Consumer Finance Monitor (Season 3, Episode 5): The FDIC's and OCC's Proposed CRA Reform: What the Agencies Consider Now in CRA Evaluations and How That Would Change

Speakers: Alan Kaplinsky and Diego Zuluaga

Alan Kaplinsky:

Welcome to the Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer finance, and what they mean for your business, your customers, and the industry. I'm your host, Alan Kaplinsky, the share of the Consumer Financial Services Group at Ballard Spahr. And I'll be moderating today's program. For those of you who want even more information about the topic we're going to be talking about today or any other topic in the world of consumer finance, please don't forget about our blog, which is also called Consumer Finance Monitor. We've hosted our blog since 2011. So there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those of the industry. So subscribe to our blog or get on the list for our webinars. And you can do that by visiting us at ballardspahr.com. And if you like our podcast, let us know about it. Leave us a review on Apple Podcasts, Google Play, Spotify, or wherever you get your podcasts.

Alan Kaplinsky:

So today, I am rejoined by someone who we had on our podcast show a short while ago. An expert in the area of the Community Reinvestment Act. Or as we'll refer to it today, CRA. And my guest is Diego Zuluaga, and I'm going to appropriately introduce Diego in just a minute. But we're going to be talking about the very recent proposed changes to CRA made by the OCC and the FDIC. And they're rather substantial changes, and they're quite controversial.

Alan Kaplinsky:

So Diego is a policy analyst at the Cato Institute Center for Monetary and Financial Alternatives, where he covers financial technology and consumer credit. He's the author of Should Cryptocurrencies Be Regulated like Securities? And germane to the topic today, The Community Reinvestment Act in the Age of Fintech and Bank Competition. He has previously testified on the impact of restrictions on short-term lending before the House Subcommittee on Consumer Protection and Financial Institutions. So Diego, welcome once again to our podcast.

Diego Zuluaga:

Thank you, Alan. It's always a pleasure to be with you, and I'm looking forward to our discussion.

Alan Kaplinsky:

Terrific. So let's lay some background here before we dive into the OCC FDIC proposed reg. And let's first talk about what is the CRA, and how did the regulators implement it at present?

Diego Zuluaga:

Sure. The Community Reinvestment Act is a law that was enacted in 1977. And the aim of this law was to end the practice that was known as redlining, whereby financial institutions, primarily commercial banks within the scope of the law, were avoiding certain geographic areas. And those geographic areas tended to be low-income, minority heavy, immigrant heavy. And this was

in the late 1970s a push that was part of the anti-discrimination legislation that was enacted from the mid-1960s all the way to the late 1970s. So we started with the Fair Housing Act and the Civil Rights Act, of course. And then in the '70s, we had the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and then finally the CRA. This was a time of a great awareness of the impact on the wealth inequality between the races that institutionalized discrimination had had for decades.

Diego Zuluaga:

And the aim of the CRA was to try and begin to redress that imbalance by making financial services and credits specifically more easily and widely available to those communities that have historically been excluded.

Diego Zuluaga:

Now in the first podcast that we had Alan discussing the CRA, we talked about the history a little bit and how government played a very significant role in actually promoting lending discrimination for years. Because it was actually government, the government institution, the homeowners loan corporation that would issue maps in the 1930s that designated geographic areas by color, and would severely disadvantage low-income and minority areas.

Diego Zuluaga:

But 40 years later, the CRA was implemented to try and readdress this practice of redlining. And the language of the statute is actually quite vague. It says regulators should make sure and encourage that banks, "Serve the convenience and needs of the communities where they conduct business."

Diego Zuluaga:

So it leaves it up to the regulators to basically define what the convenience and needs are, how they will be effectively met and how to define really where financial institutions conduct business. I should say the CRA applies only to banks. It doesn't apply to credit unions, and it doesn't to non-bank lenders. And the three regulators who are in charge of implementing it are the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board. That is the three primary bank regulators.

Diego Zuluaga:

Now, these regulators have been issuing specific implementing regulations for the CRA since the late 1970s. But the last big change happened in the mid-1990s, in 1995. When regulators, after some disappointments about the effectiveness of the CRA at achieving what was its statutory purpose, moved to defining outcomes as the main measure of evaluation. Outcomes being how much banks actually lent in home mortgages and small business loans in the various areas where they operated. How much they lent across income groups, across geographic groups. To make sure that it wasn't just a matter of banks making promises and commitments, but actual lending practices.

Diego Zuluaga:

Now all of this at the time was supposed, was premised on the notion that bank activity is defined by bank offices. That is the main office, and then a bank's branches. Because at the time, the internet was in its very infancy. And most credit applications would happen in a physical location. Certainly credit that would be extended by banks happened in that way. So it was deemed as a good reference to look at a bank's offices in the way in which then they would be asked to define their geographic area of assessment, and regulators would look at it.

Diego Zuluaga:

So it's been 25 years since the last major revision to CRA regulations. And the banking environment has changed quite a bit. So two of the three regulators at the end of November, beginning of December issued a new proposal for a regulatory change in the way that the CRA is enforced to take account of some of those changes that have happened to the banking landscape.

Alan Kaplinsky:

So what do the OCC and the FDIC want to change?

Diego Zuluaga:

So for a number of years now, it's been a mainstay of the critique of the CRA, the way it's implemented now, that it doesn't take account of the rise of non-banks. That is institutions that make substantively the same kind of loans as banks are evaluated for under the CRA. And secondly, that the statute because it was enacted in the late 1970s operated in an environment in which the rise of branching was not counted as a way to necessarily foster competition and make sure that underserved areas would actually get their credit. We shouldn't forget that well into the 1980s in the United States, we had a bunch of local banking monopolies where there were a very few players in every area. And if those lenders didn't have much lending activity in certain areas, then the people living there didn't have very many alternatives to resort to.

Diego Zuluaga:

But since the late 1970s and accelerating over the '80s and the '90s, we've had first of all the liberalization of bank branching, which makes it possible for any bank in the United States to set up a branch anywhere else in the country. They have to abide by local regulations, but there are no barriers to entry in the way that existed until 1994. And then secondly through the internet, the rise not only of non-banks as major participants in this market, but also the rise of online activity by banks. Meaning banks extending credit and taking deposits far away from where they operate their branches.

Diego Zuluaga:

So it was with that in mind that at the end of summer 2018, the Office of the Comptroller of the Currency, which is the most important CRA regulator because it covers about two thirds of regulated banks by assets, issued an advanced proposal. That is, this is the sort of call for insights call for answers from experts and interested parties on what should be done with the CRA. And they had an enormous amount of responses. I think it was something like 1,500 individual responses. I contributed one. And the idea was to take those into account, to then come up with a reform proposal.

Diego Zuluaga:

And it's taken them over a year to come up with a new proposal, but I think it has some promising elements in it. And another promising feature of the proposal is that the other, one of the other two regulators, the FDIC has signed up for it. So now we have about 83% of CRA regulated banks by assets covered by the regulators that have made this proposal. There was a pity that the fed didn't sign up for this initial proposal, but they may be able to sign up for the final rule as in when it comes out.

Alan Kaplinsky:

And I appreciate it Diego, if you could tell our listeners, what are the main features of this reform proposal? And does the proposal effectively address long standing criticisms of CRA enforcement?

Diego Zuluaga:

Sure. There are various elements to the CRA evaluation methods that regulators have used for a number of years. I mentioned that they look primarily at home mortgages and small business loans. And specifically, they look at how well distributed they are across the geography where the bank has operation. And they look at the bank's investment activities and services provision in the areas where it conducts business. So what the usual schedule is of opening hours for bank branches. What sort of investments if any, have banks made in equity for low-income lenders, or non-profits, or other organizations that are trying to improve the welfare of low-income communities. Things like that. But the main test has been the lending test, and that is looking at how well a bank is serving the various socioeconomic groups and the various geographic areas within the parts that it has operations.

Diego Zuluaga:

And for a while, in addition to failing to update regulations to take account of branching and the rise of information technology, a criticism of the CRA was that its evaluations were vague. That they were based on qualitative terms like excellent performance, good performance. And only the supervisor would know what those terms actually meant. And if you looked at the regulations, good would be defined as satisfactory performance in lending across income groups. And it would always be qualitative terms that were difficult to pin down and difficult for a bank to know in advance what they had to do in order to perform well by the CRA. So that was one criticism.

Diego Zuluaga:

Another criticism, which I have made, and I'm pleased to say that it will be addressed if the proposal is taken forward. Was that because the CRA's focus is geographic, often it rated banks according to performance that is not part of the statutory aim of CRA. What I mean specifically is that banks would be able under the existing proposal, under the existing regulations, but not be upcoming proposal, to get CRA points for making loans to high-income Bora was living in low-income areas. Because the CRA looks at low-income neighborhoods specifically. It didn't necessarily make a difference between high-income and low-income borrowers themselves.

Diego Zuluaga:

And I'd made that criticism because right now in the United States, we're living in a period in which people are flocking back into metropolitan areas. The cost of housing is going up. There's very significant gentrification, and gentrification can be beneficial for very many different reasons. It brings economic revitalization, brings crime rates down. It improves neighborhoods in very many different ways. But gentrification also means that if you don't have housing supply responding adequately to the new influx of people, those who cannot, no longer afford the living in the, whether it's rent or a mortgage payments in a particular neighborhood are displaced.

Diego Zuluaga:

And I pointed out that based on evidence I have from the District of Columbia, about two thirds of CRA lending in the district was actually going to these high-income borrowers that are moving into historically low-income areas. And that seemed to have a negative displacing effect on the existing residents, who are overwhelmingly minority residents. So we actually found that every percentage point increase in CRA lending was associated with a three percentage point decline in the minority share of the population. That's not to suggest that the CRA is promoting the exclusion of minorities. It's just that as a result of constraints on housing supply, problems of housing affordability, and so on, the CRA is actually rewarding the lending to people that should not be a public policy goal, because these people could get a loan anyway. So that was my specific criticism of the CRA, and the proposal thankfully addresses it

Alan Kaplinsky:

Comptroller of the Currency Otting who heads the OCC, which as you pointed out is the most important CRA regulator by far. Because most of the banks that are governed by the CRA are national banks. He's long been a proponent of quantitative rather than qualitative evaluations. I guess that's probably because of his experience as a banker at OneWest Bank where he was highly critical of the ways CRA was being enforced. His CRA proposal contains a number of lending ratios that CRA regulators would use as benchmarks of CRA performance. What is your assessment of these ratios?

Diego Zuluaga:

Sure. So as a bit of background, Joseph Otting as you mentioned has extensive experience as a banker in California. And a bank that he ran was eventually sold. And during that process of selling the bank, the now comptroller then CEO of OneWest Bank Otting came up against opposition from community groups. And community groups wanted to get greater commitments from the buyer about the level of lending activity that the future merged bank would undertake in specific low-income areas.

Diego Zuluaga:

And I think that experience affected Otting in the sense that he didn't think some of the opposition was fair. The relationship of the CRA to that particular event is that the CRA not only enables regulators to give, or in fact mandates regulators to give banks ratings on the basis of their performance. But it actually instructs them to use those ratings in their decision as to whether to allow a merger or not.

Diego Zuluaga:

So that if you get a lot of protests from community groups about CRA performance by a bank, a regulator could find themselves in a position that they block a merger. So it can be very economically significant obviously for bank shareholders and bank management. But it also gives community groups quite a bit of leverage over the whole process.

Diego Zuluaga:

Now that was the experience of comptroller Otting. And I think his motivation in coming at this, it's been painted as a self-serving and trying to help the interests of a particular group. But I don't think that's a primary motivation. I think the primary motivation is trying to actually define for banks specifically how it is that they should perform so that they can be sure that they're on the right side of the CRA at all time. And that there's relatively less ambiguity about how this will be looked at in the future.

Diego Zuluaga:

So in a bid to try and address that concern, he was very emphatic that he wanted more quantitative measures in the new CRA proposal. And there are a range of them included in the proposal that was released last month. But I'm a little bit concerned that they will not exactly achieve what the comptroller wants from them.

Diego Zuluaga:

First on a philosophical level, I'm skeptical that you can as a regulator define an adequate percentage of loans as a share of your deposits if you're a particular bank. That means you are performing adequately in that area, and you're lending enough so to speak. Regulators don't have the information to know what the business opportunities are in an area. They don't have the requisite knowledge about what a bank's capital position or prudential position might be at any point in time. Banks of course serve a very important function of pooling deposits from different geographic areas and then lending in the places that have highest credit demand. So I think that a ratio that defines a threshold below which you will be regarded as not performing well enough in terms of your geographic lending in that particular area, can be dangerous in that it presupposes the knowledge on the part of the regulators. And in fact, it can be damaging.

Diego Zuluaga:

The second problem which is more practical that I see with ratios. And these would be ratios of as I say, mortgages to deposits, and then comparing them to mortgages to deposits by other banks competing with you in an area. Or small business loans, the same kind of test. Those ratios are as proposed for mortgages specifically are, for sake of argument, 65% is the ratio proposal. Nothing prevents someone who has a particular agenda aiming to increase the extension of credit to a particular group in the future from changing the ratio and raising it in such a way as to retain more lending in a particular area. This would apply to the nation as a whole, but it could still be raised.

Diego Zuluaga:

And I think that can be problematic because there is an opportunity for rent seeking there in that you can then by a regulation, almost direct lending to particular groups in particular areas that are deemed whether for political reasons or economic reasons, they may be perfectly well-meaning, but that can be non-financial in nature. So I think that's another problem with ratios.

Diego Zuluaga:

And then finally, it's an illusion I think that numbers can give us certainty in this particular instance. Because as I mentioned, the statutory language of the CRA is vague itself. The way in which banks have been evaluated has changed a lot over the years. And banks are currently being evaluated when they're in fact competing with a bunch of other operators who are not evaluated under the CRA. And now it so happens that financial technology lenders, online based ones serve low-income communities as much or even more than banks do. That is great because it seems that new players are serving the traditionally underserved, but it also makes looking to banks for delivery of lending to all communities somewhat of a problematic notion, because there's someone else serving that market already. So you're going to get a different picture from the one that you would be obtaining if you only had banks operating in this area. So I have some concerns about this focus on quantitative measures.

Alan Kaplinsky:

Diego. In our earlier podcast, you criticize the current CRA regs for giving points for lending to well-off borrowers. Can you explain how the reform proposal addresses this issue if at all?

Diego Zuluaga:

Sure. So the existing CRA regulations look at where banks lend and to whom they lend. But particularly, they look at where banks lend. And where banks lend is defined as what level of income do the specific neighborhoods in which banks lend have relative to the metropolitan area in which they find themselves. So banks will have a number of branches in a metropolitan area. And they will have to define an area around it, or within that MSA that doesn't exclude groups by income. And it doesn't exclude them for other reasons, racial reasons, or any other reasons. So that they can be adequately evaluated across the geographic area where they operate. And CRA currently gives banks points for lending in neighborhoods whose median income is 80% or below the median income of the MSA as a whole. That's how low and moderate income areas are defined by the CRA regulations.

Diego Zuluaga:

But as I mentioned, a lot of those neighborhoods are very quickly transforming. And what you find in places like Washington DC, but also in New York, in San Francisco in LA, in Chicago, in Miami, is that you have neighborhoods that qualify as low and moderate income where most of the new mortgages being extended are actually going to people who are not themselves low and moderate income. So what you find is then banks getting most of their CRA points for lending to higher-income borrowers, moving to low-income areas. Again, to repeat the figure I found for the District of Columbia. And this is for recent years, this is anywhere between 2012 and 2017. Anywhere between 65 and 70% of mortgage lending that happened in low-income areas and to low-income borrowers, when you add it all together, 70% of that was actually to higher-income borrowers moving to low-income areas.

Diego Zuluaga:

And this is a criticism I raised about a year ago. I have been exploring it for a number of months. And I was gratified that soon after my paper came out and then after I wrote a couple of op-eds, one in Politico, the other one in the Washington Post, raising this issue. And after communication with the OCC, they seem to have included that in their proposal. In the sense that they propose no longer to count loans to high-income borrowers in low-income areas. In fact, comptroller Otting went so far as to use himself as an example of a borrower who had given the regulator CRA points when he shouldn't have. Because he lives in I think Navy Yard, which is a rapidly changing neighborhood near the Potomac in the District of Columbia. And he moved there recently and got a mortgage. And under the existing CRA, his loan would have qualified for CRA points. And that's exactly not the objective of the CRA. So I'm not claiming sole credit for this, but I've tried to make this point emphatically and repeatedly to the CRA regulators. And I'm glad that they've taken it on board wherever they took it from.

Alan Kaplinsky:

I'm very happy about that too Diego. Now, another criticism of the CRA is that failure to take account of the rise of branchless online banking. How does banking change? What are the implications for the CRA? And does the reform proposal adequately address this change?

Diego Zuluaga:

Yeah, this is a very interesting development. Because I mentioned the rise of the internet and the rise of online lenders as competitors with banks. But of course online lenders if they're not banks don't fall under the CRA. So that is a separate consideration that it would take a legislative change. Because the CRA right now only points to banks for these kinds of evaluations. And I'm not sure that I would like to see an extension of CRA obligations to other lenders because their features are different, they don't have the same regulatory privileges as banks do. And they have other features. They also seem to serve low and moderate income borrowers very well as it is. So the case for extending the CRA to them is questionable.

Diego Zuluaga:

But setting that aside for a moment, the other interesting development which is in the works right now, and it will only grow in the future, is the move by banks away from physical location and towards serving a national American market via the internet. So we already see one of the major American banks, one of the historic ones, Citibank, having developed a strategy for increasing their share nationwide while reducing the number of branches that they have. And they seem to be quite serious about it because it recently was revealed that they are working with Google to do better data processing and better marketing of accounts. And in other ways, a more internet friendly customer experience that will enable that deposit growth without branch growth.

Diego Zuluaga:

And at the same time as incumbent banks like Citibank seem to be taking up that strategy, you also have online lenders wanting to become banks, and payments processors, and other new players like that. So Square, which processes payments for businesses. A number of other online lenders and payments companies have explored obtaining some form of bank charter.

Diego Zuluaga:

But of course, those were they to be granted, would apply to an institution that wouldn't have any offices. They would have a headquarters somewhere in the United States, probably in Utah or in Delaware. And that would be their sole office, but their lending activity would be nationwide.

Diego Zuluaga:

So a criticism of the CRA was that under the existing regulations, the only lending activity that regulators would look at is that which happens near that headquarters. But that doesn't make any sense for a lender based in Salt Lake City, that lens in the United States as a whole to only be evaluated in Salt Lake. They should be evaluated nationwide. And indeed, it makes CRA qualifying activity, community development activity of the sort that the CRA rewards much more efficient than rational if the institution is evaluated for the nation as a whole. Because otherwise, Salt Lake is going to get all these investments, and all these partnerships, and all these other programs by the institution. And other places that are probably needier wouldn't.

Diego Zuluaga:

So the CRA proposal, I think auspiciously, proposes to change this. If a bank makes more than 50%, collects more than 50% rather of its deposits beyond the places where it has its offices, then that bank will be evaluated in all the places where it has more than 5% of its deposits. Now that is a complicated way of saying if you're a bank that doesn't have very many offices where you actually have deposit taking and lending activity, your CRA evaluation will happen there too. Not only in the places where you have locations.

Diego Zuluaga:

I still think this is only an incremental improvement. I don't think it's got us all the way where we want to be. Because it's setting some thresholds as to when you would begin to be evaluated. But I think moving to that is important, because we're going to see increasing reliance on non-physical presence in terms of expanding a bank's footprint. So I think that is quite positive, and it will hopefully facilitate also the future entry of, and their compliance with the CRA the future entry of online players.

Alan Kaplinsky:

Yeah, but how did they come up with the 50% threshold? If you have a bank that gets let's say 50.1% of its deposits in its really local community, but 49.9% elsewhere in the country, then it will be evaluated only on how it's doing in its local community. If I got that right.

Diego Zuluaga:

That's right. According to the existing proposal, that's the way it would be. I don't know how many cases you would get that would be at the threshold like that. But of course, if you are making a determination that sets thresholds about when banks will begin to be evaluated under this criteria, you're bound to fall for something like that. As you and I know, $10 billion as an asset threshold is a classic one for a bunch of different regulations. Supervision by FDIC. Sorry, supervision by the CFPB. The application of certain additional prudential requirements, your treatment as a community bank, and so on. And we see fewer banks right around the $10 billion threshold as a result. We see a bunch of them far beyond, and very many of them below $10 billion. But not very many just over it.

Diego Zuluaga:

And I think that might be the case here too to some extent. But one concern I know that regulators had in taking account of branchless banking was that they didn't want to necessarily eliminate all of the local reference to local activity and offices from CRA evaluations. If they had said no threshold, then effectively we're moving to a system where banks are evaluated nationwide. They look at your deposit taking nationwide, your lending nationwide. How does it compare? Then you're okay, you're not. Whereas I think there was a lot of interest in keeping that local attachment. Which is why only if you are a very heavily branchless bank, one of the new applicants presumably, will you actually fall under this. Because for most of the large banks, they actually conduct most of their deposit taking and most of their lending activity in places where they have branches. I'm thinking not only of the Chases, and the Wells Fargos, and the BofA's, and the Citibanks and so on. Citibank less so increasingly, but still. But I'm also thinking of community banks and regional banks that still have a lot of physical presence.

Alan Kaplinsky:

So Diego, the CRA regs evaluate bands for the mortgage and small business lending, as well as other activities. How would the small business part of the CRA test change under the reform proposal?

Diego Zuluaga:

So the main change in the regulations is that the thresholds for evaluation are again raised. Typically, regulators defined CRA qualifying small business loans as loans under a million dollars to a business with revenue under a million dollars each year. And they're raising both of those to 2 million each.

Diego Zuluaga:

Now the reason I think this is more significant than some may at first inspection realize is that the Dodd-Frank Act passed after the financial crisis has a section that includes the duty for lenders to collect demographic information on every single small business loan application that they get. This is something similar to the Home Mortgage Disclosure Act, but for small business loans. And the CFPB is charged with implementing a rule for the statutory provision, but they haven't in the nine going on 10 years that Dodd-Frank has been the law. And it's been very difficult because the statutory language is difficult. It is very all encompassing, but at the same time, the bureau has a lot of exemptive authority.

Diego Zuluaga:

But with this change to the CRA definition of small business loans, I think we finally have scope to come up with a rule that will take advantage of the CRA and the CRA experience of evaluating banks in terms of defining what good performance is in order not to have to comply with this new provision of the Dodd-Frank Act. And I think that will mitigate a lot of the resistance from banks to the implementation of a rule by the CFPB.

Diego Zuluaga:

Specifically, what I mean is that because the CRA already collects small business loan data not at the loan level, but certainly at the level of geographic distribution and how well you're serving low-income borrowers, so on. You could come up with a rule where banks that don't do much small business lending, say banks under a billion dollars in assets, which collectively do less than 10% of small business lending in America, even though they account for 85% of institutions, would be exempt from this duty. And so would larger banks that have a satisfactory or higher rating under the CRA.

Diego Zuluaga:

So in this way, you can actually get financial inclusion legislation to work together rather than add up on top of each other in a way that can be damaging both to bank profitability, but ultimately to their lending as well, because they will be reluctant to lend in places where they don't think the regulatory compliance justifies the additional profit. So I think that particular change may facilitate things. And I'm going to be elaborating on that because it's a potentially momentous development.

Alan Kaplinsky:

Yeah. Now, there's been I would fairly describe it as an outcry by a number of consumer advocates who claimed that this CRA proposal is very industry friendly, but is very harmful to consumers. That it doesn't help low and moderate income consumers. And some of them give as examples the building of a stadium in a low and moderate income neighborhood. And they say, "How could that possibly be one of the things contemplated by commerce when they enacted the CRA to help low and moderate income individuals?" How do you respond to that Diego?

Diego Zuluaga:

Well, the first response is that if you worry about that, you should really be worried about current CRA regulations most of all. Because for the reasons I described earlier, the most important metric by which banks are currently evaluated under the CRA is their lending in low-income neighborhoods. And a lot of the points they've been getting account not for lending to low-income borrowers, but actually to high-income borrowers moving to low-income areas. So if you're worried about people who are not the target of the CRA being helped by the CRA, you should be worried about the existing regulations and actually support this move away from that kind of evaluation that the proposal encourages.

Diego Zuluaga:

On top of that, I probably sympathize with, in fact I really do sympathize with the idea that you shouldn't count lending to public projects like stadiums, even if they are in low-income areas or other kinds of activities, that are not directly related to low-income communities as part of the CRA. But it is part of the definition given in the statute, because banks have to serve the convenience and needs of their communities. So regulators can very well interpret that to mean not only lending and mortgages and small business loans to low-income borrowers, but also to lend for projects that will provide for job creation and will provide for a more vibrant community where more activities happen, than where the sports activities or facilities that will enable social interaction and various other things.

Diego Zuluaga:

So if you support the spirit of the CRA, eventually you run up against the problem that a lot of activities are 'community development' activities. And even those that come across as frivolous, such as these can qualify. So we probably have to redefine the statute and be much more specific if we want to move away from that kind of evaluation. But on the whole, I

think the criticism is misplaced. Because clearly, the CRA proposal moves away from rewarding lending to people who are not low-income and underserved household.

Alan Kaplinsky:

Right. Now, you had mentioned at the outset of our podcast, that there were three regulators that deal with the CRA. The OCC, the FDIC, and the fed. And that the fed did not join in the proposal of the FDIC and the comptroller. Do you have any idea why they didn't join? And is that going to be a major problem, if they end up either keeping the old regs or coming out with their own proposal? Aren't you going to have some banks that might switch charters in order to be mainly regulated by one regulator or the other because of CRA differences?

Diego Zuluaga:

Yeah. Well I mean, it's somewhat of a baffling development. For months, we've known that the fed wasn't going to sign up to this proposal. The main governor who has led on the CRA specifically is Lael Brainard. And she has I think for some time been skeptical of comptroller Otting's suggestion of different ways to evaluate this metric based approach, this move away from branches as the main reference for CRA evaluations.

Diego Zuluaga:

But I'm frankly surprised that they didn't sign up to the proposal or try to contribute to whatever proposal the other two regulators were coming up with. Because the fed is the smallest CRA regulator. It only covers about 16% of banks by assets. But it is nonetheless a significant one because it has overarching responsibility for the financial system. It's the big systemic regulator. And it evaluates the largest banks for their performance, according to those regulations.

Diego Zuluaga:

But it's also important to keep consistency in regulation across regulators. The fed regulates the larger among the small banks in America. So to give a sketch of where the regulatory perimeter of each regulator falls, the OCC is responsible for the federally chartered banks. What I call the national banks. Which includes the largest banks in the country as well as a lot of the regional banks. The FDIC is responsible for the 4,000 odd very small banks that we still have in America. So banks under a hundred million dollars in assets, banks under a billion dollars in assets. Very small by any international comparison.

Diego Zuluaga:

And the fed is somewhat stuck in the middle there. It's the banks that are sort of anywhere between 500, 600 million, and $5 billion in assets. So these are the banks that are candidates to potential growth to merging with other institutions, to actually having the ability to compete in the future. In a way, perhaps that the smallest banks that are exempt anyway from a lot of the CRA tests would not be able to do. So I was surprised that the fed wouldn't be more forward-looking in trying to change CRA regs so as to facilitate that kind of growth.

Diego Zuluaga:

So I do think it can present problems. I don't regulatory arbitrage such as you described is necessarily a likely consequence. Because there are significant other changes that you would have to undergo to be evaluated by somebody else under the CRA. So if you're currently regulated by the fed, you will be a state chartered bank that is a member of the Federal Reserve System. So you would have to either no longer be a member of the Federal Reserve System, or become a national bank to change CRA regulator. And I think the headache would be too great. So I don't think there's going to be necessarily movement there, but there's going to be potentially inconsistency if you have an OCC regulated bank trying to merge with a fed regulated bank, or vice versa. So that kind of uncertainty can be damaging, even if the intentions of both regulators are good. And even if the final rule is good and successful.

Alan Kaplinsky:

Right. You alluded to something that I thought we ought to maybe emphasize a little bit more Diego. And that is that small banks can elect to opt out of this regulation and remain governed by the existing reg. Can you describe what that threshold is and why was that exemption provided? And do you think it's a good idea from a policy standpoint?

Diego Zuluaga:

Sure. So currently, banks that are considered small or what's called small intermediate, that's banks under $300 million in assets, thereabouts. Or $1.2 billion in assets thereabouts, are subject to a more simplified version of CRA evaluations. They typically just have to perform according to some lending test. Regulators will look at their mortgage and small business lending. Not even the small business lending oftentimes, just mortgage lending, and give them a rating on that basis.

Diego Zuluaga:

And because we have so many tiny banks in America, I think the FDIC specifically was worried about moving to a new compliance regime that banks would struggle to adapt to. And which would potentially seize to count some of the activities that they currently have, or they're currently performing, in a way that would further make it difficult for them to compete in the future.

Diego Zuluaga:

So the way that the proposal has introduced an exemption is by giving banks under $500 million in assets. And that would cover about 3,800, 4,000 banks in the United States out of 5,000 odd banks. So about 80% of the smallest banks in America would be covered by this. They now have the choice as to whether to comply with the existing simplified version of CRA evaluations that they have. Or with the new, more quantitative tests.

Diego Zuluaga:

And I think that's good. I think it's a way of appeasing a potential resisting group to CRA modernization. And I think it doesn't really harm the purpose of the CRA very much. Because the current CRA regulations that look specifically at lending for very small banks were designed for banks of that nature. Precisely the problem has been that so many other banks have grown a lot. So their activity wasn't so well taken account of. So on the whole, I think that exemption is not particularly harmful, and I think it can be constructed.

Alan Kaplinsky:

So I have one more question I'd like to ask you. And that is, I get the impression that overall, you're pleased with where the OCC and the FDIC have gone. Of course, this is not a final reg. It's only a proposed reg. Do you have any specific suggestions on what the OCC and the FDIC ought to do before they actually finalize the reg?

Diego Zuluaga:

Sure. I think they should have another look at lending ratios. And some of the specifics, I will be writing my own response to this. But I think some of the very intricate relationships that they've posited in mortgage lending and small business lending between competitors and between a specific bank's loans and their deposits. I think those may come back to bite them if they don't either come up with very simple ratios that can be used as a compliment to the existing evaluations. Or if they make them so lax that they can actually take account of changing dynamics and the evolving competitive market and so on. That's my first criticism or constructive criticism, so to speak, having another look at those.

Diego Zuluaga:

I think bringing the fed around is going to be very important. And I wonder if extending the exemption by under which banks would have choice as to which of the two sets of regs to comply with in future to for example, a billion dollars. And that would cover 4,600 banks, including most of those regulated by the fed, whether that might disarmament the fed's objection.

Diego Zuluaga:

And then finally, I think we need to move away from looking at bank lending only as a measure of access to credit and financial inclusion in a community. That is not something really that CRA regulations can easily do, because CRA regulations apply only to banks by definition. But I think as the treasury and policy makers work on how to better define financial wellbeing and inclusion in low-income communities in America, they should look much more broadly at how new technologies are making it easier to access credit outside of banks. How new technologies are also making it easier for underserved households to demonstrate their credit worthiness to potential lenders. Be it peer-to-peer, or online, or even new banks, more sophisticated banks and so on. And in that way, we can actually move away from looking at individual pieces of legislation and much more at how do you bring about an environment in which people have access to credit that they can actually pay back and that will benefit them in future.

Alan Kaplinsky:

Okay. Well Diego, once again, thank you very much for participating in our show today. Your insight into the CRA and how it has been interpreted currently, and what the regulators, at least two of the regulators are thinking of doing is very insightful, very helpful. And I look forward to having you back on our show again, once we have a final reg. I'm hopeful that the regulators act quickly here. So thank you again for being on our program.

Diego Zuluaga:

Thanks, Alan. It's always great to be with you. And I'm looking forward to the next installment, whatever our topic is. Thank you.

Alan Kaplinsky:

Okay. So I also want to thank all of our listeners who downloaded the program today. Make sure you visit our website, www.ballardspahr.com, where you can subscribe to our podcast show in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform.

Alan Kaplinsky:

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