work with their communities to establish lending, service and investment goals, and to define for themselves how they are to help meet community credit needs. Wholesale and limited purpose institutions, because of their specialized business lines, can apply for a special designation as such and be assessed on community development efforts undertaken that benefit low- to moderate-income individuals, small farms and small businesses. A summary of the new regulatory requirements for small and large retail institutions, wholesale institutions, and institutions that adopt strategic plans is presented below.

Small institutions

Small institutions, defined as institutions with assets below $250 million or an affiliate of a bank holding company with assets of less than $1 billion, can elect to have their CRA record assessed under a streamlined examination process that emphasizes their lending activities. Under this option, examiners consider the reasonableness of the institution's loan-to-deposit ratio and other lending related activities, taking into account its size, financial condition, and the credit needs of its assessment area. Examiners also give consideration to the proportion of the institution's lending in its assessment area. Additionally, examiners evaluate the distribution of an institution's lending to individuals of different income levels and businesses and farms of different sizes. They review the geographic distribution of loans made in an institution's assessment area, including low- and moderate-income geographies. Examiners also consider any complaints about an institution's CRA record and the appropriateness of actions it has taken in response to these complaints. Finally, examiners look for evidence of violations of the Fair Housing Act and the Equal Credit Opportunity Act.

Large institutions

Large institutions, those with assets of $250 million and over or an affiliate of a holding company with total banking assets of $1 billion or more, are evaluated under a lending test, an investment test, and a service test. Just as they do for small institutions, examiners judge the reasonableness of a large institution's CRA performance under each of these tests in the context of information about the institution and its community, competitors, and peers.

The lending test focuses on loan originations in assessing performance. Examiners look at the geographic distribution of an institution's loans and the proportion of its lending done within its

Appendix: New Community Reinvestment Act regulation and examination emphasis (continued)

assessment area.[1] They also review the distribution of loans among borrowers of different income levels and businesses of different sizes. Additionally, examiners look for innovative or flexible lending practices, applied in a safe and sound manner, in meeting the credit needs of low- and moderate- income individuals or geographies.

The investment test evaluates a bank's record of helping to meet the credit needs of its assessment area through qualified investments within the assessment area. Examiners review the dollar amount of qualified investments and weigh the degree of innovativeness or complexity they represent. Examiners also judge the responsiveness of qualified investments to credit and community development needs, taking into consideration the degree to which these investments are not routinely provided by private investors.

The service test evaluates a bank's record in helping meet the credit needs of its assessment area. Examiners analyze the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services. They consider the distribution of the bank's branches among all geographies and the bank's record of opening and closing branches, especially those located in low- to moderate-income geographies. In addition, examiners consider the availability and effectiveness of alternative systems for delivering retail banking services and the range of services a bank offers.

The revised CRA asks large institutions to collect additional lending data. These new data offer documentation of lending and are necessary to permit examiners to assess an institution's record and support conclusions drawn about its CRA performance.

Wholesale and limited purpose banks

Wholesale banks are banks that do not extend home mortgage, small business, small farm, or consumer loans to retail customers. Limited purpose banks are defined as those that offer only narrow product lines, such as credit card or motor vehicle loans. Institutions that seek designation as wholesale or limited purpose must be designated as such by their primary regulator.

The CRA performance of wholesale and limited purpose banks is assessed under a community development test. This test focuses on the bank's community development lending, qualified investments, and community development services. In evaluating performance, examiners review the number and amount of community development loans, including origination and purchase of loans. They also consider the number and amount of qualified investments and community development services provided by the bank. Additionally, they look at the bank's use of innovative or complex qualified investments, community development loans, or community development services,

[1] It is not expected that an institution lend evenly throughout its assessment area, but there should be no conspicuous gaps in its geographic lending patterns.

Appendix: New Community Reinvestment Act regulation and examination emphasis (continued)

taking into account the extent these are not routinely provided by private investors. Finally, examiners consider the bank's responsiveness to credit and community development needs.

Strategic plans

Banks may choose to be evaluated under a strategic plan as an alternative method of assessment under the Community Reinvestment Act. If the bank does so, it must submit the plan for public comment and have the plan approved by its primary federal banking supervisory agency. It must operate under the approved plan for at least one year before its CRA performance is evaluated. In general, the strategic plan can be no longer than five years and must have annual interim goals. Banks must seek public participation in developing their plans by publishing notice in a general circulation newspaper in each assessment area and making copies of their plans available for public review.

The strategic plan must establish measurable goals for helping to meet credit needs, particularly credit needs of low- to moderate-income individuals and small farms and small businesses. The plan must address lending, investment, and service performance categories with an emphasis on lending and lending-related activities. Finally, the plan must specify measurable goals that constitute a "satisfactory" rating. If an "outstanding" rating is designated in the plan, then the bank must specify measurable goals that reach outstanding levels of performance.