Simpson Thacher

Memorandum

Treasury Department Issues Recommendations on Reforming the Community Reinvestment Act

April 4, 2018

On April 3, 2018, the U.S. Treasury Department issued a report detailing a number of recommendations for reforming and modernizing the Community Reinvestment Act of 1977 ("CRA") framework. The report, which follows through on the commitment made by Treasury in its June 2017 report to the President to review the current CRA framework, includes recommendations for (i) changing the way CRA geographic assessment areas are defined to reflect the changing nature of banking arising from changing technology, customer behavior, and other factors; (ii) improving the CRA performance evaluation criteria to increase the transparency and effectiveness of CRA rating determinations; (iii) harmonizing CRA-related oversight and improving the CRA examination process; and (iv) improving how banks' CRA performance is incentivized to improve the benefit to communities.

The report reflects Treasury's assessments of how the CRA could be improved after soliciting input and meeting with close to 100 stakeholders, representing community and consumer advocates, academics and think tanks, financial institutions, trade associations, and law firms. A number of the recommendations will require specific action by, or significant coordination among, the federal banking agencies charged with administering the CRA, while a small number of recommendations (such as shortening CRA examination cycles for small banks) would require legislative action.

This memorandum provides a high-level summary of Treasury's key recommendations for reforming and modernizing the CRA included in the Treasury report.

Assessment Areas

In general, Treasury recommends revisiting the historic approach of determining the geographic assessment areas within which a bank's regulator will evaluate a bank's record of meeting the credit needs of its community, in order to account for the current range of alternative channels that exist for accepting deposits and providing banking services.

CRA assessment areas are currently defined to include the geographies surrounding a bank's main office, branches, ATMs, and locations where the bank has originated or purchased a substantial portion of its loans. However, Treasury has found that this definition directs CRA loans, investments, and services in a manner that may exclude a substantial portion of the communities that the banks are effectively serving. Instead, Treasury recommends allowing banks to receive credit not only for CRA activity within their branch and deposit-taking footprint, but also for CRA activity in other low- and moderate-income ("LMI") communities outside of the bank's physical footprint, and in other areas where the bank accepts deposits and does substantial business. This expanded approach may improve the application of CRA requirements to banks using alternative delivery channels, including emerging "branchless" banks.

Examination Clarity and Flexibility

In the course of its review of the CRA framework, Treasury found a number of instances of uncertainty, inconsistency, or lack of flexibility in the CRA examination process. For example, while CRA examination procedures are developed on an interagency basis, each banking agency provides additional guidance to its examiners, and each examiner applies the procedures and guidance differently. In addition, it is often unclear to banks whether certain investments will qualify for CRA credit in light of retroactively applied policy changes, and vague standards for examination criteria can be subject to inconsistent interpretations. Accordingly, Treasury issued the following recommendations to improve transparency in the examination process.

- **Process to Determine CRA Investment Eligibility**. Treasury recommends expanding the types of loans, investments, and services eligible for CRA credit and clarifying the eligibility criteria (including by more clearly aligning CRA regulatory standards and definitions with other regulatory procedures). Further, Treasury believes that banks should be allowed to obtain a limited number of advance determinations regarding the CRA eligibility of specific loans, investments, or services, with any such determinations being made publicly available.
- **Application of Bank Performance Context**. Bank examiners review a broad range of economic, demographic, institution-specific and community-specific information to understand the context in which a bank's CRA performance should be evaluated. While consideration of a bank's performance context allows the CRA process to account for local factors and challenges, Treasury found the establishment of bank performance contexts to be too subjective and inconsistent (in part because examiners responsible for defining performance contexts often do not have the required expertise). Accordingly, Treasury recommends that the banking agencies involve their research and policy staff in developing the performance context in advance of CRA examinations to provide their

expertise on the economic and business environment of the communities where banks are operating.

- **Examination Criteria.** In its meetings with stakeholders and in its own review of examiner guidance, Treasury found substantial uncertainty as to the expectations of regulators and the evaluation criteria used in assigning bank CRA performance ratings. For example, descriptions of the parameters used to weigh and score activities use vague and undefined terms such as "excellent," "substantial," and "extensive." Meanwhile, banks have no clear guidance as to what constitutes a sufficient quantity or "geographic distribution" of CRA-eligible activities.

  Treasury calls for establishing clear criteria for grading CRA loans, investments, and services that incorporate less subjective evaluation techniques. In addition, Treasury recommends establishing a "measurement" of CRA activity that is reportable in a clear and transparent manner, allowing for better assessment of the impact of CRA activities.

- **Overemphasis on Branch Network in the Service Test**. Treasury calls for establishing a modernized, forward-looking approach to the CRA's Service Test with a reduced emphasis on traditional branch-based services, especially in light of the ongoing adoption of alternative delivery channels which have lessened the relevance of physical branches to communities. In addition, the scope of CRA-eligible services should be expanded to promote innovation and address technological advancements.

Examination Process

Treasury recommends that the banking agencies standardize the CRA examination schedules (which may, in some cases, require statutory changes), and provide more CRA ratings since the amount of time that it takes to conduct CRA examinations and to publicly disclose performance evaluations has become excessively long.

CRA Performance

- **CRA Downgrades for Violations of Consumer Protection Laws**. Treasury recommends that the federal banking agencies adopt uniform guidance, similar to the guidance issued by the OCC in October 2017, to clarify the impact evidence of discriminatory or other illegal credit practices can have on CRA ratings. Such uniform guidance should consider whether there is a logical nexus between a bank's CRA rating and evidence of discriminatory or illegal credit practices to ensure that banks are not penalized in their CRA assessments for minor violations or practices unrelated to CRA lending activities. In addition, such guidance should consider remediation efforts undertaken by the bank.

- **Performance Evaluation Delays Due to Consumer Protection Law Investigations**. Under current practice, CRA performance evaluations are often delayed until the CFPB, the Justice Department, or other regulators have completed their investigations and/or taken enforcement actions under consumer protection laws. Treasury recommends that rather than delaying CRA performance evaluations due to pending consumer protection law investigations or enforcement actions, any evidence of a consumer protection law violation that is discovered after the issuance of a CRA performance evaluation should be considered in the bank's subsequent performance evaluation.

- **Impact of Less-Than-Satisfactory Ratings and Remediation.** A bank's CRA rating may impact the bank's expansionary plans, as regulators are required to take CRA performance into account when evaluating applications for mergers and acquisitions under the Bank Merger Act and Bank Holding Company Act, as well as applications for charter conversions, branch establishment and main office relocations.

  A less-than-satisfactory CRA rating has typically resulted in an automatic denial of such applications. In November 2017, however, the OCC issued new guidance clarifying that while applications from banks with a less-than-satisfactory CRA rating would continue to receive enhanced scrutiny, the CRA rating would not result in an automatic denial of a licensing application. Instead, the OCC will consider how recently the CRA rating was issued, the severity of the less-than-satisfactory rating, the progress made by the bank in addressing the issues underlying the rating, and the effect that approval of the application would have on the bank's ability to meet the credit needs of the communities to be served.

  Treasury recommends that the Federal Reserve and FDIC adopt principles that are generally aligned with those adopted by the OCC for evaluating various applications from banks with a less-than-satisfactory CRA rating. In its report, Treasury indicated that regulators use the application process as an incentive to encourage banks with a less-than-satisfactory rating to commit to engaging in additional CRA-eligible activities in LMI communities.

  Notably, the Treasury report does not suggest any safe-harbor or similar relief for banks with "Outstanding" CRA ratings, or otherwise recommend updates to the public comment process for licensing applications. Under current practice, the receipt of any adverse public CRA comment on a merger or other expansionary application will typically delay application processing significantly (and regulators will often consider public comments received even after the close of the comment period), which has been a source of frustration to banks with exemplary CRA ratings. In 2017, the OCC updated its policy on the review of public comments for licensing filings, clarifying that the OCC will not accept comments after the close of the comment period and will only extend the comment period in extenuating circumstances. However, the Treasury report does not recommend that the Federal Reserve and FDIC adopt policies similar to those adopted by the OCC for reviewing public comments on application filings.

- **Use of Community Benefits Plans**. In response to adverse public comments received in connection with applications for mergers, acquisitions or other expansionary plans, some banks have entered into "community benefits plans" with prominent community groups to demonstrate the bank's commitment to meeting the convenience and needs of the community. Such plans have been an increasingly common demand from community activists critical of a bank merger, and Treasury recommends that the bank regulators clarify that such plans are not required (although the agencies have already made explicit comments to this effect in recent guidance and approval orders).

However, Treasury believes that regulators should make it clear that a community benefits plan, among other strategies, can be an effective tool for banks with less-than-satisfactory ratings to demonstrate how approval of an application would benefit the communities served.

- **Maintaining a Public CRA File in Bank Branches.** Treasury recommends that CRA regulations be amended to allow banks to store their public CRA files electronically on the bank's website, rather than requiring banks to maintain a physical copy of the public file at the bank's main office and at one branch office in each other state in which the bank is located.

Miscellaneous Items

- **Disparate Treatment of Debt and Equity Investments**. Currently, community development investments are treated differently than community development loans when considered for CRA credit. Loans to qualified entities are counted toward CRA credit only in the year originated, while equity investments in qualified entities are counted toward CRA credit each year that the investment is held. Treasury recommends that community development loans receive the same annual consideration as community development investments.
- **Inclusion of Affiliates in CRA Assessments.** Banks are currently given the option to include the activities of their affiliates for consideration in the bank's CRA performance evaluation. Treasury recommends that the CRA regulators evaluate their approach to affiliates in order to ensure that performance evaluations accurately reflect the CRA-eligible activity of the overall bank and to prevent banks from artificially inflating their CRA performance by strategically deciding whether to include the activities of affiliates in their CRA performance evaluation.
- **Impact of CCAR on CRA Investments.** For banking organizations subject to CCAR, public welfare investments with non-complex structures are generally assigned higher loss projections (and assessed higher capital requirements under CCAR) than public welfare investments with more complex capped loss structures. Because this differing capital treatment may discourage certain types of investments in non-capped loss structures that would otherwise benefit LMI communities, Treasury encourages the banking agencies to review the CCAR treatment of public welfare investments.

- **Nonbanks and CRA**. Although Treasury acknowledges the increasing market share of nonbanks in the market for CRA-eligible loans, Treasury recommends only that regulators continue to monitor the impact of nonbanks on the effectiveness of CRA, calling for more research on the extent to which nonbanks are meeting the credit needs of LMI communities.

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