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Commentary: Finding the impact on munis in CRA reform

By

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Domestic banks have been whipsawed in the last several years by changing incentives to hold munis. On the one hand, regulators provided flexibility on counting munis toward high-quality liquid assets (HQLA). On the other hand, the tax equivalent benefit equation was completely scrambled alongside changes to the corporate tax code. At the start of 2020, banks once again have a new reason to consider their muni portfolios due to potential regulatory changes.

Over the last month, banks and community development professionals have grappled with the potential fallout brought by dramatic changes to the Community Reinvestment Act (CRA) proposed in a draft rule released by the OCC and the FDIC. To date, the remaining bank regulator, the Federal Reserve, has not joined the rulemaking process but the rule, if adopted, would impact 85% of banks subject to the CRA.

I work for a primarily rural bond issuer in a state with limited CRA dollars and I was optimistic at the start of the reform that a new framework could help benefit more communities by distributing demand beyond overlapping areas of large bank concentration. The proposed rule, however, does not safeguard small-scale and high-impact infrastructure that would most benefit from additional investment.

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The CRA, enacted in 1977, places one or more requirements related to lending, investment, and service requirements on banks. This legislation was passed to combat practices of denying credit to business and residents (often minority and/or low income) within defined geographies through the use of infamous "redlining" around these areas.

As part of the CRA, the largest banks are required to make loans and investments (as well as provide services) within their "assessment areas" to low and moderate income (LMI) populations as well as middle-income populations in distressed and underserved areas. From a CRA perspective, investments include financial vehicles like tax credit equity but can also include securities, which is why municipal housing bonds have been a lynchpin of CRA compliance for banks.

If adopted, the rule would potentially expand the role of munis through greater flexibility to receive credit for investments in the projects munis typically finance. The current opportunities for munis under the existing rule are laid out in the interagency Q&A on CRA. Reference in this document is limited to examples of projects wholly contained in a qualifying area and related to a redevelop plan.

Essential infrastructure is referenced but only related to efforts to “revitalize or stabilize” a qualifying underserved or distressed nonmetropolitan area.

In contrast, the proposed rule provides additional flexibility by giving credit to essential infrastructure and essential community facilities. Among other examples, the proposed rule references roads, mass transit, water supply, schools, and hospitals. Critically, the rule would give credit even if the project is located outside of a qualifying area or partially services a nonqualifying population so long as some portion of the project does address these areas or populations.

The above changes are significant for munis; however, limitations on their efficacy are also incorporated in the proposed rule. First, securities are only given credit for the period they are held on balance sheet during the year (ex. holding for half a year would be 50% credit for the year). This was intended to provide an incentive to hold eligible investments long term versus short term buying and selling before and after the end date for a performance evaluation. Second, the proposed rule introduces a scoring methodology whereby investments in less liquid vehicles such as tax credits, receive a two times multiplier versus mortgage-backed securities or munis that have no multiplier.

Alongside changes to qualifying activities are modifications to the primary driver for CRA investment demand—the assessment area. Historically, assessment areas have been based on areas surrounding bank branches and deposit taking ATMs. In the digital era, the relevancy of this strict geographic definition is under question, which is reflected in the proposed rule that splits assessment areas in to “facility based” and “deposit based” assessment areas.

As proposed, the non-territorial “deposit based” assessment area is designated if 50%or more deposits are located outside the traditional definition. Banks would be tested for compliance in assessment areas as well as in aggregate at the bank level. Notably, loans and investments can also occur outside of these assessment areas in the bank level test. The various tests are primarily centered around compliance with a new “one ratio” concept proposed where the dollar value of all CRA related activities (after the multipliers) are summarized and divided against total retail deposits for either an assessment area or in aggregate for the bank.

In a vacuum, small issuers and rural communities would benefit most from expanded eligibility for infrastructure in conjunction with changes that would redistribute some CRA dollars away from overlapping facility based assessment areas. Unfortunately, it’s not clear this will translate to benefits.

Remote deposits certainly exist in places like Vermont but the 50% test is high and no nexus is described linking deposit activity and out of assessment area investments. Additionally, large questions remain on whether enough incentive exists to put dollars where they are needed most versus where they are easiest to find a home or most expedient to meet the “one ratio” via large and liquid bond issuances.

Informed issuers may be able to closely connect their projects to a newly standardized “performance context” describing community needs but the draw of large block sizes may be too much to overcome and result in continued overlapping demand in traditional CRA “hot spots.”

I know that the projects undertaken by the Bond Bank’s borrowers are often the only community development activity for years on either side of the investment and that the impact of small essential infrastructure is substantial. I’m encouraged by the potential of more flexibility for banks on where investments are made but also think the impact of these dollars, both in terms of projects and price benefits, should be at the forefront of revisions to the final rule.