November 19, 2018

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E–218
Washington, DC 20219

Re: Reforming the Community Reinvestment Act Regulatory Framework
Docket ID OCC–2018–0008

To Whom It May Concern:

I appreciate the opportunity to comment on the Office of the Comptroller of the Currency's (OCC) advance notice of proposed rulemaking on reforming the Community Reinvestment Act (CRA) regulatory framework.

The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace. Cato's Center for Monetary and Financial Alternatives, at which I am a policy analyst, is dedicated to revealing the shortcomings of today's centralized, bureaucratic, and discretionary monetary and financial regulatory systems and to identifying, studying, and promoting alternatives more conducive to a stable, flourishing, and free society. I thank Comptroller Otting and the OCC for their leadership in the discussion of how regulation needs to change to better promote financial inclusion.

The Community Reinvestment Act is a 41-year-old statute that requires depository institutions "to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business […] consistent with the safe and sound operation of such institutions."[1] The CRA seeks to improve the welfare of low- and moderate-income (LMI) Americans by assessing and rating depository institutions on the basis of how much they lend to, invest in, and serve the communities in which LMI Americans live. Racial minorities were and continue to be overrepresented among LMI communities, so the CRA is considered part of the anti-discrimination legislation of the late 1960s and 1970s.[2]

For its first 18 years of existence, the CRA was "a vague statement of principle without much real-world effect."[3] Notably, a series of investigative articles in the *Atlanta Journal-Constitution* in 1988 documented large and persistent differences in the amount of bank credit extended to majority black communities compared to majority white ones.[4] The reports uncovered evidence of redlining, that

[1] 12 U.S. Code § 2901.
[2] Raymond H. Brescia, "Part of the Disease or Part of the Cure: The Financial Crisis and the Community Reinvestment Act," 60 *University of South Carolina Law Review* 617 (2009), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1392843.
[3] Jonathan R. Macey and Geoffrey P. Miller, "The Community Reinvestment Act: An Economic Analysis," *Virginia Law Review*, Vol. 79 No. 2 (March 1993): 292-348, https://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2662&context=fss_papers.
[4] Bill Dedman, "The Color of Money." Available on www.powerreporting.com/color.

is, the denial of services to poor and minority geographies.[5] However, it was only after 1995, when changes to CRA enforcement shifted the focus from banks' *ex ante* lending commitments to actual lending outcomes, that an increase in bank lending and other activities in LMI communities became observable.[6]

But whether this increase was beneficial on net is unclear. There is evidence that CRA-regulated institutions engage in significantly riskier lending in advance of CRA assessments, compromising their safety and soundness.[7] Such risky lending, which results in higher rates of default, harms the financial well-being of the borrowers who struggle to repay. The use of CRA ratings in regulators' deliberations on bank mergers also creates incentives for inefficient lending and may distract attention from more important factors for consumer welfare, such as local bank competition.[8]

There are other reasons to question the present-day usefulness of the CRA. This submission argues that the Act is ill-defined in its policy objectives, arbitrary in its assessment practices, and likely to harm borrowers and bank depositors. The disappearance of regulatory barriers to branching and the growth of online lenders have, on the other hand, increased access to banking services, helping to more efficiently achieve the goals of CRA-like regulation to serve low- and moderate-income communities. Although the case for repealing the CRA is strong, if repeal is not possible the current system of ambiguous and compliance-heavy assessment should at least be replaced with a system of tradable obligations related to the lending, investment, and services that the CRA seeks to encourage.[9]

Background

The Community Reinvestment Act became law in 1977. It was an attempt to reduce credit discrimination and improve access to financial services by poor and minority communities, along with the Fair Housing Act (FHA, 1968), Equal Credit Opportunity Act (ECOA, 1974), and Home Mortgage Disclosure Act (HMDA, 1975).[10] The CRA applies to all insured depository institutions except credit unions.[11] It is enforced by the eligible institution's primary regulator, which may be the OCC, the Board of Governors of the Federal Reserve System (FRB), or the Federal Deposit

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[5] Redlining is "the practice of denying services, either directly or through selectively raising prices, to residents of certain geographies." See Department of the Treasury, "Memorandum for the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation: Community Reinvestment Act – Findings and Recommendations," April 3, 2018, https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf.

[6] Richard Marsico, "Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act," New York Law School Research Paper 14, January 2005, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=651482.

[7] Sumit Agarwal, Efraim Benmelech, Nittai Bergman, and Amit Seru, "Did the Community Reinvestment Act (CRA) Lead to Risky Lending?," *Kreisman Working Papers Series in Housing Law and Policy No. 8*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2172549.

[8]Calomiris, Charles W., and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*(Princeton: Princeton University Press, 2014), document the ways in which CRA influenced regulators' decisions on bank mergers.

[9] Michael Klausner, "A Tradable Obligation Approach to the Community Reinvestment Act," in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, Federal Reserve Banks of Boston and San Francisco, September 2009, https://www.frbsf.org/community-development/files/revisiting_cra.pdf.

[10] Brescia, "Part of the Disease or Part of the Cure."

[11] Office of the Comptroller of the Currency, "Fact Sheet: Community Reinvestment Act," March 2014, https://www.occ.treas.gov/topics/community-affairs/publications/fact-sheets/fact-sheet-cra-reinvestment-act.pdf.

Insurance Corporation (FDIC).[12] Since 1990, regulators' assessments of CRA-eligible institutions have been available to the public, enabling activist groups to use those assessments to oppose bank expansions and mergers on the grounds that the bank is failing to lend sufficiently in the communities where it operates.[13]

CRA regulations assess bank lending to low- and moderate-income borrowers.[14] LMI borrowers are those with an income of less than 80 percent of the assessment area median, and those living in census tracts with an income that is 80 percent or less than the area median, as determined by the Census Bureau.[15] Assessment areas consist of one or more metropolitan statistical areas (MSAs) or metropolitan divisions (MDs) where an institution subject to the CRA has its main office, branches, and deposit-taking automatic teller machines (ATMs), as well as surrounding areas where the institution has originated or purchased a substantial portion of its loans.[16]

In 1995, the CRA underwent a significant reform which shifted assessment from process – what a bank's plans were for increasing lending to LMI communities – to outcomes – how much LMI lending it actually extended.[17] This reform also created separate assessment tiers for banks of different asset sizes, lengthening the time between assessments for smaller banks. In 2005, those tiers were indexed to the Consumer Price Index.[18] Since the 1995 reforms, regulators have assessed eligible institutions with a three-pronged test of their lending, investment, and services to LMI customers and communities. Of the three prongs, the lending test is the most important. No institution can receive an overall "satisfactory" CRA rating unless it scores at least "low-satisfactory"[19] on the lending test.[20] Between 2006 and 2014, no more than 3.5 percent of CRA-eligible institutions received an overall rating below "satisfactory" in any year.[21]

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[12] 12 U.S. Code § 2901.

[13] Macey and Miller, "An Economic Analysis."

[14] However, financial institutions face uncertainty about individual LMI loans' eligibility for CRA credit. See *ABA Banking Journal Podcast*, "Key Points on CRA Modernization," American Bankers Association, November 14, 2018, https://bankingjournal.aba.com/2018/11/bonus-podcast-key-points-on-cra-modernization/.

[15] Ben Horowitz, "Defining 'Low- and Moderate-Income' and 'Assessment Area,'" Federal Reserve Bank of Minneapolis, March 8, 2018, https://www.minneapolisfed.org/publications/community-dividend/defining-low--and-moderate-income-and-assessment-areas.

[16] 12 C.F.R. § 25.41.

[17] Brescia, "Part of the Disease or Part of the Cure."

[18] Ibid.; Darryl E. Getter, "The Effectiveness of the Community Reinvestment Act," Congressional Research Service, January 7, 2015, https://www.newyorkfed.org/medialibrary/media/outreach-and-education/cra/reports/CRS-The-Effectiveness-of-the-Community-Reinvestment-Act.pdf.

[19] CRA score definitions are discretionary and qualitative. For an explanation of the FDIC's definition of each score, see Federal Deposit Insurance Corporation, "CRA Ratings System," *FDIC Compliance Manual*, https://www.fdic.gov/regulations/compliance/manual/11/xi-7.1.pdf.

[20] William C. Apgar and Mark Duda, "The Twenty-Fifth Anniversary of the Community Reinvestment Act: Past Accomplishments and Future Regulatory Challenges," *Federal Reserve Bank of New York Economic Policy Review* (June 2003), https://www.newyorkfed.org/medialibrary/media/research/epr/03v09n2/0306apga.pdf.

[21] Getter, "The Effects of the CRA."

The CRA was flawed at its inception

Its local bias undermines loan diversification

When the CRA became law in 1977, policymakers worried about "capital export" by financial institutions.[22] Capital export refers to the practice of lending deposits outside of the communities where those deposits are collected. CRA proponents argued that depository institutions, which since 1933 have enjoyed federal deposit insurance, had an obligation to lend to the communities where they took deposits.[23] The idea that loanable funds should remain in the areas where the creditors live is a long-standing one in American banking. It informed the persistence of regulatory restrictions on intra- and inter-state branching well into the 1980s.[24]

Economically, the practice of confining savings to the localities where they are collected is very costly. A useful function of banks is to pool depositor savings and to deploy those funds as loans. Pooling facilitates beneficial diversification: where individuals acting on their own could only commit funds to one or a handful of projects, exposing themselves to the specific risks of those borrowers, banks allocate funds among hundreds of thousands of different lending opportunities. Diversification reduces portfolio risk for a given level of returns. It helps depositors earn more at lower risk.[25]

Geographic diversification also makes bank failure less likely. One of the reasons that 9,100 banks suspended operations during the Great Depression was the prevalence of unit banking, which made a unit bank's fortunes wholly dependent on economic conditions in its local community.[26] Banks with multiple branches, on the other hand, could offset losses in some hard-hit areas with earnings from relatively less affected ones. Branch banking made California's banking system more stable and efficient than it would otherwise have been.[27] Another example is the Canadian banking system—characterized by a small number of much larger banks—which has exhibited a great deal of stability over 150 years, without detriment to depositor rates of return.[28] According to the World Bank's Findex database of financial inclusion, Canada also has higher rates of deposit and savings account use than the United States.[29]

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[22] Brescia, "Part of the Disease or Part of the Cure."

[23] Community Credit Needs: Hearings on S.406 Before the Senate Committee on Banking, Housing and Urban Affairs, 95th Congress (1977), statement of Chairman Proxmire, https://babel.hathitrust.org/cgi/pt?id=mdp.39015078092130;view=1up;seq=15.

[24] Calomiris and Haber, *Fragile by Design*, discuss the agrarian populist tradition in U.S. banking history. On the prevalence of credit localism in the American imagination, see Macey and Miller, "An Economic Analysis."

[25] Ross Levine, "Finance and Growth: Theory and Evidence," *Handbook of Economic Growth*, Volume 1A, eds. Philippe Aghion and Steven Durlauf (Amsterdam: North Holland, 2005), https://www.nber.org/papers/w10766.pdf.

[26] Charles A. Calomiris and Joseph R. Mason, "Fundamentals, Panics, and Bank Distress During the Depression," *American Economic Review* Vol. 93 No. 5 (December 2003): 1615-1647, https://www.aeaweb.org/articles?id=10.1257/000282803322655473.

[27] Mark Carlson and Kris James Mitchener, "Branch Banking as a Device for Discipline: Competition and Bank Survivorship during the Great Depression," *Journal of Political Economy* Vol. 117 No. 2 (April 2009): 165-210, https://www.jstor.org/stable/10.1086/599015?seq=1#metadata_info_tab_contents.

[28] Michael D. Bordo, Hugh Rockoff, and Angela Redish, "The U.S. Banking System from a Northern Exposure: Stability versus Efficiency," *The Journal of Economic History* Vol. 54, No. 2 (June 1994): 325-341, https://www.jstor.org/stable/2123916?seq=1#metadata_info_tab_contents.

[29] See http://datatopics.worldbank.org/financialinclusion/country/canada. The comparison is imperfect because of differences in bank legislation.

The CRA undermines risk diversification by implicitly requiring that a share of deposits be lent out where the deposits are collected.[30] Furthermore, and contrary to the philosophy that informed the CRA, the deposit-taking activities of banks benefit communities quite apart from any related lending operations. Deposit facilities give their holders access to the benefits of loan diversification. They also contribute to depositors' credit histories, facilitating future use of other credit products. Finally, deposit accounts give depositors a return on their funds, either in the form of free banking services, or explicitly as regular interest payments.

It is difficult to picture a scenario in which political direction of bank lending can improve over the allocation resulting from market prices: if attractive projects in the local community can yield an adequate return for a given risk, there is no need for a political directive to mandate such lending. If there are better opportunities elsewhere, such a mandate is harmful to depositor returns and banks' safety and soundness. Proponents of the CRA in the 1970s and 1980s argued that bank redlining warranted political intervention. But, as argued below, CRA regulations may be undermining the financial inclusion of LMI communities in today's much-changed banking environment.

The CRA cannot solve instances of "rational redlining"

Even some CRA critics believe that legislation might be justified if informational asymmetries specific to LMI communities lead banks to ration credit more than they do elsewhere—what one author calls "rational redlining."[31] For example, credit rationing can occur because an insufficient amount of local transactions takes place, leading to more uncertain home appraisals. Uncertain appraisals raise the down payments demanded by banks, further dampening loan volumes.[32]

However, even if rational redlining is a problem in some present-day LMI communities, CRA regulations can only be of limited help. The CRA's assessment policy relates lending to deposit-taking. But if banks are taking deposits in a community, they are likely to have access to information about credit quality, local economic conditions, and property values. Conversely, those lenders that lack such information are unlikely to have operations or take deposits in that community, precisely because they face uncertainty regarding available business opportunities. In either case, CRA regulations cannot effectively address rational redlining.

The changing U.S. banking landscape

The OCC's advance notice of proposed rulemaking points out two structural trends in U.S. banking that underscore the case for CRA review: bank consolidation as a result of the removal of branching restrictions and the growing market share of online (fintech) lenders.[33] Both of these trends cast

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30 Some pre-crisis reform proposals argued for explicit market share and loan-to-deposit ratios to be used in CRA assessment. Their use would have increased the Act's credit allocative role. See Marsico, "Democratizing Capital."

31 Michael Klausner, "Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act," University of Pennsylvania Law Review, Vol. 143 (1995): 1561-1593, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3575&context=penn_law_review.

32 William W. Liang and Leonard I. Nakamura, "A Model of Redlining," *Journal of Urban Economics*, Vol. 33 No. 2 (March 1993): 223-234, https://www.sciencedirect.com/science/article/pii/S0094119083710144.

33 Office of the Comptroller of the Currency, "Reforming the Community Reinvestment Act Regulatory Framework," Advance Notice of Proposed Rulemaking, Office of the Federal Register, September 5, 2018, p. 45054 https://www.federalregister.gov/documents/2018/09/05/2018-19169/reforming-the-community-reinvestment-act-regulatory-framework.

doubt upon the usefulness of existing assessment practices and weaken the case for the CRA altogether.

Branching has increased competition and choice

The liberalization of intra- and inter-state branching that began in the 1980s and culminated in 1994 with passage of the Riegle-Neal Act has led to rapid bank consolidation.[34] The number of FDIC-insured commercial banks peaked at 14,496 in 1984. By the time Riegle-Neal was passed, it stood at 10,453, dropping to 7,279 on the eve of the financial crisis, and 4,918 by the end of 2017. The number of branches, on the other hand, had expanded to 79,168 by 2017, which is only slightly lower than the 2009 peak of 83,130.[35] This means that the number of bank offices (headquarters plus branches) is much higher today than at any time before the trend of consolidation started—albeit below the number just before the financial crisis.

Table 1. FDIC-Insured Commercial Banks, their Branches and Offices

Year	Institutions	Branches	Offices
1984	14,496	42,731	57,227
1994	10,453	55,115	65,568
2007	7,279	79,269	86,548
2017	4,918	79,163	84,081

Source: FDIC, 2018.

The CRA was passed during a period of extensive branching restrictions. At the time, there was a worry that communities where the locally headquartered bank did not lend might have struggled to find a competing supplier. In addition, Regulation Q—which between 1933 and 1986 set an interest-rate ceiling on bank savings deposits, and until 2011 banned interest on demand deposits—subsidized bank funding, creating rents for banks and strengthening the case for local lending mandates.[36] However, those rents were a product of interest-rate controls and could have been better addressed by repealing Regulation Q sooner. At any rate, the rationale for community reinvestment that Regulation Q provided disappeared with its repeal.[37]

The steady growth in bank offices since branching deregulation illustrates that bank competition has increased as a result of deregulation. More banks serve individual communities, making deposit rates more competitive, increasing loan options, and otherwise raising consumer welfare.[38] An illustration

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[34] H.R. 3841 – Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, https://www.congress.gov/bill/103rd-congress/house-bill/3841.

[35] Federal Deposit Insurance Corporation, "Number of Institutions, Branches and Total Offices," https://www5.fdic.gov/hsob/HSOBRpt.asp.

[36] R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," Federal Reserve Bank of St. Louis, February 1986, https://files.stlouisfed.org/files/htdocs/publications/review/86/02/Requiem_Feb1986.pdf.

[37] 76 FR 42015.

[38] Katherine Ho and Joy Ishii, "Location and Competition in Retail Banking," *International Journal of Industrial Organization*, Vol. 29, Issue 5 (September 2011): 537-546, https://www.sciencedirect.com/science/article/pii/S0167718710001372; Astrid A. Dick, "Nationwide Branching and Its Impact on Market Structure, Quality, and Bank Performance," *Journal of Business*, Vol. 79, No. 2 (March 2006): 567-592, https://www.jstor.org/stable/10.1086/499131?seq=1#metadata_info_tab_contents, finds that local competition was

of this expansion of choice is the long-run trend of increase in the average distance between small business borrowers and lenders, from 100 miles in 1996 to 250 miles by 2016.[39] When prospective borrowers have access to more distant lenders, the local bank's willingness to lend can no longer determine whether borrowing will occur.

Online lenders are helping to solve the problem of asymmetric information

The growth of online lending is important for two reasons. First, it has led to a decline in the loan market share of depository institutions subject to the CRA.[40] The state of CRA lending has thus become less representative of overall lending conditions in LMI communities. Second, online lenders have devised ways to allocate credit profitably and competitively without an established relationship with prospective borrowers. Indeed, recent evidence suggests that online lenders can allocate credit more efficiently – with higher loan volumes at lower interest rates – than depository institutions.[41] Online lending has therefore reduced the potential for asymmetric information to lead to rationing in local credit markets.[42]

Together, freer local bank entry thanks to branching liberalization and the advent of online lending have increased competition, reducing the potential for persistently low lending in LMI communities. Market developments are therefore solving the primary issue that the CRA has attempted to address. Additionally, racial desegregation of inner-city neighborhoods, itself a welcome development, has weakened the link between geography and CRA-targeted populations: minorities and LMI households.[43] This trend has further undermined the CRA's effectiveness in promoting lending to vulnerable communities.

Beyond redlining: contemporary policy issues in LMI lending

At the time of the CRA's passage, there was a concern that certain depository institutions would systematically refuse to lend to minority communities, even when doing so did not mean taking on

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unaffected by deregulation, but that consumers benefited from larger fee-free networks and the broader range of services offered by larger institutions.

39 João Granja, Christian Leuz, and Raghuram Rajan, "Going the Extra Mile: Distant Lending and Credit Cycles," NBER Working Paper 25196, National Bureau of Economic Research, https://www.nber.org/papers/w25196.pdf. Other scholars have noted a similar increase in the distance between borrower and lender in mortgage markets. See James Charles Smith, "The Structural Causes of Mortgage Fraud," *Syracuse Law Review*, Vol. 60 (2010): 473-503, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1652910.

40 Apgar and Duda, "The Twenty-Fifth Anniversary of the CRA."

41 Julapa Jagtiani and Catharine Lemieux, "The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform," Federal Reserve Bank of Philadelphia Working Paper 18-15, April 2018, https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2018/wp18-15.pdf.

42 Klausner, "Market Failure and Community Investment." Klausner cites the canonical credit-rationing model in Joseph E. Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information," *American Economic Review*, Vol. 71 No. 3 (June 1981): 393-410, https://www.jstor.org/stable/1802787?seq=1#metadata_info_tab_contents.

43 For example, CRA lending in the historically black Philadelphia neighborhood of Point Breeze seems to be reaching mostly newer (and better-off) white residents. But these loans still count for CRA assessment purposes. See Aaron Glantz and Emmanuel Martinez, "Gentrification Became Low-Income Lending Law's Unintended Consequence," *RevealNews.org*, February 16, 2018, https://www.revealnews.org/article/gentrification-became-low-income-lending-laws-unintended-consequence/.

undue credit risk.[44] Investigative reporting, notably by the *Atlanta Journal Constitution*, continued to expose redlining years after the CRA's passage.[45] However, 41 years later, the barriers to the financial inclusion of low-income and minority communities are different. The CRA not only fails to address those barriers but may contribute to the difficulty of overcoming them.

LMI and minority communities are overrepresented among the unbanked

According to the FDIC, as of 2017 there are 8.4 million U.S. households (6.5 percent of all households) without a bank account. Another 24.2 million have only limited access to banking services and must instead resort to alternative—usually costlier—providers.[46] Unbanked rates are much higher for minorities: 16.9 percent for black households and 14 percent among Hispanic ones, compared to three percent for whites. Additionally, more than half of black and Hispanic households with incomes below $30,000 report no mainstream source of credit.[47]

Two commonly cited reasons for lacking a bank account are not having enough money to deposit and account fees' being too high.[48] A driver of both account fees and minimum deposit amounts to avoid those (and other) fees are increasing regulatory compliance costs. A recent survey of community banks found that the CRA accounts for 7.2 percent of their compliance costs.[49] This percentage is much lower than the share taken up by the Bank Secrecy and Truth in Lending Acts. But it is still significant, especially considering that overall bank compliance costs have increased in recent years.[50] Thus, while it might appear that the CRA improves LMI financial inclusion by mandating lending, its indirect impact on account charges likely reduces access to deposit and credit services by LMI and minority households.

The proliferation of "banking deserts" hurts LMI communities most

The decline of small banks, further bank consolidation since the financial crisis, and rising compliance costs have all contributed to the phenomenon of so-called "banking deserts"—census tracts with no bank branches within a 10-mile radius of their centers.[51] 3.7 million Americans live in such banking deserts, while another 3.9 million live in areas that may lose their last bank office.[52] Banking deserts are mostly rural and therefore do not account for a large share of the unbanked

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[44] Raymond H. Brescia, "The Community Reinvestment Act: Guilty, but Not as Charged," *St. John's Law Review*, Vol. 88, No. 1 (Spring 2014): 1-38, https://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?article=6669&context=lawreview.
[45] Dedman, "The Color of Money."
[46] Federal Deposit Insurance Corporation, "National Survey of Unbanked and Underbanked Households, 2017," https://www.fdic.gov/householdsurvey/2017/2017report.pdf.
[47] Ibid.: "A household is considered to have used mainstream credit if it used [a credit card; a personal loan or line of credit from a bank; a store credit card; an auto loan; a student loan; a mortgage, home equity loan, or home equity line of credit (HELOC); or other personal loans or lines of credit from a company other than a bank] in the past 12 months."
[48] Ibid.
[49] Federal Reserve Bank of St. Louis, "Compliance Costs, Economies of Scale and Compliance Performance," April 2018, https://www.communitybanking.org/~/media/files/compliance%20costs%20economies%20of%20scale%20and%20compliance%20performance.pdf.
[50] Ibid.
[51] Drew Dahl and Michelle Franke, "'Banking Deserts' Become a Concern as Branches Dry Up," Federal Reserve Bank of St. Louis, Q2 2017, https://www.stlouisfed.org/publications/regional-economist/second-quarter-2017/banking-deserts-become-a-concern-as-branches-dry-up.
[52] Michelle Franke, "Who Would Be Affected by More Banking Deserts?," Federal Reserve Bank of St. Louis, July 17, 2017, https://www.stlouisfed.org/on-the-economy/2017/july/who-affected-more-banking-deserts.

population.[53] Nevertheless, some states with a high population share living in banking deserts, such as Arizona, Nevada, and New Mexico, also have above-average unbanked rates.

Banking deserts have lower median incomes than non-deserts. Median household incomes of potential banking deserts are 10 to 20 percent below the nationwide median.[54] Households in, or likely to soon end up in, banking deserts thus tend to have incomes below the U.S. median.

Growing regulatory compliance costs are a key factor driving up the cost of operating bank branches.[55] CRA regulations worsen the problem of banking deserts by discouraging the establishment of bank branches and ATMs in sparsely populated areas. Without the implicit lending requirements of the CRA, depository institutions might be more willing to take deposits in and serve low-density geographies. But CRA reporting requirements might discourage them from expanding to areas with few lending opportunities.

Predatory lending is a bigger problem than redlining for LMI communities

The financial crisis brought to light the extent to which many households, particularly LMI ones, had taken on large housing debts.[56] There is considerable evidence that the push, starting in the mid-1990s, to extend mortgage lending to LMI communities—with the guarantee that government-sponsored entities (GSEs) Freddie Mac and Fannie Mae would buy the mortgages—drove that increase.[57] The extent to which the CRA is responsible for unprofitable lending to LMI households remains a matter of debate, but CRA commitments between 1992 and 2007—totaling $4.5 trillion—and affordable housing loans by the GSEs in excess of their historical norm track each other closely.[58]

Even if the CRA was not the main contributor to bad mortgage credit growth in the run-up to the crisis, it may have enabled the proliferation of credit by giving aggressive lending practices the respectable cover of community reinvestment. Pre-crisis accounts of the CRA's "success" support this hypothesis, as they focus on the growth of LMI lending and homeownership, rather than its suitability for borrowers or its implications for bank safety and soundness.[59] Testimony by community organization representatives before the financial crisis explicitly pointed to more lenient underwriting and GSE standards as the product of the CRA.[60]

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[53] Donald P. Morgan, Maxim Pinkovskiy, and Davy Perlman, "The 'Banking Desert' Mirage," *Liberty Street Economics*, January 10, 2018, https://libertystreeteconomics.newyorkfed.org/2018/01/the-banking-desert-mirage.html.
[54] Franke, "Who Would Be Affected by More Banking Deserts?"
[55] This is both because higher fixed compliance costs induce consolidation, and because higher regulatory costs raise the required return on a bank branch. See Julie Stackhouse, "Why Are Banks Shuttering Branches?," Federal Reserve Bank of St. Louis, February 26, 2018, https://www.stlouisfed.org/on-the-economy/2018/february/why-banks-shuttering-branches.
[56] Edward J. Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study," American Enterprise Institute, May 2011, http://www.aei.org/wp-content/uploads/2010/10/Pinto-Government-Housing-Policies-in-the-Lead-up-to-the-Financial-Crisis-Word-2003-2.5.11.pdf.
[57] Calomiris and Haber, *Fragile by Design*.
[58] Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis."
[59] See, for example, Michael S. Barr, "Credit Where It Counts: The Community Reinvestment Act and Its Critics," *New York University Law Review*, Vol. 75, (May 2005): 101-233, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=721661.
[60] See, for example, National Community Reinvestment Coalition, "CRA Commitments," September 2007, https://community-wealth.org/sites/clone.community-wealth.org/files/downloads/report-silver-brown.pdf.

The financial crisis, however, illustrated the harm that a single-minded drive to increase mortgage lending could do to vulnerable communities. It was a surfeit of politically induced housing credit, rather than a scarcity of credit, that left households badly exposed when the crisis hit. Yet the CRA continues to assess depository institutions primarily on their lending to LMI areas, despite evidence that such lending is riskier.[61]

The CRA is a harmful form of industrial policy

A key way in which the CRA encourages bank compliance is by directing regulators to take CRA performance into account when evaluating an institution's application for a "deposit facility"—that is, whenever that institution wants to set up a branch or merge with another depository institution.[62] On the one hand, such use of CRA ratings encourages regulators and activist groups to oppose the applications of banks perceived to underperform in their lending to LMI communities. On the other hand, a good CRA record can trump other concerns, such as the impact of a large bank merger on local credit spreads, even if this impact is more economically significant.[63]

The CRA has thus become a tool of industrial policy, rewarding institutions for meeting political goals and punishing those who fall short. This facet of the CRA raises important concerns. First, it may reduce efficiency by blocking consolidation that would lower bank operating costs and increase diversification.[64] Foreclosing such efficiency-enhancing mergers would harm depositor returns and undermine bank safety and soundness. Second, the CRA may reduce competition if a bank merger gives the resulting institution sufficient market power to raise prices. This possibility is particularly worrying in the contemporary U.S. context of high regulatory barriers to entry in banking—due not least to CRA itself.[65]

CRA regulations weaken the incentive for banks to guard against unprofitable lending, if the benefits from easier consolidation are perceived to outweigh any losses made from CRA loans.[66] CRA commitments grew 511-fold in the 1992-2007 period compared to 1977-1991, suggesting that banks are willing to spend heavily to please their regulators.[67] Evidence also suggests that loans timed to coincide with banks' CRA evaluations are riskier than other loans.[68]

How can financial regulators best promote community development?

Credit volumes are an imperfect proxy, certainly not a substitute, for the welfare of communities and households. In 1977, the CRA focused on LMI lending because there was evidence of widespread redlining, abetted by nationwide restrictions on bank branching. Four decades later, the issues facing LMI communities are different. Moreover, the record of the CRA to date shows that it has created

[61] Agarwal et al., "Did the CRA Lead to Risky Lending?"
[62] 12 U.S. Code § 2903.
[63] Calomiris and Haber, *Fragile by Design*, cite the Fleet Financial-BankBoston merger of 1999 as an example where good CRA performance led the Fed to approve the merger despite concerns about its competitive effect.
[64] The steady trend of consolidation since passage of the Riegle-Neal Act and the still large number of small banks in America both suggest that some gains from economies of scale in U.S. banking remain to be grasped.
[65] Lawrence J. White, "The Community Reinvestment Act: Good Goals, Flawed Concept," December 18, 2008, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1434487%20.
[66] Macey and Miller, "An Economic Analysis."
[67] Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis."
[68] Agarwal et al., "Did the CRA Lead to Risky Lending?"

problems of its own and made other problems worse. Thus, the time is ripe for wide-ranging reform.

There are various other ways for regulators to increase credit availability to minorities at the local level, while also promoting bank safety and soundness.

Facilitate lender entry

One way to increase credit availability is to make entry into local lending markets easier, by issuing more charters and reducing regulatory barriers for non-depository institutions. The rate of new bank creation has slowed dramatically, from an average of more than 100 banks per year between 1990 and 2008, to just thirteen for the entire period since 2010.[69] While low interest spreads and a growing post-crisis regulatory burden account for some of the decline, the FDIC also toughened capital requirements for *de novo* banks in 2009, discouraging entry.[70] The economic expansion and new leadership at FDIC provide an opportunity to ease *de novo* charter policies.[71]

The growth of online lending shows that innovation, including innovation aimed at LMI markets, can also come from outside depository institutions. The OCC's proposed special purpose national bank charter for fintech firms can make nationwide operations by nonbank lenders easier, as the cost of state-by-state licensing and examinations can reach up to $30 million.[72] Unfortunately, policy uncertainty due to state-level legal challenges has so far discouraged firms from taking up the new charter.

Clearly define the goals of financial regulation

The objectives of the CRA remain vague and ill-defined. Regulators should clarify these objectives, both among themselves and to eligible institutions and community organizations. Is the goal of the CRA to fight lending discrimination, to increase lending in LMI communities, to raise living standards in LMI communities, or to achieve other public-interest goals?

If the CRA is supposed to fight discrimination, then the ECOA is a better tool, as it specifically addresses the disparate treatment of prospective borrowers according to race, gender, age, marital status, or other protected characteristics.[73] Together with HMDA, the ECOA can prevent lending discrimination in the mortgage market.[74] Both of these statutes involve compliance costs and

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[69] American Bankers' Association, "ABA Data Bank: Economic Recovery Leaving De Novo Banks Behind," September 28, 2018, https://bankingjournal.aba.com/2018/09/data-bank-economic-recovery-denovo/#_ga=2.123103299.972253470.1541449002-1656967743.1541449002.
[70] Robert M. Adams and Jacob P. Gramlich, "Where Are All the New Banks? The Role of Regulatory Burden in New Charter Creation," Federal Reserve Board, December 16, 2014, https://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.
[71] FDIC Chairman Jelena McWilliams recently indicated interest in easing *de novo* bank entry. See Jelena McWilliams, "Remarks at the Federal Reserve Bank of Chicago Thirteenth Annual Community Bankers Symposium 'Back to Basics,'" November 16, 2018, https://www.fdic.gov/news/news/speeches/spnov1618.html.
[72] Government Accountability Office, "Financial Technology: Additional Steps by Regulators Could Better Protect Consumers and Aid Regulatory Oversight," Report to Congressional Requesters, March 2018, https://www.gao.gov/assets/700/690803.pdf.
[73] 15 U.S. Code § 1691.
[74] 12 U.S. Code § 2803.

perverse incentives of their own, but unlike the CRA they focus on preventing the unfair treatment of individual vulnerable borrowers.[75]

Increasing lending is not a sound policy goal on its own, as it might encourage unprofitable loans that end up harming borrowers. If the goal of the CRA is to raise the real incomes of LMI communities, then a more diverse array of policies offers greater promise than loans by depository institutions. They range from liberalization of zoning laws to lower the cost of housing; a reduction in occupational licensing to facilitate employment and entrepreneurship; lower tariffs on food and clothing imports; to less strict childcare regulations.[76]

How should the CRA change if it is preserved?

There is reason to believe that the CRA is outdated and ill-suited to the present-day needs of LMI communities. The OCC is right to reexamine the CRA regulatory framework in light of recent market developments, but Congress should consider whether the Act is suitable given the changes in today's credit markets, or whether it is ripe for repeal. If the CRA is preserved, so that eligible institutions are expected to lend in LMI communities in proportion to other relevant activities in those communities, an approach that encourages the most efficient institutions to discharge CRA obligations would improve outcomes.

Should fintech firms be subject to the CRA?

The growth of online lending has led proponents of the CRA to call for its extension to "branchless" fintech lenders.[77] Such an extension would not be possible under the present CRA evaluation framework, which defines eligible assessment areas as those where institutions have offices, branches, or ATMs.[78] Moreover, the rationale for mandating "community reinvestment" by banks—that they enjoy government deposit insurance—fails to apply to fintech lenders.

The proposed extension would also have negative practical effects. Fintech lenders have gained a substantial foothold in mortgage lending over the last decade, owing to new regulations placed on banks and to a technological advantage.[79] Indeed, critics of the CRA warned of its potentially adverse impact on depository institutions' ability to compete not long after its passage.[80] Yet, subjecting fintech lenders to CRA regulation would discourage their participation in marginal lending markets, with an adverse impact on credit conditions and welfare in those communities, for

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75 For a recent survey of the problems with ECOA enforcement, see Daniel Press, "The CFPB and the Equal Credit Opportunity Act," Competitive Enterprise Institute, May 2018, https://cei.org/content/cfpb-and-equal-credit-opportunity-act.

76 See Ryan Bourne, "Government and the Cost of Living: Income-Based vs. Cost-Based Approaches to Alleviating Poverty," Cato Policy Analysis 847, September 2018, https://object.cato.org/sites/cato.org/files/pubs/pdf/pa_847.pdf, for a comprehensive discussion.

77 Kenneth H. Thomas, "Why Fintechs Should Be Held to CRA Standards," *American Banker*, August 24, 2018, https://www.americanbanker.com/opinion/why-fintechs-should-be-held-to-cra-standards.

78 12 CFR 25.41.

79 Greg Buchak, Gregor Matvos, Tomasz Piskorski, and Amit Seru, "Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks," NBER Working Paper 23288, September 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2941266. The authors find that 60 percent of the growth of "shadow banks" is due to regulation, while 30 percent is because of technology.

80 See, for example, Macey and Miller, "An Economic Analysis."

the same reasons that the CRA has discouraged depository institutions from participating in some of those markets.

The justification for the CRA was the underwriting of bank credit risk by federal deposit insurance.[81] Arguments to extend the CRA to non-deposit-taking firms would therefore not create a level playing field but would rather unduly broaden the scope of a statute whose contribution to welfare is questionable.

A cap-and-trade system for LMI loans

If the CRA is preserved, there is a better way to allocate the task of increased LMI lending and other financial services: a market for tradable CRA obligations.[82] Under this system, the regulator would define lending, investment, and services obligations among eligible depository institutions in an assessment area. Obligations could be allocated in various ways, but for consistency with present CRA practice it might be easiest to use local deposit market share. Lenders, including non-bank ones, would be able to buy CRA obligations from eligible banks in exchange for a fee.

A cap-and-trade system would have several advantages over current CRA enforcement. First, it would ask regulators to quantify the lending, investment, and services needs of LMI communities, introducing rigor into the assessment process and making explicit the community obligations of banks. As a result of trading in CRA obligations, a price would emerge to reflect the cost of fulfilling the Act's requirements.

Second, a system of tradable obligations would encourage specialization and competition among lenders, while ensuring that CRA obligations continue to be met.[83] Lenders from outside the assessment area, and non-CRA-eligible lenders, would have an incentive to participate in this market. As competition increased, the cost—that is, the market price for a representative obligation—of complying with the CRA would decline.

Third, tradable obligations would allow for a measure of portfolio diversification by CRA-eligible banks that is not possible at present because of the "capital export" rationale underpinning the 1977 Act.

Fourth, a system of tradable obligations would reduce assessment uncertainty for depository institutions. Instead of a mounting list of ill-defined objectives, banks would discharge their obligations either by lending and investing directly, or by paying more efficient competitors to do so on their behalf. This would reduce compliance costs for CRA-eligible firms, and evaluation costs for the regulator. Meanwhile, communities would get what they need—or at least, what regulators think they need.

Indeed, quantifying the CRA needs of individual communities will present an important challenge. The difficulty of ascertaining unmet yet profitable credit demand is precisely why developed

81 Barr, "Credit Where It Counts."
82 Klausner, "Market Failure and Community Investment."
83 Klausner, "A Tradable Obligation Approach."

financial systems largely rely on markets for credit allocation.[84] The CRA forecloses this possibility. The setting of CRA obligations by regulators is therefore likely to be undertaken in conjunction with banks and community groups. This form of decision-making is imperfect, as it would open regulatory compliance to interest-group pressures. But that is already the case under the current uncertain and compliance-heavy CRA. Moving to a cap-and-trade system would bring the benefits listed above while revealing the opportunity cost—in terms of both foregone loans, and safety and soundness—of the CRA.

Conclusion: What is the best way forward?

The lending landscape in the United States has changed substantially since the enactment of the CRA in 1977. The Act was written for a competitive environment shaped by branching restrictions. It took no account of the opportunities for technological innovation to expand financial services provision. Furthermore, the CRA is ill-suited to address the problems of unequal access to banking and credit as they currently affect low- and moderate-income borrowers.

In today's environment of widespread branching and diverse lending sources, the CRA has become a piece of legislation in search of a public policy role. Congress should consider whether preserving it justifies the costs outlined in this letter. The ECOA and other anti-discrimination legislation can better prevent financial exclusion. Supply-side policies outside of financial regulation stand a greater chance of improving living standards in LMI communities. Perhaps the time of the Community Reinvestment Act has simply passed.

Sincerely,

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[84] F.A. Hayek, "The Use of Knowledge in Society," *American Economic Review* Vol. 35 No. (September 1945): 519-530, https://www.jstor.org/stable/1809376?seq=1#page_scan_tab_contents.