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## CRA's 25th anniversary: the past, present, and future

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**CRA's 25th Anniversary: The Past, Present, and Future**

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## **ABSTRACT**

This paper focuses on the past, present, and future rules and regulations implementing CRA as developed, applied, and enforced by the federal bank and thrift regulators. The *past* rules and regulations refer to those in effect during the law's first 18 years, through 1995, when CRA underwent its first major reform. The *present* CRA rules and regulations were adopted then, with the mandate that they would be reviewed for possible reform in 2002. The *future* rules and regulations are being drafted now by the regulators, based on their review of approximately 400 public comments; the reform recommendations should be released sometime during the second half of 2002.

The future of CRA's legacy as arguably the perfect fair market regulation in a world of Compassionate Capitalism will depend upon the direction of these reforms. Optimal public policy by the bank and thrift regulators in this regard must represent the ideal balance between competing consumer and industry interests. This paper represents the first comprehensive analysis of the public comments and concludes with specific recommendations that will lead to optimal public policy.

## COMMUNITY REINVESTMENT ACT OF 1977

The Community Reinvestment Act of 1977 (CRA) is 25 years worth of living proof that capitalism can have a corporate conscience without degrading itself into socialism or gambling on the other extreme of completely unregulated markets.

CRA can be argued to be the nearly perfect example of striking the correct balance between government and market regulation in a capitalist economy. Too much regulation is as bad as too much deregulation as we saw with the S&L crisis and most recently Enron. Somewhere between regulated and unregulated markets is the ideal point known as “fair” markets, representing the optimum balance between consumer and industry interests.

CRA is arguably the perfect example of a fair market regulation for many reasons:

- By providing access to credit for all, it gives everyone an equal chance at (but no guarantee they will get) their share of the American Dream;
- It is needs not race based, with the focus on the most needy low- and moderate-income group;
- It does not require banks to make bad loans or lose money;
- While there is a reasonable compliance cost to banks, there is little to no cost to taxpayers, who get something in return for federal subsidies to the banking industry;
- The law, which has “politically correct” curb appeal, has more bark than bite in terms of actual enforcement and is therefore not overly intrusive to business;
- It relies more on the positive power of disclosure in the market than regulatory brute force; and,
- It is reformed periodically so that it remains responsive to both consumer and industry interests.

This paper focuses on the past, present, and future rules and regulations implementing CRA as developed, applied, and enforced by the federal bank and thrift regulators. The *past* rules and regulations refer to those in effect during the law’s first 18 years, through 1995, when CRA underwent its first major reform. The *present* CRA rules and regulations were adopted then, with the mandate that they would be reviewed for possible reform in 2002. The *future* rules and regulations are being drafted now by the regulators, based on their review of approximately 400

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## **CRA: THE PAST**

### **The Credit Access Plight of the LMI Underclass**

Just as everyone should have the right to apply to the college of his or her choice, so too should there be the right to apply to a bank for a loan. Whether or not someone is accepted by the college or bank of their choice should depend on that person's willingness and ability to meet the requirements of the institution.

Students with good high school GPA and SAT scores, letters of recommendations, and other desired characteristics deemed necessary to succeed as determined by the college will be accepted. If not by the student's first choice then by the others applied to, even if it means the "safety" or last choice college.

Likewise, loan applicants with a good credit score, letters of recommendations, and other desired characteristics deemed necessary to repay the loan (i.e., the banker's 6 "C's" of credit such as character, collateral, capacity to repay, etc.) *should* be approved. Again, if not by the applicant's first and usually most convenient choice, then by the other banks applied to where there may be additional direct and indirect costs.

This all sounds reasonable and fair, but this is not always the way things work in the real world of academia OR banking. Sometimes good college applicants are denied in favor of less qualified ones such as a sought-after "jock," a family member of a generous alum, or someone with "connections." But, at least there was an opportunity to apply and a sense of hope after submitting the application that you might get accepted by your dream school.

Despite the shortcomings of college application and acceptance procedures, they are an infinite improvement over the comparable ones in banking, particularly for low- and

moderate-income (LMI) individuals, especially first-time homebuyers and small business entrepreneurs.<sup>1</sup>

For far too long many people with LMI incomes OR living in LMI areas would not even feel comfortable going into a bank, much less talking to an officer about an application. Many who did often were dissuaded from making an application, and those who persisted were realistic in not being too hopeful for an approval, at least for the amount and terms desired.

### **The Government Responds With CRA**

Aware of the credit access plight of the LMI underclass, the government created a crude lending safety net in the form of FHA, VA, SBA, and other alphabet soup programs.

Additionally, there were, as there are today, always lenders of last resort for the more than 10% of Americans that are unbanked, such as family and friends, second-floor finance companies, payday lenders, and even unregulated lenders and loan sharks. Just as there is always some matchbook cover or internet diploma mill where you can buy a degree, there is always someone who will lend you money, even if it means going to Tony Soprano.

Senator Proxmire of Wisconsin believed that the LMI deserved the same opportunity to access credit as their higher income counterparts. He was particularly outraged that some LMI communities in Chicago and elsewhere were being deprived of the lifeblood of bank credit through “redlining.” This referred to the practice of geographic (not racial) discrimination in the granting of credit to qualified applicants in certain neighborhoods that were targeted or “redlined.”<sup>2</sup>

Reasoning that all taxpayers, regardless of income, ultimately backstopped the FDIC and our financial system through the Treasury, he shepherded through the Community Reinvestment Act of 1977 (CRA).<sup>3</sup>

Senator Proxmire felt CRA would be a reasonable *quid pro quo* for the various federal subsidies received by the banking and thrift industries, such as access to the payments mechanism and below-market rate lending from the Federal Reserve System (FED). By

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<sup>1</sup> LMI is defined to mean an income of 80% or less of the median, which would be \$40,000 or less in the case of all U.S. families according to the 2000 Census. This includes, by definition, about 40% of American families.

<sup>2</sup> Presumably these excluded neighborhoods were circumscribed by a red marker on a city map in a bank’s board room.

<sup>3</sup> An extensive literature exists on CRA; see, for example, Haag, 2000, and U.S. Department of the Treasury, 2000.

contrast, there is no CRA for Wal-Mart or McDonalds, as they don't benefit from such federal subsidies.

The CRA is elegantly simple: it encourages (not requires) federally insured banks and thrifts to help meet the credit needs of their entire communities, including LMI neighborhoods, consistent with safe and sound banking practices.

This means that everyone should have an equal opportunity to apply for and, if necessary, be denied credit. Access to credit, which can almost be argued to be an inalienable right, has no guarantees other than a fair chance to be accepted or denied based on a bank's underwriting practices.

The banking industry, as expected, opposed this new law as a form of "credit allocation," but what was unexpected was the opposition of the FED. Thus, began the Jekyll and Hyde bank regulator that publicly put on a pro-CRA face but privately encouraged member banks to lobby Congress to weaken the law. This was a first for a federal bank regulator in modern times.

In passing the law, Congress determined that regulated financial institutions are required to demonstrate that their deposit facilities serve the convenience and needs of their community, which include the need for credit services as well as deposit services.

To ensure the continued and affirmative obligation of financial institutions, Congress directed the bank and thrift regulators to periodically assess an institution's record of meeting community credit needs, and to consider that record when acting on deposit facility branch or other expansion applications. These regulators are the FED and the Federal Deposit Insurance Corporation (FDIC) as well as two agencies of the Department of Treasury, namely the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS).

This carrot and stick approach afforded community groups the possibility of holding up branch, merger, and other expansion applications while they persuaded regulators to require changes in a bank's credit practices, sometimes resulting in grants to the protesting groups. Opponents of CRA labeled such practices as nothing more than "legalized extortion."

In the early years, there was no middle ground with CRA, as you were either with the banks or with the community groups. This, like almost everything else, changed over time.

### **The CRA Triangle**

What quickly developed was a model of consumer, government, and business interaction known as the "CRA Triangle" (Thomas 1993 and 1998). As seen in Figure 1, there is an on-going and

often volatile dynamic tension among the three elements or “corners” of the CRA Triangle:

1. “C” – Community groups representing consumer interests;
2. “R” – Regulators, influenced and monitored by Congress and the Administration, representing the interests of the "public;" and,
3. “A” – America's banks and thrifts subject to CRA (excluding credit unions) representing the interests of their stockholders.

The isosceles form of the CRA Triangle in Figure 1 represents an ideally balanced and proportioned model with three equal sides and angles where none is more important than another. Community groups and banks together form the base of the triangle, with regulators in the middle position equidistant to both corners.

In this ideal model of the CRA Triangle the regulators act as impartial referees between community groups and banks, attempting to fashion a “socially optimal” result benefiting both parties. The reference to “optimal” public policy in CRA reform is based on reaching the ideal balancing point within this triangle perspective.

This policy ideal must consider the potential conflicts of interest, pressures, and other factors impacting each of the corners of the CRA Triangle. While it is normally assumed that each corner will act in the best interests of its constituent group, this is not always the case. It is possible, for example, that conflicts of interest can exist at community groups being funded by banks or even at friendly regulators interested in going to work for a bank.

CRA reform would certainly benefit if each of the triangle’s corners properly represented their constituents’ interests, but this would mean avoiding the “Top Ten New CRA Mistakes” for each of these corners as displayed in Figure 3 (Thomas, 1998). These CRA mistakes are just as relevant now as they were during the last CRA reform.

Even if each corner truly represented its constituents’ interest, there may be constraining factors. Just as banks are under stockholder and regulatory pressure, the regulators themselves may be under congressional scrutiny, especially a financially struggling agency undergoing budget cuts. Community groups too can be the subject of congressional scrutiny which can change the way they operate and obtain funding.

The continuous conflict and cooperation among the three corners of such a triangle represents the dynamic tension keeping the triangle strong. The simplicity and strength of a triangle, which represented life in primitive art, is seen in many facets of our society.



The best example is the triangle portraying the three branches of our government. The dynamic tension evident in the conflict and cooperation among the executive, legislative, and judicial corners helps keep our system going. It works better sometimes than others, but the checks and balances inherent in that government triangle assure us that the public interest is considered from those three perspectives.

A system with only two participants, like a duopoly in industry, is more susceptible to potential collusion, but such counterproductive activity is considerably more difficult with three participants.<sup>4</sup>

A triangle must have three corners and three sides, but they are not always equal. The “Friendly Regulator Hypothesis” (Thomas, 1993 and 1998) states that regulators have become far too close to the banks they supposedly regulate. Such “friendly regulators,” act more like cheerleaders than impartial referees, promoting one team (i.e., the banking industry) over another (i.e., consumers).<sup>5</sup>

Thomas (1993 and 1998) identifies the FED as the quintessential friendly regulator, and Figure 2 depicts the resultant “FED-distorted” CRA Triangle. This (scalene) triangle has the friendly regulator cooperating quite closely with the banks, and both of these corners are significantly isolated from consumer interests. A similarly distorted triangle can exist when community groups get too close to banks providing them funds.

Our government is not always the perfect model of how different positions are balanced in the public interest. For example, the Federal Aviation Administration apparently was based on a presumed balanced position between the safety interests of the flying public and the business interests of the airline industry. Concerns that the agency was getting too chummy with the industry after the 1996 ValuJet catastrophe in the Everglades resulted in the elimination of this dual role of industry regulator and promoter.

Just as the previously FAA-distorted airline triangle was restored to a more balanced model in the public interest, there is hope that this too will be the case with the CRA Triangle as this law is reformed this year.

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<sup>4</sup> This is based on the same logic of trying to preserve at least three major competitors in large markets (Thomas, 1998).

<sup>5</sup> It is interesting to note that the thrift and two of the three bank regulatory agencies are currently directed by former bankers or bank attorneys, with the only exception being ex-Wall Streeter Alan Greenspan of the FED.

## **Implementing Rules and Regulations**

The federal bank and thrift regulators, operating independently and jointly through the Federal Financial Institutions Examination Council (FFIEC), a “super regulator” of sorts, regularly publish rules and regulations implementing CRA. These include examination procedures, periodic Questions and Answers (Q&As), and various other brochures and documents (several of these are reproduced in Thomas, 1993 and 1998).

One of these documents is a performance evaluation (PE) format to be used by the regulators during their CRA examinations. The original PE was based on a laundry list of 12 assessment factors.<sup>6</sup>

The first column of Table 1 titled “Old CRA Regulations” summarizes the key implementing provisions of the law. The first column of Table 2 titled “Old CRA” identifies each of the assessment factors. These 12 (or 13 counting the delineated community) assessment factors were categorized by the regulators into five performance categories:

- I. Ascertainment of community credit needs
- II. Marketing and types of credit offered and extended
- III. Geographic distribution and record of opening and closing offices
- IV. Discrimination and other illegal credit practices
- V. Community development

Regulatory examiners, who periodically visited banks and thrifts, would review various required documentation, including policy statements and lending records, to assign a CRA rating. Separate profiles were developed for each assessment factor and the overall rating.

Originally there were five numerical ratings similar to the regulatory safety and soundness ratings, which ranged from the highest rating of 1 to the lowest rating of 5. This is equivalent to the standard student rating system used by schools of “A” through “F.” While the three federal banking regulators always considered a rating of 2 and above to be satisfactory or better, the Federal Home Loan Bank Board (the OTS predecessor) used a lower threshold of 3.

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<sup>6</sup> In reality there were 13 assessment factors, as institutions were also evaluated on the reasonableness of the community which they delineated.

## **CRA's Watershed Year of 1989**

Like a paper street that exists only a map, CRA was much the paper law during the first dozen years of its existence. Although the law was not meaningfully implemented until 1979, there were more important concerns in Washington like the 1980 election and the back-to-back 1980-81 and 1981-82 recessions.

CRA ratings were being made, but there was little serious concern over them by bankers or regulators. Very rarely would there be a CRA protest, and even more rarely would there be a CRA denial, although the first one was in April 1979.

While CRA lay dormant for most of the 80s during the Reagan and Bush administrations, there was a revival of interest in CRA in 1989. Rather than due to any change of heart by the Bush administration, the interest in CRA was driven more by a change in the congressional climate in the midst of the S&L scandal, the biggest and costliest financial debacle since the Great Depression.

The year began with Chicago's troubled Continental Illinois being the first big bank to have an application denied on CRA grounds. There were a record four CRA denials in 1989. Also, the FFIEC released more specific methods of compliance and CRA enforcement, partly in response to Senate Banking Committee hearings critical of CRA enforcement. The OTS instituted a specialized compliance program in 1989, soon to be followed by the FDIC and OCC in subsequent years.

The law took on real teeth that year when Congressman Joe Kennedy of Massachusetts used the S&L bailout (Financial Institutions Reform, Recovery, and Enforcement Act) as leverage to require that a bank's CRA rating and a portion of its exam be made public beginning on June 1, 1990.

## **The Positive Power of Public Disclosure**

The disclosure of CRA ratings and a public portion of the exam was the first time any bank rating or exam was ever opened to public scrutiny in this country. This was a significant event not just for CRA but a bold experiment in government disclosure.

This disclosure afforded researchers the first opportunity to see how examiners evaluated and graded banks. The first major analysis of these exams involved a systematic review of 250 PEs and ratings made public by the four federal bank and thrift regulators (Thomas, 1993). This

analysis advanced the Friendly Regulator Hypothesis and revealed a level of grade inflation that even made Harvard look tough.

In a major policy move to accompany the public disclosure of ratings, the four regulators switched from the five-tier, numerical, pre-disclosure system to a four-tier, descriptive or narrative rating as follows:

1. Outstanding
2. Satisfactory
3. Needs to Improve
4. Substantial Noncompliance

The stated purpose for this switch was to prevent any possible confusion with the five-tier, numerical safety and soundness rating. While the likelihood of any such confusion was probably remote, the real problem was that the compression of the ratings resulted in a significant loss of the richness of the data.

Regulators and consumers, and indeed the bankers themselves, could no longer distinguish between “good” or High Satisfactory “B” performance and just-passing, average “C” performance. Ultimately, 80% or more of banks would be pushed into the massive “satisfactory” range, which encourages many banks to make such “satisficing” their CRA objective.

Even before CRA ratings were to be made public, just the prospect that they would be disclosed had an apparent impact on regulators with an increase in the proportion of below-average ratings and a decrease in the percentage of above-average ones. The proportion of banks with below average ratings for the first 18 months ratings were made public reached its highest level ever (11%) and was over three times the comparable pre-disclosure average level (Thomas, 1993).

Even with this somewhat tougher grading policy, only a tiny fraction of banks with below-average ratings had their branch or merger plans disrupted. CRA enforcement was an oxymoron, as there were only 11 CRA denials of more than 50,000 branch and merger applications from 1977 to 1989; by 1996, there were just 31 denials out of nearly 105,000 applications (Thomas, 1998).

Pro-CRA congressional Democrats strengthened CRA even more by adding 1991 amendments requiring better documentation of a bank's performance and rating in the public PE. Congressional amendments in following years strengthened CRA even more. The 1992 election of Bill Clinton, who was publicly committed to community reinvestment, was a major victory for CRA.

CRA was the proverbial law without teeth, with one very important exception. The public disclosure of the names and exams of banks with failing CRA ratings apparently was more damaging than any action taken by the friendly regulators. CRA quickly became the most hated law in banking.

## **CRA: THE PRESENT**

### **The Need for Reform**

The new disclosure requirements put CRA on the radar of not only regulators but also the media. Banks and thrifts consequently began to take the law seriously. Independent researchers, citing increasing evidence of lending bias and "redlining," called for a strengthened and reinvigorated CRA as well as other community development agents, such as a network of community development banks (see, for example, Papadimitriou, Phillips, and Wray, 1993).

The industry and community groups both complained about overly subjective CRA exams and ratings that emphasized paper documentation and process over actual lending performance. Community groups argued that there was grade inflation, and bankers countered that the compliance burden was excessive. The regulators, caught in a no-win situation, were themselves unhappy with the exam and rating system. No one cared when the exams and ratings were confidential, but all of this changed with the new disclosures.

All corners of the CRA Triangle agreed that a reform was in order to make the law more effective and efficient, and on July 15, 1993 President Clinton called for the first major reform of CRA. The stated goals of the reform were to:

1. Promote consistency and evenhandedness in CRA enforcement
2. Improve public CRA performance evaluations
3. Implement more effective sanctions
4. Develop more objective, performance-based CRA assessment standards

## **The 1993–95 CRA Reform Process**

What was to have been a one–time reform became a controversial process with three different versions spanning three years. Table 1 compares the major provisions of these versions of the “new” CRA to the “old” CRA.

The first December 1993 proposal, which was aggressively pro–consumer, resulted in over 6,700 comment letters. While everyone expected conflicts between the community and industry positions, no one expected the publicized infighting by the regulators themselves, specifically between the pro–CRA OCC and the generally perceived anti–CRA FED.

Members of the FED’s Board of Governors publicly criticized the 1993 proposal, which was mainly drafted by OCC Comptroller Gene Ludwig, a Bill Clinton classmate. FED governor Larry Lindsay stated that he was “perfectly willing to tear it up, throw it into the fireplace, and go back and start again” (Cummins, 1993).

Other FED governors condemned the proposal as the “wrong” approach and a “fundamental policy mistake” resulting in not only credit but also “resource allocation.” In addition to concluding that “the time to say no is now,” one governor publicly stated that the FED would oppose the proposal if bankers complained loudly enough! Even the presidents of the Federal Reserve Banks piled on criticism, with the banker–friendly San Francisco FED arguing against the disclosure of CRA public examination schedules.

The FED, with the help of the banking lobby, which it called to action, was successful in watering down many of the toughest provisions of the 1993 proposal. The OCC was not happy but went back to the drawing boards. The result was the September 1994 proposal that proceeded to generate over 7,200 comments. It was decidedly less pro–consumer, but this was also a sign of the shifting political and even regulatory sentiment.

First, there was a much stronger than expected negative reaction by the industry to a Department of Justice (DOJ) August 1994 fair lending suit against Maryland’s Chevy Chase Bank and its affiliated mortgage company. This was followed by a September 1994 conflict between the FED and the DOJ over a fair–lending investigation at Florida’s Barnett Banks.

A defining political moment during the last decade was the November 1994 Republican sweep of Congress. It is not insignificant that the chairman of the National Republican Senatorial Committee who led the successful effort to restore a Republican majority in the Senate was Texas Senator Phil Gramm (see following discussion).

Part of the Republican’s “Contract with America” dealt with reducing unnecessary and burdensome government regulations, and anti-CRA advocates used this as further momentum against pro-CRA reforms. The following month, December 1994, witnessed a major DOJ decision limiting CRA enforcement efforts that had a similarly chilling effect on pro-consumer CRA reforms.

The end result of approximately 14,000 comment letters (on average more than one for every bank and thrift) and seven public hearings was the third and final May 1995 “new” CRA regulations. The banking lobby, with the strategic help of the FED, won almost every CRA reform battle it fought. These regulations, which went into effect starting in 1996, are the ones under which we have been operating since that time.

### **The “New” CRA**

The final column in Table 1 summarizes the major implementing provisions of the “new” CRA. Table 2 details specific performance standards and tests under the new CRA.

The most important change in the new CRA was a more performance-based exam and rating system. The previous “one-size-fits all” old CRA regs were replaced with four tests based on an institution’s size and business strategy (see Table 2 for details):

1. *Small bank test (independent institutions with \$250 million or less in assets or affiliated with \$1 billion or less holding company)*

This streamlined test is based on four specific lending ratios with optional Investment and Service Tests to upgrade a Satisfactory rating to an Outstanding one. Each of the four ratios has only three possible performance levels for a total of 12 cells in the Small Bank Performance Ratings Matrix.<sup>7</sup>

2. *Large retail bank test (for retail banks beyond the “small” definition)*

This is, by far, the toughest CRA test and includes three component tests each with three to seven performance factors. This is the only new CRA test with five possible ratings

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<sup>7</sup> A fifth possible criterion is the “response to complaints,” but this is rarely rated because of the very low incidence of filed complaints.

(including High Satisfactory) for the component tests, but four possible overall ratings (excluding High Satisfactory). The combined three tests have 70 different cells in their respective performance ratings matrices. The three tests with their component weightings for the overall rating as well as the number of component performance factors (see Table 2) in each test are as follows:

- a) Lending Test (50% weighting) with seven performance factors times five possible ratings for 35 cells in the Lending Test Performance Ratings Matrix
- b) Investment Test (25% weighting) with three performance factors times five possible ratings for 15 cells in the Investment Test Performance Ratings Matrix
- c) Service Test (25% weighting) with four performance factors times five possible ratings for 20 cells in the Service Test Performance Ratings Matrix

3. *Wholesale and limited-purpose community development (CD) test (for special purpose banks)*

This is a streamlined and subjective test allowing banks a choice of being evaluated under CD lending, CD investments, and/or CD services. With only four possible ratings (no High Satisfactory) and three performance factors, there are only 12 cells in the CD Test Performance Rating Matrix.

4. *Strategic plan test (for any bank as a matter of choice)*

All institutions have the option of being evaluated under this test where banks propose their own lending, investment, or service performance standards upon which they are evaluated for one of four possible ratings. Very few banks have chosen this option for a number of reasons, including the fact that regulators often raise the bar as to the level of lending performance required to obtain certain ratings (often viewed as “credit allocation”).



## **New Problems with the New CRA**

Regardless of which test is used by a bank, each institution is evaluated relative to its “performance context,” which includes such factors as business strategy and constraints as well as community needs and opportunities. This performance context can sometimes be used, however, as a regulatory crutch for a subjective and especially inflated rating.

Large retail institutions not only have the burden of the toughest test under the new CRA but also have additional data requirements regarding small business, small farm, and community development loans.

More important is the fact that the three-part test reduces the role of LMI lending to just 50% of the total rating, with the new Investment and Service Tests accounting for 25% each. This was a major change in and a bold experiment with this traditional LMI lending law.

Besides watering down the original LMI lending purpose of CRA, this three-part test for big banks proved both costly and problematic, as there was and continues to remain a shortage of suitable CRA investments with acceptable returns. Many examiners responded by inflating the Investment Test rating to allow a bank to receive an overall passing rating. Thus, this test and to a lesser extent the Service Test became a key source of grade inflation.

Wall Street carpetbaggers immediately capitalized on the shortage of qualified investments by creating an entire “CRA investment” industry comprised of mutual funds and other investment vehicles for desperate banks. Many of these investment credits, however, do little to help LMI people or neighborhoods, as one LMI securitized loan, for example, might be repeatedly flipped so several banks get Investment Test credit.

There are other questionable qualified investments that may have little to no relationship to LMI lending. For example, the mere purchasing of no-risk CDs in minority banks, the definition of which was recently expanded, is considered a qualified investment. However, some minority banks merely invest the funds in government securities rather than convert them to LMI loans as presumed by the CRA regs. Also, outright grants to community groups are considered qualified investments, an important but rarely mentioned reason why they apparently have defended the Investment Test.

## **Grade Inflation**

The subject of CRA grade inflation is discussed elsewhere in more detail (Thomas, 2000). One of the important conclusions of such research is that anyone can allege grade inflation, just like

anyone can file a lawsuit. But, proving the case is an entirely different matter and requires considerable analysis.

A simple or even complex comparison of overall or individual test ratings among different groups does not prove anything but differences that may exist among them for different reasons. The only sound grade inflation methodology requires a case-by-case analysis of each bank, its public PE, and considerable other publicly available data for it. This means an entire re-examination, without some of the data and resources available to an examiner, but still enough to reach key performance rating conclusions.

Thomas (1998) reviewed over 1,407 small bank exams and ratings under the new CRA in this manner and found that nearly half of them (47.1%) were inflated. Significant grade inflation was also found in the large retail bank exam, especially in the Investment Test, as well as in the community development exam for special purpose banks.

A recent study attempted to make grade inflation conclusions about the Service Test (Stegman, Thompson, and Faris, 2001). This study was attached to the October 8, 2001 CRA reform comment of the director of the Center for Community Capitalism of the University of North Carolina (UNC).

This UNC study, however, reached its grade inflation findings based on a statistical comparison of CRA component test ratings for many exams, making certain assumptions as to desired overall ratings based on component ones.

This type of macro-analysis demonstrates considerable differences in component and overall ratings. By contrast, a comprehensive micro-analysis of re-examining performance data on each Service Test rating factor for each individual PE on a bank-by-bank basis is required to prove grade inflation (or deflation).

The UNC study's authors realized this problem: "Because performance data on the six individual service test criteria must be compiled by hand and are discussed and reported inconsistently in CRA Public Evaluation reports, a statistical analysis comparing the borderline banks to the larger population would be extremely difficult" (Stegman, Thompson, and Faris, 2001). They later noted: "Again, because performance data must be compiled by hand and because many examination reports do not provide full and consistent statistics on all six service test criteria, a statistical analysis was not feasible."

Such a statistical analysis, while extremely difficult to do by hand, is in fact feasible and was conducted not just for the Service Test but all other tests and all types of exams (Thomas, 1998).

The common and inescapable thread throughout that analysis is grade inflation.

### **The CRA Anti-Christ**

There would be no CRA without Wisconsin Senator Proxmire. Some two decades later Texas Senator Phil Gramm did everything within his power to gut CRA. To the extent that Senator Proxmire was the equivalent of a “CRA Christ,” Senator Gramm was nothing less than the “CRA anti-Christ.”

This ex-professor from Texas A&M University holds a Ph.D. in economics. He first won election to Congress as a Democrat but then switched to the Republican party. Despite a failed attempt at the presidency, Senator Gramm established a serious power base after successfully restoring a Republican majority to the Senate in 1994.

Once he became chairman of the powerful Senate Banking Committee, Senator Gramm did more to weaken CRA than anyone in Washington during the last quarter century. Previously identified Congressional “enemies of CRA,” (Thomas, 1998) such as Senators Mack (FL) and Shelby (AL) and Representatives Bereuter (NE) and McCollum (FL) were amateurs compared to the professional CRA “hit man” Gramm.

His anti-CRA emotions were so strong that he risked killing his own landmark financial reform law, one of the most significant pieces of financial legislation in more than 50 years, unless he could extract some CRA flesh. The battle over financial reform in 1998 and 1999, which culminated in the passage of the 1999 Gramm-Leach-Bliley Act (GLB), appeared to be centered more around CRA than the underlying financial reform issues involving the repeal of the Glass-Steagall Act of 1933.

Under the biggest seige of its life, CRA would have been eliminated without the most powerful people in Washington, led by none other than President Clinton, coming to its rescue. Even Rev. Jesse Jackson came to the defense of CRA, and it became a most divisive and heated issue in Washington.

While some community groups like to take credit for “saving CRA,” it was their actions in the first place that apparently motivated Senator Gramm to pursue his unprecedented CRA witch hunt. He was particularly concerned with the increasingly powerful community groups and their lucrative financial relationships with banks.

As stated in his personal correspondence to the President (Gramm, 1999):

“What’s not at issue is the [CRA making] capital available to people in the communities...What is at issue is an unsavory practice in which protestors file official complaints under CRA regulations and pursue them until they are paid by the banks to stop protesting. They will go away, but only after getting everything from cash contributions to salaries as ‘advisors.’ That’s extortion, and it’s wrong...I hope you will join me in the effort to make it illegal to give or receive cash in connection with a CRA complaint.”

One of Senator Gramm’s favorite examples of such alleged abuses was a 1994 deal where Fleet Financial paid the Neighborhood Assistance Corp. of America, which is headed by CRA activist extraordinaire Bruce Marks, 2.75% of \$140 million of loans (or \$3.9 million) in addition to “start-up” costs of \$200,000 (Gigot, 1999).

Community groups fired back at the Senator. In one well-publicized case several hundred members of the Chicago-based National People’s Action descended on his residence on a Sunday morning with banners, leaflets, and an effigy of the Senator (Barancik, 1999). We would learn later that this protest (while he was at home) and especially his trampled flowers, seemed to make him more determined than ever to attack CRA.

Various versions of his financial reform attacked CRA in different ways. One reform bill passed the Senate with an unprecedented CRA exemption for nonmetropolitan banks with assets of \$100 million or less. Presidential vetoes were threatened over that and other anti-CRA provisions.

GLB finally became law on November 12, 1999 and revamped our financial system by allowing financial holding companies to expand beyond normal banking activities to the insurance and securities businesses.

Despite all of Senator Gramm’s anti-CRA bark, the only bite he was able to muster in the passed version of GLB was a significant reduction in the frequency of CRA exams and a controversial “sunshine” requirement that required community groups to disclose how much they got from banks. Considering that banks and members of Congress must disclose the source of their funds, this requirement was not unreasonable, as a few community groups and their leaders might have other priorities (see following section).

CRA’s arch-enemy announced his retirement in 2001, the first year filings on sunshine contributions became available. Senator Gramm’s legacy will likely be shaped not just by GLB but by the controversy over contributions... not from banks to community groups, but from the failed Enron Corporation to Senator Gramm and his wife, Wendy, an Enron Director and former

Chair of the Commodity Futures Trading Commission. Hopefully, the same sun that brought light to bank funding of community groups will shine on Enron's funding of the Gramms.

### **A Decade of CRA Ratings**

CRA ratings began the last decade under the "10-80-10" rule: roughly 10% above- and below-average ratings with the remaining 80% in the middle (i.e., "Satisfactory"). Published CRA ratings data over this period (Thomas, 1993 and 1998) were updated by the federal regulators and their web sites for the analysis in this section.

According to these data, the proportion of below-average or "failing" ratings, which was just above 10% at the beginning of the last decade, fell to 2% by mid-decade, and remained in that range for the remainder of the decade. The most recent data for 2001 show this proportion inching up slightly to the 3% range in 2001, which means the probability of a CRA examiner giving a failing rating is not that different from the probability of a Wall Street stock analyst giving a "sell" rating.

The proportion of above-average ratings also starting out at just above 10% in 1990, peaked at about 27% in 1996 and then dropped back to about 15% in 2000 and to just above 10% in 2001. Thus, the proportion of Outstanding ratings in 2001 was roughly where it was in 1990, having peaked in 1996.

It can be argued that the transition to the "new" CRA in 1996 was responsible for the more than halving of above-average ratings by 2001 and the slight increase in below-average ratings. This would, however, be over-simplistic, as there are other relevant explanatory factors that likely played a role in these trends.<sup>8</sup> Grade inflation (or deflation) cannot be proved by looking at ratings alone.

One of the most significant developments regarding CRA exams during the last decade was the major cutback in the number of them. The total number of CRA exams during the first part of the decade averaged around 5,600, with 1993 being the peak year with about 6,700 exams. With the new CRA being transitioned in during 1996, the number of exams fell to just under 5,000. The number of exams continued to decline to the 4,000 range for both 1997 and 1998 before dropping even more to about 3,500 in 1999. There was an increasing level of bank consolidation during this period causing the total number of banks and thrifts (and exams) to

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<sup>8</sup> Examiners may have become "tougher" or perhaps bank CRA performance as measured under the new standards was lower; or, more than likely, it was a combination of several factors.

continue to dwindle.

The 1999 GLB mandated a change of CRA exam schedules resulting in considerably fewer exams. This 1999 law caused the number of CRA exams to precipitously drop by more than one half from around 3,500 in 1999 to about 1,600 in 2000. This trend continued with the number of exams plunging even further to less than 900 in 2001. Obviously, fewer exams not only mean that fewer examiners are needed but also that CRA performance is being monitored less frequently.

### **CRA Urban Legends**

An entire CRA folklore has been developed, especially during the last decade. Most of the CRA urban legends were started by bankers (and even some anti-CRA regulators and congressman like Senator Gramm) who opposed the law regardless of its costs or benefits.

One urban legend of recent vintage is that CRA has not worked. In other words, it really has not had a meaningful impact on the designated LMI target group. The fact is that the proportion of conventional home purchase loans to LMI *borrowers* (regardless of area) jumped from 14.4% in 1990 to 25.4% in 2000, while the proportion made in LMI *areas* (regardless of income) grew from 10.7% to 12.2% over the same period (FFIEC, 2002). While it is difficult to prove a causal relationship between CRA and these improved LMI numbers, it is reasonable to assume as much with the very significant and visible push toward LMI lending.

A Treasury study on the impact of GLB on CRA concluded that CRA has had a favorable impact on LMI home lending and that CRA lenders and their affiliates increased their LMI lending faster than independent non-bank lenders. That same study found that CRA has made a substantial difference in the behavior of lenders and credit flows in LMI areas (Treasury, 2001). A separate study by Harvard University concluded that CRA-regulated entities originated significantly more LMI loans than they would have without CRA (Harvard University, 2002).

If not by any other standard, CRA was a success based on the \$1.6 trillion dollars of written CRA agreements for loans or commitments that were made by financial institutions (NCRC, 2002A). To the surprise of both banks and even their doubting regulators, the results from CRA lending were much better than expected.

It is no doubt easier and more efficient to make a single \$1 million loan over a golf outing at the country club compared to 10 LMI home loans of \$100,000. The latter, however, results in

greater diversification and many times even a stronger credit, as an LMI family will do just about anything, including taking on an additional job, to keep current on mortgage payments.

Wall Street later discovered an even better secret about these LMI loans: they are much *less* likely to prepay or refinance when rates drop. This makes the loans even more valuable since they are being carried at a higher rate. Companies like Bear Stearns became leaders in packaging securitized CRA loans, which now represent a major sector of the secondary market.

Godzilla banks like JPMorgan Chase, having been burnt badly by lending heavily to big borrowers like Enron and Argentina, probably now wish they would have made more LMI loans in their local communities.

CRA has never caused a bank to fail or lose significant market cap. In fact, two studies by the FED made several very positive conclusions about CRA loans, thus dispelling the CRA urban legend that such loans are unprofitable.

A 1997 FED study, for example, found that among banks specializing in mortgages, “we find no evidence of lower profitability at commercial banks that specialize in home purchase lending in lower-income neighborhoods or to lower-income borrowers” (Canner and Passmore, 1997).

The study went on to state that for the 1993–95 period of high CRA-related lending, “the profitability of banks seems unrelated to, or perhaps slightly positively related to, the proportion of lending they extend in lower-income tracts.” The most comprehensive study on the profitability of CRA-related lending, which likewise reaches many favorable conclusions, was also done by the FED. That study is discussed in greater detail in the following section.

Another CRA urban legend is that the law’s main benefactors are minorities, particularly African Americans and inner city communities. Since CRA is an LMI income-based law, there is no race card, which explains why this 1977 law has supporters on both sides of the aisle. In fact, 60% of LMI individuals are non-Hispanic white (Thomas, 1998). While affirmative action laws or programs may impact some college applications, this is not the case with CRA loan applications.

A final CRA urban legend is that compliance with the law is very costly to banks. While this may have been somewhat true in the early 90s, the situation greatly improved for most banks with the law’s 1995 reform. A Treasury study concluded that the GLB reporting requirements were expected to lead to “modestly higher compliance costs” (Treasury, 2001).

Still, though, there is room for improvement, and this is one of the goals of the public policy recommendations in this Working Paper.

### **The FED’s Study on the Profitability of CRA–Related Lending**

As part of GLB, Congress asked the FED to conduct a comprehensive study of CRA loan profitability (see Board of Governors of the Federal Reserve System, 2000 and summary in Avery, Bostic, and Canner, 2000). This study was based on 143 responses to surveys sent to the 500 largest financial institutions (a 29% response rate).

The survey focused on four loan products representing \$712 billion in estimated 1999 originations by the 500 surveyed financial institutions. Roughly 18% of all originations or \$130.1 billion were CRA–related. The breakdown of 1999 total and CRA–related originations for the four product categories in the FED survey are as follows:

<b>Loan Product in FED Survey</b>	<b>Total Originations (billions)</b>	<b>Amount CRA–Related (billions)</b>	<b>Percent CRA–Related</b>
Home Purchase and Refinance	\$570.0	\$56.0	10%
Home Improvement	12.0	2.2	18
Small Business	117.0	58.9	50
Community Development	13.0	13.0	100
<i>Total Loans</i>	<i>\$712.0</i>	<i>\$130.1</i>	<i>18</i>

Source: Board of Governors of the Federal Reserve System

Virtually all of the 500 largest financial institutions are \$1 billion or larger in asset size. The FED estimated that the 500 largest financial institutions accounted for roughly three–fourths of all CRA–related lending in 1999, with the respondents representing about half of all such lending. These results are therefore quite representative of CRA–related lending.

The authors concluded that “...overall as well as CRA–related home purchase and refinance lending is profitable or marginally profitable for most institutions.” While the results for home improvement lending were similar to the first category, “Nearly all respondents reported that small business lending overall and CRA–related small business lending are both



profitable.” Regarding the last category, “Virtually all respondents reported that community development lending is at least marginally profitable.” Also, two-thirds of the FED survey respondents said that their CRA-related lending “has led to new business opportunities.”

The major profitability results by product category are as follows:

<b>Loan Product in FED Survey</b>	<b>Loan Category</b>	<b>Profitable or Marginally Profitable</b>	<b>Break Even</b>	<b>Unprofitable or Marginally Unprofitable</b>
Home Purchase and Refinance	Total	94%	4%	2%
	<i>CRA-Related</i>	82	3	15
Home Improvement	Total	94	2	4
	<i>CRA-Related</i>	86	4	10
Small Business	Total	96	2	2
	<i>CRA-Related</i>	96	2	2
Community Development	Total	93	4	3
	<i>CRA-Related</i>	93	4	3

Source: Board of Governors of the Federal Reserve System

The profitability experience of small business lending is identical for those portions that are CRA-related and those that are not. This is a significant finding because this is the largest single category of CRA-related lending, accounting for about 45% of it. Counting CD lending, all of which is CRA-related, we can conclude from this FED study that over half (55%) of all CRA-related lending has general profitability characteristics identical to all other bank lending that is not CRA-related. This is an important finding helping to dispel the myth that CRA-related lending is unprofitable.

The remainder (45%) of CRA-related lending is home-related. This general category can also be viewed quite favorably, with between 82 and 86% of it being considered profitable or marginally profitable. The most significant differences in profitability clearly are in the home purchase/refinance and improvement categories, where the proportion of CRA-related lending that is unprofitable or marginally so is in the 10–15% range compared to the 2–4% range for

lending that is not CRA-related (see table above).

Additional delinquency rate and other data in the FED survey support the general finding that while the vast majority (i.e., 82–96%) of CRA-related lending is profitable or marginally profitable, it falls short in this regard compared to lending that is not CRA-related. Also, that portion of the survey related to the roughly \$11 billion in CRA special lending programs found about 25% of them were unprofitable or marginally so.

Senator Phil Gramm of Texas immediately seized upon these results to argue that the FED report “largely refutes the argument that CRA lending is good business for banks and the American credit market” (Gramm, Phil, 2000). By arguing that the surveyed loans would not have been made without CRA, Senator Gramm ironically made one of the strongest arguments in support of CRA, namely that this law *is* needed to encourage banks to make credit available to LMI people and neighborhoods.

The fact is that without CRA, much of this 40% of our population would be facing a much more difficult time accessing credit for home lending and improvement, small businesses, and community development.

### **CRA Sunshine**

Despite Senator Gramm’s continued CRA onslaught, the only anti-CRA provisions he could pass in GLB was a reduction in the frequency of CRA exams and a controversial “sunshine” requirement.

Community groups were unsuccessful in their vehement fight against this requirement. The CRA sunshine provision requires community groups to disclose how much they got from which banks. Non-governmental entities or persons as well as insured depository institutions and their affiliates that are parties to certain CRA agreements must make them public and file annual reports about them with the regulators.

The sunshine rule only applies to written, CRA-related agreements preceded by a (favorable or unfavorable) CRA communication. A covered loan agreement must be for at least \$50,000, while a non-loan agreement, such as a grant, must be at least \$10,000 to be reportable.

The regulators have made limited sunshine data available, and the only way to access it at this time is via Freedom of Information Act (FOIA) requests to individual regulators.<sup>9</sup> The

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<sup>9</sup> One of the recommendations in this brief is that all CRA sunshine reports be made available on-line at the regulatory web sites.

author made a series of FOIA requests to the four federal bank and thrift regulators on October 21, 2001, but the responses were not all received until mid-December.

Table 3 reports a sampling of the first such publicly available group of sunshine reports from the OCC. This table summarizes filings of \$100,000 or more to selected community groups by some of the largest national banks for the 2001 reporting cycle. This listing does not include multi-million dollar loan agreements. As can be seen from this tabulation, several prominent community groups receive sizable funds from large banks around the country.

### **CRA Sunshine Clouded**

The author's requests to all four regulators did *not* reveal some CRA agreements between community groups and bank related firms as they were apparently exempt under the new law.

Depository institution "affiliates" are limited to firms that were considered in recent CRA exams. Thus, community groups do not have to report agreements or grants, some of which may be substantial, received from non-covered affiliates or other for-profit firms who supply CRA services or products to banks.

A community group or financial institution may interpret a particular agreement's nature or even the relevant CRA communication to be exempt from filing requirements. Some community groups or institutions may even structure their agreements so that they are exempt from CRA sunshine reporting. Alternatively, a community group may state that it does not take any funds for operating support from financial institutions, but makes an exception for the sponsorships of conferences (where it is possible the funds are commingled for other uses).

Even if a community group involved in CRA is somehow exempt from sunshine filing, all non-profits are required to make public their IRS Form 990, Return of Organization Exempt From Income Tax. While these IRS forms are available at no charge on the internet (e.g., [www.guidestar.org](http://www.guidestar.org)), the community groups are not required to list their contributors by name, as would be the case with a CRA sunshine report.

Upon receipt of the FOIA-requested sunshine reports from the four regulators, the most glaring omission was the lack of any filing for the Washington D.C. based National Community Reinvestment Coalition (NCRC). They are the nation's most vocal CRA coalition, with 800 member organizations from around the country according to their October 2, 2001 CRA reform comment. Each of the regulators independently confirmed that there were no CRA sunshine

filings by NCRC.<sup>10</sup>

NCRC led the battle against Senator Gramm's sunshine provisions, and provides advice to its members on complying with sunshine requirements. Therefore, it is reasonable to assume that they are operating under some type of filing exemption. But, it is likewise reasonable to expect that NCRC *should* disclose the specific sources of all of its funding, as this organization is so central to the CRA reform debate.<sup>11</sup>

The only public information readily available on the finances of NCRC is their IRS Form 990, which was obtained from the above-mentioned site. Schedule B of that form for 2000 lists 19 individual contributors ranging from \$5,000 to \$100,000 each for a total of \$507,000 (IRS, 2000). Unfortunately, all of the contributor's names, presumably financial institutions for the most part, were deleted.

A statement to Schedule A of that form showing contributions over the 1996-99 period ranging from \$130,000 to \$290,000 each for a total of \$1.84 million for six major contributors likewise did not identify the name of the contributors. Thus, as many as 25 contributor's names were redacted in their Form 990.

Considering that NCRC has and continues to make demands on financial institutions (and the regulators) for different types of data disclosure, they and similar CRA community groups that are apparently exempt from sunshine filing, should voluntarily disclose the sources of its contributions on this form. This could be done as a voluntary sunshine filing with the regulators or at least on their own web sites.<sup>12</sup>

While the apparent exemption of this or similar community groups may meet the letter of the sunshine law, it clearly does not meet its intent. Sunshine in this corner of the CRA Triangle would allow for more informed public policy debate and decisions.

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<sup>10</sup> Possibly due to differing interpretations of the CRA sunshine requirement, some banks such as Wells Fargo identified in its own sunshine filing its \$250,000 contributions to NCRC (see Table 3).

<sup>11</sup> For example, NCRC claims that it was the "lead organization" for the introduction of the CRA Modernization Act of 2001 (NCRC, 2002B). Also, their internet announcement of their "Advanced CRA Manual" boasts that it includes a "Case study of how NCRC and one of our member organizations commented on a CRA exam and merger application and almost flunked the lender and stopped the merger application" (NCRC, 2002C).

<sup>12</sup> Many nonprofits publish their IRS Form 990 on their own web sites to keep members informed of their financial situation, including key revenue and expense items.

## **Need for CRA Sunshine**

The sunshine requirement is a refreshing start to disclose the nature of relationships within the CRA Triangle, especially when they can impact CRA public policy. This was the case during Wells Fargo Bank's 1995 hostile bid for First Interstate, the second-largest merger ever at that time. Unfortunately, there was no sunshine law in effect at that time.

The Greenlining Institute in San Francisco refused to disclose what were believed to be significant direct and indirect contributions from Wells Fargo Bank during and prior to the merger. While the California Reinvestment Committee, most other independent community groups, and more than 600 commenters, including the author, favored First Bank System's white knight bid or some alternative deal, the Greenlining Institute was reportedly responsible for 120 of the 135 (89%) of the witnesses supporting Wells Fargo.

As part of the author's comment on this merger, the FED and Wells Fargo were repeatedly petitioned to disclose the bank's contributions to Greenlining, but both refused. The Greenlining Institute, aware of these repeated requests, remained silent. In fact, the FED's order approving the merger specifically *refused* the author's request that they consider Wells Fargo's contributions to community groups like the Greenlining Institute when weighing comments on the merger (Board of Governors of the Federal Reserve System, 1996).

It can be argued that the FED, which apparently has yet to meet a big bank merger it has not liked, would have approved that deal anyway. A CRA sunshine law in 1995, however, would have disinfected that approval process and explained why the Greenlining Institute virtually stood alone among community groups in supporting Wells Fargo Bank.

Today, thanks to the sunshine law, we can determine the financial relationship between the Greenlining Institute and Wells Fargo. Using selected excerpts from their first such filing available from the regulators, Table 4 indicates that the \$260,000 from that bank was Greenlining's most important source of contributions in their 1999 fiscal year.

According to this table, total bank and thrift contributions for that year for this one community group were nearly \$1 million, resulting, after salaries and other expenses, in an excess contribution ("net income") of \$0.6 million. Contributions of \$259,500 to their minority and diversity programs are separately listed in Table 4.

It is interesting to note that there are many banks in the U.S. that did not even make \$0.6 million in net income in 1999. According to the FDIC's web site, of the 10,220 banks and thrifts at the end of 1999, 4,194 or 41% had income of less than \$0.6 million (FDIC, 2002A).

Thus, the Greenlining Institute, whose primary source of income is banks and thrifts, is making more money than roughly four of every ten such financial institutions.

The top officers of that community group, with total 1999 compensation and contributions (to benefit plans and deferred compensation) in the \$140,000 range (see Table 4), probably make more than the top officers of many banks and their regulators.<sup>13</sup>

Like a banker complaining about the CRA regulatory burden, Greenlining's legal counsel strongly criticized the CRA sunshine requirement as "bureaucratic and onerous," not to mention a First Amendment violation of free speech (Gnaizda, 2001).

In justifying the need for a race-based CRA and a new race reporting requirements for CRA small-business lending data, that Greenlining representative commended by name two "progressive financial institutions," namely Washington Mutual and Wells Fargo, that supported such a requirement. It is interesting to note from Table 4, that Washington Mutual is the only institution that has given more money to the Greenlining Institute than Wells Fargo, counting that community group's minority/diversity programs.

### **Potential Failure of the CRA Triangle**

In all fairness to the Greenlining Institute, it has been a lightning rod for community activism in California and elsewhere by "using a combination of tools, including negotiation, litigation, media coverage, and community education," according to their IRS Form 990. They have been in the forefront of the movement to extend CRA to insurance companies and brokerage firms, which their legal counsel claims will triple the impact of CRA (Rehm, 2002).

They have sponsored CRA and fair lending conferences that FED Chairman Greenspan has keynoted, and their legal counsel has personally met with President Bush to discuss CRA topics. This community group has the ear of and access to the top two people in the Beltway, and it would appear that everyone, including those in the White House, returns their calls.

To the extent they have become so visible and powerful as a representative of the CRA and fair lending movement, this raises an interesting public policy question. What if, for example, they are asked by one of their top financial institution contributors (e.g., Washington Mutual or Wells Fargo) to put in a good word for them with the top people in Washington, perhaps about a

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<sup>13</sup> Other community groups have reported relatively sizable "net income" levels, including NCRC, which showed a net of \$0.4 million in both 1999 and 2000. According to their IRS Form 990, NCRC's top

controversial topic like their subprime lending or during a difficult period when they need help? This would not be that dissimilar to what apparently happened in 1995 when Greenlining virtually stood alone among community groups in supporting Wells Fargo in their successful hostile takeover.

Another example of a similar potential public policy issue is the case where the CEO and a fellow board member of a prominent national community group also serve on the board, including one in the role of its chair, of a for-profit fund selling CRA investments to banks. Moreover, each of the respective organizations contains web links to and even articles promoting each other. While there is no public information on any financial or other relationship between these organizations, it is possible that the community group's position on maintaining the Investment Test may be affected by this relationship. All of the details of such a relationship should be disclosed in any CRA reform or other public comment about the Investment Test.

While we expect bank trade groups and their lobbyists to take pro-industry (and sometimes but not always anti-consumer) positions, this is not expected for a community group. This could result in a failure of the CRA Triangle to properly function, and instead of the FED-distorted CRA Triangle in Figure 2, the result would be a community group-distorted one. At least with CRA sunshine, we might be able to explain some of these potential failures.

## **CRA: THE FUTURE**

### **Past Reform Proposals Still Relevant Today**

One of the beauties of CRA is that it is periodically reformed to keep it current and responsive to the needs of both communities and banks. Fortunately, CRA is once again being reformed this year on its 25<sup>th</sup> anniversary. This will be its second scheduled reform after the 1993–95 first major effort. While it is possible that the current reform will require multiple proposals, the number of current comments relative to those submitted during the last reform (see below) do not suggest that this will be the case.

Regulators realized during the last reform effort that they might not get everything “right.” They consequently built in a required reform for 2002, which would give at least five years of

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officer had compensation and contributions in 2000 of \$168,000, up from \$130,000 in 1999 (IRS, 1999 and 2000). Again, many top bank officers and regulators are not compensated at these levels.

experience with all aspects of the new CRA (that was transitioned in during 1996 and 1997).<sup>14</sup> Now with this experience we can improve on those parts of CRA that encouraged access to LMI credit and eliminate or modify those that did not have this effect.

Thomas (1993) made numerous recommendations to reform CRA. Table 5 summarizes the key such recommendations made in that 1993 book. Many of those recommendations were adopted in the 1995 final CRA reform effort. With the exception of the suggestion concerning a CRA “assessment proposal,” most of those recommendations are still relevant today, except for those that have already been adopted.

Thomas (1998) restated and argued for the top 10 recommendations that were still relevant at that time. These recommendations are summarized in Table 6. With the exception of *mandatory* Investment and Service Tests for the small bank streamlined exam (#7), these recommendations are still relevant today.<sup>15</sup>

### **Proposed 2002 Reform Process**

The Appendix contains the July 19, 2001 Federal Register notice of the Advance Notice of Proposed Rulemaking (ANPR) for the reform of the CRA regulations (Federal Register, 2001). The ANPR begins by raising some fundamental general issues about the need for and overall approach to CRA reform. It then identifies eight specific issues for comment:

1. Large Retail Institutions: Lending, Investment, and Service Tests
2. Small Institutions: The Streamlined Small Institution Evaluation
3. Limited Purpose and Wholesale Institutions: The Community Development Test
4. Strategic Plan
5. Performance Context
6. Assessment Areas
7. Activities of Affiliates
8. Data Collection and Maintenance of Public Files

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<sup>14</sup> The reforms recommended here call for a mandatory review and potential reform of CRA five years after the complete transition to the present reforms; if the reforms due out in 2002 are fully transitioned by the end of next year, the next reform should occur in 2008.

<sup>15</sup> The reforms recommended here will maintain the *status quo* of optional Investment and Service Tests in the small bank streamlined exam to improve a Satisfactory rating.



The comment period closed on October 17, 2001, and the four bank and thrift regulators received approximately 400 different comments. This was only 6% of the 6,700 comments received on the first December 1993 CRA reform effort. This suggests either satisfaction with the current regulations or perhaps relative indifference or more likely some combination thereof.

### **CRA Reform Comment Analysis**

The author made multiple FOIA requests of the four bank and thrift agencies for all submitted comments. While the OTS was the only user-friendly agency having these comment letters on line, the other regulators are hopefully moving in that direction.

Almost all of the comments to the regulators came from either community groups or the bank and thrift industry. Again, from the perspective of the CRA Triangle, the regulators are acting as a referee or perhaps arbitrator to come up with the socially optimal reform proposal that will best meet public policy goals.

The author reviewed these comments and categorized them as from either group and summarized the most common elements of the two views. A common profile quickly developed, oftentimes the result of the views of the most prominent community group and industry trade associations.

Some of these national organizations, on both the community group side (e.g., NCRC and the Woodstock Institute) and bank side (e.g., Independent Community Bankers of America) sides, circulated CRA reform comment “boilerplate” or form letters, which added to the quantity but not quality of comments.

In fact, the “NCRC Sample Letter on the CRA ANPR,” which was widely circulated on the internet, was reprinted on October 16, 2001 on congressional letterhead and signed by 23 Members of Congress. The NCRC form letter was even reprinted on the stationery of a well-known law professor who has written on CRA.

Two tables were prepared using the submitted comments of the most prominent and representative community groups and industry associations, as well as those from a few individual financial institutions. These tables only present selected excerpts from the submitted comments, many of which were quite lengthy, in a standard format based on the above ANPR eight issues for comment.

Table 7 summarizes ten industry views on CRA reform, mainly those of trade groups with a few individual financial institutions. Table 8 presents a comparable tabulation of ten views

from the most prominent community groups. Almost all of these comments were dated October 17, 2001, the last date for public comment. The following discussion will not only reference these representative comments but also those from other banks and community groups.

### **Comments from Special Interests Outside of the CRA Triangle**

The comment analysis here focused on those coming from the community group and industry corners of the CRA Triangle, as the relevant regulators did not submit comments.<sup>16</sup> Several individuals submitted comments, but most of these were boilerplate letters, most likely downloaded in response to community group internet requests to submit them.

A few vendors who sell securities to banks and thrifts to satisfy their Investment Test requirements submitted comments, but they were clearly one-sided in promoting their special interests.

For example, a mutual fund that sells its qualified investment product nationwide requested that financial institutions be given more flexibility in choosing which of the three tests they should be evaluated under, much like the community development test (which they felt should be applied to all banks and thrifts). This fund would eliminate the 50% weighting for the Lending Test and have CRA investments be weighted identically to loans.

The “CRA premium” for CRA qualified investments has been the bane of banks (see following sections) but the boon of brokers. The commenting mutual fund proposed that banks purchasing loans or securities at a premium be given additional CRA credit. Because of an apparent concern that banks may be “padding” their investments with grants and contributions, they should be counted under the Service Test according to this investment vendor.

In an apparent effort to broaden the market for CRA investments beyond large banks, this fund proposed that small banks be allowed to include targeted MBS as part of the streamlined Lending Test. Finally, and not surprisingly, this securities firm noted that they failed to see the validity of the argument regarding the availability of qualified investments.

### **The Optimal CRA Reform Recommendations**

The 20 tabulation summaries in Tables 7 and 8, while accounting for just 5% of the roughly 400 total comments, are quite representative of the overall community and industry views. Using the respective community and industry profiles adopted in this analysis, in addition to the input

from the remaining community and industry comment letters, the “optimal” reform strategy was developed as being the one most responsive to both of these corners of the CRA Triangle.

Table 9 summarizes the specific “optimal” reform recommendations for CRA. Many of these recommendations were previously made by the author, as seen in Tables 5 and 6. Several of the reform proposals in Table 9 were discussed elsewhere (e.g., Thomas, 2001A).

The following discussion of the most controversial CRA reform issues highlights the different perspectives of the industry and community group corners of the CRA Triangle and why the recommended reform package in Table 9 is the optimal one.

### **Regulatory Interest in the Investment Test**

The first public proposal from a regulator to eliminate the Investment Test came from former FDIC Chairman Donna Tanoue, who suggested replacing it with a new Community Development test (Heller, 2000).

While the OCC was the bastion of CRA regulatory intelligence during Eugene Ludwig’s tenure as Comptroller, this function switched to the FDIC when the OCC’s well-respected CRA guru, Steve Cross, became head of the FDIC’s Division of Compliance and Consumer Affairs in May 1999. The managing director of the OTS compliance function as well as top compliance people from other agencies joined Division Director Cross the following year. Since the FDIC became the new CRA regulatory brain trust, this agency’s position on replacing the Investment Test was well thought out and responsive to both consumer and industry interests.

While other regulators generally have been silent on the controversial Investment Test, the FED’s San Francisco bank has established and aggressively promoted an entire Investment Test infrastructure, which is generally perceived as being supportive of this test. For example, the Federal Reserve Bank of San Francisco’s Community Affairs Department has six separate “Community Investment Specialists” who put on a series of quarterly roundtables throughout the West.

The San Francisco FED has their own *Community Investments* publication, and the March 2002 “Special Edition” titled “A Guide to Community Development Investments” contains articles by several non-profit and for-profit Investment Test vendors with contact information (Federal Reserve Bank of San Francisco, 2002). These and other vendors have appeared at numerous roundtables and other FED-sponsored CRA conferences to promote qualified

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<sup>16</sup> There were a few comments from members of Congress and assorted government agencies.

investments, and many of them have been most successful in this regard with banks and thrifts in that region.

Unlike most of the other Federal Reserve Banks, the Community Affairs Department of the San Francisco FED has more of a pro–industry than pro–consumer reputation (Thomas, 1998). Several of their conferences, many of which are held at plush resorts, have been co–sponsored with industry trade groups. The previous head of their Community Affairs Department became an officer at the largest financial institution in Hawaii.

This background is relevant to the extent that this substantial Investment Test infrastructure at the FED serves as a motivating force for them to maintain the *status quo* (i.e., the Investment Test). If there is no Investment Test or alternatively a significantly reduced one, will there be a need for the San Francisco FED’s glossy *Community Investments* magazine or their several community investment conferences? What about their numerous community investment specialists, the most senior of whom probably developed valuable contacts in the banking and securities industries?

Good public policy by the federal bank regulators dictates that their one and only concern must be what is in the public interest, giving appropriate consideration to both consumers and the industry alike. Hopefully the FED’s position on CRA reform will not be influenced by their San Francisco bank’s significant Investment Test infrastructure.

Similar potential conflicts may exist in some very large banks that have likewise built up significant Investment (and Service) Test infrastructures. What if you were hired because of your expertise and contacts in these specific areas that now might be eliminated or greatly cut back? Again, stockholder rather than employee special interests *should* dictate bank policy on the Investment or Service Tests, and regulators must consider the source of all comments.

### **Elimination of Investment and Service Tests**

Many large banks and virtually every bank trade association are rightfully asking that CRA be returned to its LMI lending roots by abolishing the Investment Test and, to a lesser extent, Service Test experiments or at least making them optional as is presently the case for small banks.

The \$400 million Southern Commercial Bank of St. Louis, in its October 10, 2001 CRA reform comment, asks: “If CRA is about banks meeting the credit needs of their communities why are there investment and service tests?”

Community groups generally want to keep everything in CRA and add new requirements. They are loathe to admit that any part of the law or its implementing rules and regulations cannot be cost-benefit justified, as the apparent goal is to increase not decrease the coverage and scope of the law.

This can, however, be counterproductive since the extraneous Investment and Service Tests reduce by 50% the weight given to LMI lending. For this reason, good public policy dictates that these two tests be reduced to individual performance evaluation factors under the Lending Test, as long as they can be documented to be LMI-credit related (see Table 9). At some point, these two tests can even become optional to improve a Satisfactory rating, as is presently the case under the streamlined small bank exam.

### **Reduce Grade Inflation by Removing Two of Three Inflated Tests**

The most comprehensive CRA grade inflation analysis of actual large bank exams revealed that fully 71% of the ratings on the Investment Test were inflated by one grade, compared to 32% and 29% comparable inflation rates for the Lending and Service Tests, respectively (Thomas, 1998). Thus, the Investment Test was determined to be a primary cause of overall CRA grade inflation.

Several government agencies have examined various inconsistency and other problems associated with CRA exams and ratings (see U.S General Accounting Office, 1995 and Office of Inspector General, U.S. Department of the Treasury, 1998), but they do not, perhaps for political reasons, broach the highly controversial issue of grade inflation.

This practice changed, however, with a December 21, 2000 internal evaluation of OTS PEs (see Office of Inspector General, U.S. Department of the Treasury, 2001). This study was “unable to validate the appropriateness of the investment component ratings” for 41% of its sample.<sup>17</sup>

Regarding the Investment Test, the OTS study found “apparent rating inconsistencies” as well as “limited instances where the investments component may have been rated higher than warranted.” The analysis concluded with ten very useful recommendations to ensure that PEs provide an accurate performance assessment. The optimal public policy reforms advocated in

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<sup>17</sup> The comparable percentage in this OTS study for the only other test evaluated in this way was 20% for the Lending Test; thus, the Investment Test is at least twice as problematic as the Lending Test in this regard.

this Working Paper adopt all of them (see Table 9).

The October 8, 2001 comment from the Center for Community Capitalism of the University of North Carolina at Chapel Hill suggested that grade inflation existed in the Service Test. While that study used a streamlined macro-analysis comparing CRA component test ratings, this same conclusion was reached earlier by Thomas (1998) using a detailed micro-analysis based on a re-examination of individual bank PEs.

Besides the methodology issue, the UNC results must be interpreted with some caution because the authors may have misunderstood how to classify low-cost accounts in the Service Test. When the OCC was asked to clarify this issue, they cited the relevant regs and interagency Q&As to conclude that a low-cost or basic banking checking account is generally considered a *retail banking* service; however, if it is targeted to LMI people, it would be considered a *community development* service (OCC, 2002). The UNC study, which failed to make this important distinction, assumed all low-cost accounts as CD services, when some of them are not directed to LMI individuals.

Regardless of the methodology and related technical issues, there is a general consensus that grade inflation is a serious concern, not just with individual tests but also with overall ratings. One remedy generally advanced by community groups is to make both the Investment and Service Tests much more quantitative and rigorous, often with new ratios and guidelines. This, however, would result in an additional burden not just for banks and thrifts, but also for regulators, some of whom (e.g., the OTS) are facing budget cuts.

The optimal solution to reducing grade inflation with these two tests is not to expand their data and analysis but to eliminate the tests by converting them into separate performance rating factors under the key Lending Test. To the extent these tests benefit LMI credit, they will be appropriately counted, but not at a morbidly obese 50% of the final rating.

### **Why the Service Test Should be Eliminated**

The Service Test includes both retail banking and CD services (see Table 2). One reason why there is considerable inflation in this test is the fact that every bank, which is in the “financial services” business by definition, provides some sort of retail banking service and is therefore entitled to some credit. Many banks make no qualified investments, and some banks make few if any loans during certain review periods. But, every bank including internet ones offers some retail banking service under the terms of its charter.

Another problem with the Service Test is the confusion that sometimes exists between its two main retail banking and CD components, such as the previously cited one in the UNC study. Also, CD services are often subjectively defined by examiners. CD services that can be documented to encourage access to and the provision of LMI credit are useful and deserve credit. This is also the case for retail banking services of this type. But, not to the tune of 25%, the current weighting for this test, which effectively dilutes the Lending Test.

For the above and other reasons, both the retail banking and CD services should be folded into the Lending Test as separately evaluated factors, but only if they can be documented to be LMI-credit related. Under this proposed reform, banks and community groups involved in such LMI-credit related activities will still benefit, but not to the same degree.

### **Community Groups Potentially Conflicted in Defending Investment and Service Tests**

Community group attempts to defend the non-lending tests are not only unrealistic but also somewhat self serving. In the case of the Service Test, some groups benefit by acting either directly as a beneficiary of some CD services or indirectly by sometimes being compensated for performing such services by banks (e.g., home ownership counseling to LMI home buyers). This is a relatively minor concern compared to the Investment Test.

The actual and potential conflict is most apparent with the Investment Test, as some groups have significant financial incentives to maintain it. Bank contributions to community groups count as qualified CRA investments, and the groups may feel this source of funding will be reduced or perhaps even eliminated without a standalone Investment Test.

The defense of the Investment Test in this regard was quite clear in the October 15, 2001 CRA reform comment of the Chicago Association of Neighborhood Development Organizations (CANDO): “Over 22% of CANDO’s revenues, for next fiscal year, are projected to come from grants by our bank partners. Grants from banks have provided critical operating support.” Grants are just the tip of the iceberg for some community groups.

There would be, for example, an even greater incentive to defend the Investment Test in the case where a community group and a for-profit CRA investment firm have: an interlocking Board of Directors; an arrangement where each promotes their affiliation with the other in newsletters and web sites; and, an agreement that relates community group funding to CRA investments sold.

The National Community Reinvestment Coalition (NCRC) in its October 2, 2001 CRA reform comment strongly defended the Investment Test. This group complained that “CRA examiners do not differentiate among types of investments or consider the extent to which investments are not routinely provided by the private sector.” An example was provided: “...grants to nonprofits are scarcer than investments in municipal bonds.” This was followed by a most unusual proposal: “CRA exams could readily incorporate ratios that compare grants as a percent of bank assets...”

The National Congress for Community Economic Development’s October 15, 2001 CRA reform comment proposed a ratio measuring bank grants against a bank’s recent earnings.

The Greenlining Institute’s October 15, 2001 CRA reform comment complained that “Philanthropy for economic development is inadequately rewarded on CRA exams.” Rather than calling for new ratios measuring and comparing grants, this community group argued that “bonus credits should be give for key grants.”

ACORN’s October 17, 2001 CRA reform comment unabashedly proposed that “Most notably, grants or commitments that support effective community efforts...should be given more weight than other investments.”

The Neighborhood Reinvestment Corporation, a public nonprofit established by Congress, made the following October 17, 2001 CRA reform comment about the impact of the loss of access to local decision-makers: “Under such circumstances, substantive grants or investments in nonprofit organizations...should be encouraged. Regulators may wish to expand the range and value of incentives that encourage institutions to make these kinds of investments.”

To defend a questionable test that can financially and otherwise benefit community groups is one thing, but to propose new grant-measuring ratios or awarding bonus credits for grants is pushing the envelope. Community groups should realize that they received grants from banks *before* the Investment Test and will continue to receive them even if that test is eliminated or greatly reduced in scope.

Meanwhile, in the same way that the author requested that the FED should consider the source of one community group’s comments on the 1995 Wells Fargo merger proposal, so too should the regulators consider the source of such community group comments on the reform of the Investment Test.



### **Misleading “Equity Investment” Defense of the Investment Test**

The main defense of the Investment Test by community groups is an oft-repeated 1999 quote from FED Chairman Greenspan stressing the need for greater “equity” investment in small businesses in lower-income communities (Greenspan, 1999).

This is, unfortunately, somewhat misleading, as most CRA “qualified investments” under the Investment Test are not of this type but rather purchased and repurchased LMI mortgage backed securities or even certain municipal bonds and minority bank certificates of deposit. This is a very important distinction, because true equity investments as referenced in the Greenspan quote are very much the exception rather than the rule.

The Bank of America October 16, 2001 comment, for example, pointed out that “Equity funding is less in demand and more expensive to maintain as part of balance sheet management. Moreover, equity is a form of permanent and often nontransferable funding.”

California Federal Bank’s October 17, 2001 CRA reform comment was even more blunt by stating that the current Investment Test results in “equity investments that are effectively grants with virtually no hope of a yield or return of principal.”

Community bankers have likewise come to this realization as seen from this October 12, 2001 CRA reform comment by First American Bank in Elk Grove Village, IL:

“Grants, regardless of their putative goodness, were never contemplated by CRA. The Act itself only addresses credit needs. Every ‘investment’ opportunity that we’ve been presented with has been substantially uneconomic....At best, these investments hold significantly below market returns. At worst, they are actual or de facto grants.”

Community groups are also fond of defending the Investment Test by stressing the need for long-term, “patient” capital. In reality, their emphasis on direct grants and “indirect grants” (i.e., a troubled equity investment) is usually more short- than long-term. This point is emphasized in the October 10, 2001 CRA reform comment by Commerce Bank of Kansas City, MO:

“There still remains a question as to whether or not donation type investments were ever intended to be a part of the regulation for evaluation purposes. Encouraging institutions to make profitable qualified long-term investments would be more in line with the intent of the law than short-term charitable donations.”

### **“Community Enrichment Act”**

An entire “CRA investment” industry has been created by Wall Street to take advantage of the shortage of qualified investments, which, when coupled with the increased demand for them,

has created a “CRA premium.” The problem is that many of the Wall Street opportunists that have moved into CRA are more interested in profiteering off of CRA investments than increasing LMI credit. But, this is not surprising whenever Wall Street meets Main Street.

The General Counsel for BancorpSouth, Inc. in Tupelo, MS writes in his October 17, 2001 CRA reform comment about the dilemma of meeting CRA goals with limited qualified investment opportunities:

“Securities dealers have ‘learned’ of this dilemma for financial institutions and are directly taking advantage of the dilemma. Securities dealers structure complex, risk-laden investments in a regulatory environment that is hyper-sensitive to risk management on the part of the bank. CRA requirements have therefore actually created a cottage industry within the investment community as dealers have discovered that banks are willing to pay above-market prices just to obtain CRA eligible investments.”

This same source identified the CRA premium on a mortgage-backed security (MBS) of one-half to three-quarters points vs. the one-eighth point the dealer would normally make on an identical, non-CRA instrument.

Interchange Bank of NJ, in their October 17, 2001 comment, claimed that this premium is as much as one full point and “is doing nothing more than fattening the wallets of Wall Street.”

A recent *Forbes* article titled the “Insider Enrichment Act “ exposed how CRA “helps certain wealthy investors get wealthier” (Kellner, 2001). The article focuses on how the nation’s largest black-owned investment bank and asset manager with \$4 billion under management is “exploiting” the CRA “gold mine” through a \$125 million fund.

Matthew Lee of the Inner City Public Interest Law Center in the Bronx, stated in that article that the referenced CRA fund was a “perversion of the CRA.” This fund was later cited as justification for returning CRA to its LMI lending roots (Thomas, 2002).

### **Investment Test Profiteers**

There are many other such Wall Street CRA profiteers likewise getting rich off the Investment Test. Unfortunately, there are little visible improvements in LMI credit access as a result of these activities.

California Federal Bank’s October 17, 2001 CRA reform comment complained that the shortage of qualified investments has resulted in “newly formed investments that are highly risky and/or simply create profit opportunities for intermediaries with no or little benefit passed

on to the community.” One such cited example: “Funds have been created that provide no or minimal added value to lower-income communities, but rather create profit opportunities to fund managers.”

WestAmerica Bank of Fairfield, CA writes in their September 27, 2001 CRA reform comment that the premium and competition for the limited number of qualified CRA investments is “not passed through to the schools and cities who have formed the securities but generated as profit to underwriters and traders.”

The current Investment Test has led to many “qualified investments” that merely recycle existing ones with no new underlying LMI loans being created. One LMI loan may be bought and sold many times and then securitized and repeatedly traded as an LMI MBS. Since it is defined as a “qualified” CRA investment, many banks get CRA credit for but one underlying LMI loan.

While Investment Test vendors and even their banking clients will argue that such activities “enhance access to LMI credit,” this is not unlike their Wall Street brethren churning a portfolio for commissions. Some MBS have been churned so much by the Investment Test that the underlying LMI purpose of the original loan and CRA has been long forgotten.

A community banker originating an LMI loan may even remember the property location and perhaps the name of the family. MBS purchasers only remember the amount of “CRA premium” paid to the securities broker and how much credit they got from the CRA examiner. All of this and more is the result of the Investment Test animal created in the last CRA reform.

The October 15, 2001 comment of the California Reinvestment Committee, while defending the Investment Test in terms of grants to community groups, among other things, perceptively stated that “One type of investment that has limited meaning for community development is mortgage-backed securities which appear all too often on the investment lists of financial institutions.”

California Federal Bank’s October 17, 2001 CRA reform comment stated that the lack of qualified investments has caused institutions to convert loans into investments: “This is costly with no compensating benefit to the transaction or the community being served and can increase the level of repayment risk to the institution.”

JPMorgan Chase’s October 17, 2001 CRA reform comment about the Investment Test “numbers game” emphasized its relatively limited community development value:

“The current stand-alone Investment Test for large retail banks is of concern because there are not enough eligible investment funds or other investment vehicles to grow a large, profitable, responsive and diverse CRA portfolio that has a meaningful impact on local community development needs. There may be enough investment opportunities, however, to grow a very large, modestly profitable portfolio of CRA eligible investments that has little community development value in terms of responsiveness to community development needs. In a numbers game, the latter is the portfolio of choice.”

These “numbers game” and other problems with the Investment Test were unforeseen during the 1993–95 CRA reform process. As pointed out by California Federal Bank, “While the inclusion of a standalone investment test in the 1995 Amendments was innovative and well intended, it has not worked well and its unintended consequences have been severe.”

Besides failing the cost-benefit test (except for Investment Test vendors and grant-happy community groups), the 25% weighted test, like the equally-weighted Service Test, reduce by one half the import of the key Lending Test. This has resulted in a 50% dilution of the LMI impact of CRA, and this is not good public policy.

### **The Proposed Streamlined Exam for Large Banks**

The streamlined small institution evaluation has been quite popular with the industry, although persistent grade inflation has been a continued problem. The small bank exam is totally focused on lending and includes specific LMI ratios; the *optional* Investment and Service Tests may allow a Satisfactory rating at a small bank to be increased to an Outstanding one.

There is no question that the small bank streamlined exam is less of a regulatory burden than the comparable large bank retail exam. According to the October 17, 2001 comment by the California Bankers Association, one member bank that recently graduated from the small to the large bank exam experienced over \$50,000 of additional costs unrelated to the investment of new dollars or services into its community.

One of the goals of good CRA public policy is to streamline the large bank exam as much as possible. As seen in Table 9, the optimal CRA reform results in a streamlined exam for large banks, since the two of the three current tests would be eliminated. The result is that the new Lending Test would count for 100% rather than just half of the overall CRA rating.

The 1995 revised CRA regs make an important distinction between the performance criteria within each test and the performance rating factors within the performance ratings matrix used by examiners.

In the case of the Lending Test, there are five performance criteria and seven rating factors (see Table 2). Since there are five possible ratings in the Lending Test performance ratings matrix, there are 35 possible cells.

By comparison, the Investment Test contains four performance criteria and three factors in its 15–cell ratings matrix, while the Service Test has six criteria and four factors in its 20–cell ratings matrix. Thus, there are a total of 70 possible cells in all three large bank exam matrices.

The current CRA regs specify five performance criteria for the Lending Test: lending activity, geographic distribution, borrower characteristics, CD lending, and innovative or flexible lending.

The proposed streamlined exam for large banks would include eight criteria. The first four Lending Test criteria would remain the same, but the fifth current innovative/flexible factor would be replaced by a “Qualitative LMI Lending Characteristics” factor. This factor would also include consideration of any predatory or other adverse credit factors that would impact LMI people or areas as well as small businesses/farms. Conversely, a bank would be given additional credit for graduating qualified LMI subprime customers into prime ones. The three new evaluation criteria would be investments, CD services, and retail banking services that can be documented to help meet the credit needs of LMI people and neighborhoods as well as small businesses/farms.

Thus, the proposed streamlined large bank exam summarized in Table 9 would include the following eight performance criteria:

1. Lending activity
2. Geographic distribution
3. Borrower characteristics
4. CD lending
5. Qualitative LMI lending characteristics
6. LMI credit–related investments (replacing the Investment Test)
7. LMI credit–related CD services (replacing the CD portion of the Service Test)
8. LMI credit–related retail banking services (replacing the retail banking service portion of the Service Test)

The actual Lending Test Performance Ratings Matrix from the 1995 regs divides the geographic distribution criterion into two items and adds a highly–economically–disadvantaged

item. Thus, under those regs there are not five but rather seven performance rating factors (see Table 2).

Just as the current CRA regs convert the five performance criteria into seven performance rating factors, the proposed streamlined large bank exam would convert the eight new criteria into the following ten ratings factors:

1. Lending activity levels responsive to AA credit needs % loans in AA
2. Borrower distribution by income and business/ farm size in AA
3. Geographic distribution of loans in AA
4. Lending to highly economically disadvantaged geographies and low income people and very small businesses in AA
5. Qualitative LMI lending characteristics
6. CD lending activities
7. LMI credit-related investments
8. LMI credit-related CD services
9. LMI credit-related retail banking services

The resultant performance ratings matrix for the large retail bank streamlined exam would have these ten factors times five possible ratings for 50 possible cells. This matrix with the ratings would be published in each PE. While an explicit weighting scheme for the different factors would result in a more quantitative approach, the PC and related exam factors should determine the appropriate weighting.

As noted in Table 9, the overall CRA rating would now be one of five rather than four possible ratings. Table 9 also contains specific recommendations regarding performance evaluation procedures such as a time-sensitive evaluation (and pro-rata weighting) over the review period and limited (pro-rata) credit for CRA qualifying activities commencing within six months of an exam starting date.

The proposed large retail bank exam would be streamlined for both banks and examiners alike since:

1. There would be one rather than three tests (a 67% reduction)
2. There would be a total of ten rather than 15 performance criteria (a 33% reduction)

3. There would be one rather than three performance ratings matrices (a 67% reduction)
4. There would be 50 rather than 70 individual rating matrix cells (a 29% reduction)

Those large banks with extensive CRA investments and services will continue to garner credit under this streamlined large bank exam, as long as they are legitimately LMI credit-related. In the event the current grade inflation and other problems associated with the Investment and Service Tests continue, they can become optional factors as is presently the case with the small bank exam. Although this recommended approach allows for a smooth transition, these two tests may have to ultimately be eliminated depending upon the future experience with them under this streamlined approach.

### **Expansion of Definition of “Small” Banks to Qualify for Streamlined Exam**

The Number One priority for small banks is to increase the minimum allowable size by which such banks can qualify for the streamlined exam. Community groups are against any such increases.

Currently, a small bank is defined as one with assets of \$250 million or less that is an independent institution or affiliated with a holding company with less than \$1 billion in assets. The streamlined test represents a significant time and cost savings compared to the large bank exam.

As seen in Table 7, most bank trade groups would increase the former number to at least \$1 billion and either remove the latter requirement or increase it to as much as \$5 billion. Community groups, on the other hand, according to Table 8, would keep this definition unchanged and even make this exam less streamlined (e.g., NCRC’s proposal to make the optional Investment and Service Tests mandatory).

The optimal solution from a public policy perspective is to *double* the current independent minimum asset level to \$500 million, a number commonly associated with a “community bank” in today’s competitive environment. The comparable holding company minimum should likewise double to \$2 billion.

The proposed \$500 million and under definition for a community bank has been used by many regulators. For example, a recent FED article (Hall and Yeager, 2002) about community banks noted that “Community banks are typically smaller banks; most have fewer than \$500

million in assets.” Also, an OCC economist (Whalen, 2001) used the same \$500 million and less range to define a community bank.

In fact, several small banks and thrifts (e.g., State Bank of LaCrosse, WI; Ledyard National Bank of Hanover, NH; First State Bank of Irvington, KY; and, even the New Jersey League of Community & Savings Bankers) departed from the CRA reform boilerplate letter circulated by their national trade groups and recommended a \$500 million and under rather than \$1 billion asset level as a reasonable definition of a small bank.

Probably the most compelling argument in favor of the \$500 million and under small bank definition is the fact that it would encompass roughly 90% of the nation’s nearly 10,000 banks and thrifts compared to the approximately 80% covered with the \$250 million and less definition. By making the quantum leap to \$1 billion and less would take in nearly 95% of the industry, hardly a reasonable basis for a small/large size distinction.

The fact that the large bank exam would be streamlined under these reform recommendations may somewhat reduce the urgency of being designated a “small” bank. Good public policy should not result in significant differences in compliance burden based solely on size.

### **Misguided Community Group Proposal to Make CRA Race Based**

Community groups are flat out wrong by asking that CRA become race based, something that could jeopardize the future of this needs-based law. Nothing could be more damaging to CRA than to change or even redirect its primary focus away from LMI lending.

Most leading community groups have explicitly called for a race-based CRA in addition to its statutory needs-based (LMI) history. Even some respected researchers have apparently confused the statutory intent of CRA in this regard by frequently mentioning “minority” communities alongside “lower-income” ones in their discussions of CRA (e.g., Harvard University, 2002).

NCRC, one of many D.C.-based community groups, wants minorities to be explicitly considered on the Lending Test just like LMI people and areas. The Greenlining Institute argues in its October 15, 2001 CRA reform comment that “CRA exams should not be colorblind,” citing the large percentage of minorities in California.

What is not mentioned by that community group, however, is the fact that, California, our largest state, is now “majority-minority” according to the 2000 Census, which means over half



(i.e., 51% to be exact) of its population is made up of designated minorities, specifically Latinos, Asian Americans, African Americans, and Native Americans (Munoz, 2000).

Census Bureau data analyzed by the Center on Urban and Metropolitan Policy at the Brookings Institution found that 52 of the 100 most populous cities in the U.S. are majority–minority (Schmitt, 2001). In fact, some demographers have suggested that the entire US will be majority–minority sometimes around or shortly after the midpoint of this century.

With a majority–minority state or large city, a race–based CRA proposal would lessen the public policy benefits of the law. This is because limited resources would be diverted from helping those people and areas most in need to those people and areas that may or may not be in need, but just happen to be associated with a certain ethnic group. Just as there was a backlash with affirmative action programs, this would make CRA more controversial than ever and more than likely reduce its strong bipartisan support. CRA has survived for 25 years as a race–blind law, and any changes in this regard could jeopardize it.

The banking industry would likely not even consider amending CRA to become race based, although some segments of it have proposed deviating from its LMI–based focus. Wachovia Corporation, for example, in its October 17, 2001 CRA reform comment, proposed that the “community development” definition should be expanded to include all such projects rather than those in LMI areas. This misguided proposal, like the race–based idea from community groups, would likewise serve to undermine the needs–based foundation of CRA.<sup>18</sup>

### **Subprime vs. Predatory Lending Issues**

Community groups are also playing with a two–edged sword in their efforts to heavily regulate subprime lending to root out predatory problems. This is because many community group leaders fail to distinguish between subprime lending which is “good” and predatory lending which is not.

For example, the head of a national coalition in past congressional testimony tied the two concepts together by expressing concern over the exponential growth of “subprime (and potentially predatory) lending” (NCRC, 2000). Another national community group issued a news release and study lambasting predatory lending and “financial apartheid,” but all of the supporting data referred to subprime loans (ACORN, 2000).

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<sup>18</sup> This Wachovia proposal should be viewed in light of the reputation of this bank’s predecessor, First Union, as not being consumer or CRA friendly (see, for example, Thomas, 1998).

Even worse than confusing subprime and predatory lending, are those who would criticize others merely for being associated with a subprime product. This was the case with a community representative turned professor, who completed a Ph.D. dissertation on CRA (Metzger, 1999). He attacked a prominent housing finance professor because he “has ties to the subprime industry,” due to his association with a firm that sells mortgage origination software to prime and subprime lenders alike!

Besides the confusion between subprime and predatory lending, some community groups even propose penalizing banks with legitimate subprime lending. For example, the October 2, 2001 CRA reform comment of NCRC proposes that “subprime lending must not count as much as prime lending.” The October 15, 2001 comment of the California Reinvestment Committee (CRC) reports that “Survey responses from CRC members overwhelmingly state that financial institutions should receive little to no credit for subprime lending.”

This confusion between predatory and subprime lending and, worse yet, stigmatizing of the latter may have the perverse impact of limiting the availability of credit to CRA’s target group, namely LMI individuals and areas, where subprime lending is important. Well-meaning public officials, under pressure from vocal community groups, may be throwing the CRA baby out with the predatory bath water. This is not good public policy.

The FED has attempted to clarify the distinction between subprime and predatory lending: “Just as the expansion of subprime lending has increased access to credit, the expansion of its unfortunate counterpart, predatory lending, has made many low-income borrowers worse off” (Gramlich, 2000).

A joint report on predatory lending by two federal departments made the same conclusion: “Subprime lending serves an important role, by providing loans to borrowers who do not meet the credit standards for the prime mortgage market. Some borrowers in the subprime market, however, may be particularly vulnerable to abusive lending practices” (HUD, 2000). Not all community groups confuse subprime and predatory lending. The Neighborhood Reinvestment Corporation, a public nonprofit established by Congress, identified still another problem with the wholesale condemnation of subprime lending in its October 17, 2001 CRA reform comment: “We would stress, however, that discouraging regulated institutions from directly or indirectly engaging in subprime lending could prove counter-productive. Regulated institutions are more likely to provide the service in a responsible manner,” compared to unregulated institutions, some of whom are “totally unscrupulous” according to this source.

Another community group that has apparently seen the light on subprime lending is the Greenlining Institute. An article about Washington Mutual, the nation's third largest subprime mortgage lender, quoted Greenlining's legal counsel that "Our position from the beginning has been that we want every major regulated bank doing subprime" (Mandaró, 2001).

The community corner of the CRA Triangle has influenced most of the public policy involving subprime and predatory lending, including numerous city, county, state, and federal actual and proposed anti-predatory laws. Unless the subprime lending industry develops a unified voice and improved image for its "high risk" lending product, public policy, including possible federal preemption of local and state anti-predatory laws, will continue to be weighted against the industry (Thomas, 2001B). Such a failure of the CRA Triangle will not result in good public policy.

It makes sense that the qualitative aspects of LMI lending be evaluated in the context of a CRA exam (see recommendation in Table 9). Those banks and their affiliates, for example, that can document a significant effort to move qualified subprime borrowers to the lower-cost prime market, should receive credit under this qualitative factor. Those banks and their affiliates carrying loans deemed to be predatory would be downgraded. Contrary to the position of most community groups, this analysis, however, should not include any race-based factors, which are the province of fair-lending exams.

### **Assessment Area (AA) Definition**

It is not far from the truth to argue that banks and thrifts generally prefer AAs to be as small as possible, while community groups (and oftentimes the regulators) take the opposite view. A larger AA means loan, investment, and service performance will be evaluated for an expanded area. This can be costly for banks and thrifts but beneficial to community groups in the expanded areas, if they can now benefit from additional grants (i.e., a "qualified investment" under the Investment Test).

Banks and thrifts are generally happy with the current AA approach, as they have the flexibility to define this key geography with but a few constraints. Community groups, on the other hand, would eliminate some of this flexibility, especially for banks with alternative delivery systems such as internet banks where the groups feel a national AA might be appropriate.

These banks and others using the mail, telephone, or brokers to extend nationwide credit often have pockets of borrowers all over the country but just a small percentage (often 15–25% or less) from within its AA, typically narrowly defined around its legal residence. The smaller AA penalizes that bank in terms of the percentage of lending in its AA, but that local geography is not the most relevant concept for such a bank.

We must keep in mind, however, that there are a relatively small number of internet and other such nontraditional banks, *excluding* those legitimately covered under the limited purpose and wholesale bank test. Although there was much hype about internet banks during the dot com era, there are only a handful of true internet banks remaining. Some have failed, and others have opened traditional brick and mortar branches.

It is not good public policy to establish a new AA regulatory framework for all banks based on the special circumstances of a relatively small number of fairly new and oftentimes struggling banks, as the new regs will most likely prove an undue burden for all banks.

Some community groups have proposed that internet and similar banks define their AAs on the basis of their lending market share in local markets, using a very small 0.5% bright line. Assuming this was a reasonable approach, the relevant cutoff would have to be significantly higher, perhaps 5–10% or more, before the subject bank's relative performance might have a meaningful impact on the local credit market.

Still another suggestion for evaluating the performance of internet banks is to evaluate their performance under the CD test as originally proposed by the OTS. This proposal had appeal when it appeared that internet banks might become so popular to justify their own special purpose category like limited purpose and wholesale banks. However, the actual experience with this exam suggests that it be reserved for truly special purpose banks that are not retail ones.

Based on the small number of pure-play internet banks, it makes more sense to evaluate them as the retail banks they are but give them credit for any LMI-related activity outside of their AAs, as long as local LMI credit demand is being met by the bank. This same approach can be applied to any bank with a nontraditional delivery system.

Thus, this recommendation would maintain the AA *status quo* but require examiners to report on the LMI loan characteristics of such a bank's entire portfolio, regardless of its location. This means that even if an internet or other nontraditional bank has a very small percentage of its loans in its defined AA, the proper PC analysis will result in a lower weighting

of the AA loan percentage rating factor relative to other performance factors, especially nonlocal LMI lending. The examiner evaluating the LMI borrower and geographic characteristics of the nonlocal lending will give appropriate credit for such CRA lending regardless of where it occurs.

This would be similar to the recommended approach under the CD test of giving CRA credit for LMI-related CD activities anywhere, even if outside of the AA or broader statewide and regional area. The bottomline should be CRA credit for any legitimate LMI credit-related activity, regardless of location, as long as local LMI credit needs are first being met.

### **Elimination of the Strategic Plan Option**

Additional streamlining of CRA would come from eliminating the ill-conceived strategic plan option. This would reduce the number of possible CRA exams from four to three, a 25% reduction. It is good public policy to eliminate regulations that have few benefits relative to significant costs and uncertainties as is the case with this option (Thomas, 1998).

While most banks would rather keep the strategic plan option in their CRA regulatory closet for possible use, very few have selected or would ever consider this option.<sup>19</sup> It is somewhat ironic that the banking industry would favor a reduction in the regulatory burden but nevertheless insist on keeping this rarely used and controversial CRA regulation on the books.

Community groups are generally in favor of keeping this or any existing part of the regs, but few have conducted an objective evaluation of it. One of the exceptions is NCRC, which argues for the elimination of the strategic plan option: “It has been abused too often; banks declare easy goals and examiners approve these goals.”

It is somewhat ironic that NCRC should now propose the elimination of an option which it championed so much for during the 1993–95 reform process. In fact, one of that group’s directors was reportedly responsible for suggesting and/or promoting this option to the regulators. It is even more ironic that a recent proposal by representatives of both NCRC and the Greenlining Institute to expand CRA to the insurance business called for “strategic community investment plans” as part of their suggested new requirements (Gamboa and Taylor, 2001).

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<sup>19</sup> According to the October 17, 2001 CRA reform comment of the Center for Community Change, only 14 of 9,821 or .01% of FDIC-insured institutions have chosen the strategic plan option.

## **Improvement of Public Performance Evaluations**

Thomas (1998) made a number of specific recommendations to improve PEs for each of the different types of CRA exams. A recent analysis by the Office of Inspector General of the OTS made ten recommendations to improve the quality of PEs issued by the OTS (Office of Inspector General, U.S. Department of the Treasury, 2001), and most of these were identical to those in Thomas (1998).

Good public policy would dictate that each of the following OTS recommendations for PEs should become mandatory for all agencies as part of the current CRA reform:

1. Better ensure complete and full disclosure as to how examiners evaluated each component area in arriving at the component ratings.
2. Seek through FFIEC interagency deliberations, further regulatory guidance as to how an institution's CRA performance is to be considered and weighed in the application process.
3. Consider establishing internal written guidance to better ensure that CRA performance is taken into consideration in a consistent and uniform manner in the application process.
4. Ensure that performance context information is appropriately incorporated into the PE report.
5. Seek through FFIEC interagency deliberations to establish more objective regulatory criteria as to how investments are to be assessed.
6. Provide for quality assurance reviews of CRA examinations to include a broader analysis comparing inter- and intra-regional examinations and PE reports for consistency.
7. Seek through FFIEC interagency deliberations to establish objective criteria and/or clarification as to what constitutes strong lending and CD lending when these activities are used in support of a Low Satisfactory investment rating for thrifts with little or no qualifying investments.
8. Improve controls to better ensure that examiners contact community groups and that the results of those contacts are more fully described in the PE report.
9. Assess the value of requiring a comparison of thrift lending relative to assessment area demographics to enhance the performance context of a thrift's lending.
10. Provide examiners with further guidance to ensure greater consistency in applying the agency's approach to non-traditional thrifts.

## **Need for Specialized Compliance Examiners and Exam**

The topic of specialized compliance examiners and exams relative to safety and soundness ones at two of the four regulatory agencies has only become a recent public policy issue in banking. The primary motivating forces are budget cuts in the case of the OTS and efforts to reduce the regulatory risk burden in the case of the FDIC.

While budget or regulatory burden cuts could occur anywhere at these two agencies, it appears that the compliance and CRA areas may be most adversely impacted.<sup>20</sup> In this case, good public policy is undermined to the extent “friendly regulators” are acting more in the industry’s interest rather than that of consumers.

The FDIC’s program was euphemistically titled “Reducing Burden on Banks and the Public” (FDIC, 2002B). It appears, however, that all of the proposed reductions will likely benefit banks and will only benefit the public under the usually unrealistic assumption that cost reductions are passed on to them.

Part of the FDIC’s actions under this program was to fold their Division of Consumer and Compliance Affairs, which has been independent since 1991, into the Division of Supervision. That one policy shift alone has significant CRA ramifications, because the Division of Consumer and Compliance Affairs under Steve Cross is the informal CRA regulatory nerve center. To the extent that Division is reduced in importance or worse yet consolidated into another one suggests a non-CRA and more generally non-consumer mindset at the FDIC.

The OTS budget cuts received much more interest because that agency has long been rumored to be a candidate for consolidation into the OCC, also a part of the Department of the Treasury. The OTS has lost money every year since 1998, and expected losses in 2002 were expected to be nearly \$2 million (Blackwell and Garver, 2002). Also, the OTS has been reeling from bad PR after a few spectacular thrift failures.

Assessment income at the OTS has dropped markedly during the past decade as the number of thrifts fell by more than half. The OTS responded by raising fees and examination charges. This angered many thrifts causing some to convert to banks. The recent conversion of one of its larger members (Cleveland’s Charter One Financial) to an OCC bank, reportedly reduced assessment income at the OTS by \$4.2 million annually and caused their projected 2002 operating deficit to swell from \$2 to \$5 million (Garver, 2002).

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<sup>20</sup> The fact that the new heads of both the OTS and FDIC are ex-bankers is not unimportant, because the end result of these current activities may be a regulatory– distorted CRA Triangle like Figure 2.

The vulnerability of the OTS to the loss of another large thrift calls into question the continued viability of this agency as an effective regulator in the public interest. Using September 30, 2001 asset totals, there are three other thrifts larger than the \$37.2 Charter One, with the \$185.7 billion and growing Washington Mutual (WAMU) being the largest by far. WAMU is also the nation's third largest subprime mortgage lender.

Considering that the OTS probably could not survive as an independent agency with the defection of WAMU to a competitive agency, how can OTS be an effective regulator of that giant thrift? Will the OTS really tell them what they think or will the agency be more concerned about upsetting them and losing them as a "customer"? Who wants to be the OTS examiner willing to say "no" to WAMU, especially in a sensitive area such as subprime lending? It is not inappropriate to ask the question: Does the OTS regulate WAMU or does WAMU regulate the OTS? These are important public policy questions that must be answered, especially as WAMU keeps growing and the OTS keeps shrinking.

The OTS unveiled a restructuring plan in April 2002 to enable it to remain as an independent agency. This involved a 20% staff cut to about 930 employees, with compliance examiners being reduced more than three times the rate of safety and soundness ones. Significantly, the OTS eliminated separate compliance exams and examiners. In a stunning change in bank regulatory policy, the OTS called for thrifts to conduct a "self-evaluation" of their compliance before examiners arrived for the new consolidated exam.

The OTS claimed this approach would "place emphasis on institutions, not the regulator, to ensure compliance with all existing laws, including consumer protection statutes" (Heller, 2002). The latter statutes include the CRA and about 25 other laws such as Truth-in-Lending, Truth-in-Savings, and many more.

This OTS statement, in addition to being what Congressman LaFalce called a "complete abrogation of the mandate your agency has been given by Congress" (Heller, 2002), is nothing less than a breakdown of the CRA Triangle. This is also the best justification yet for why this desperately struggling agency, like the troubled thrifts it used to regulate, should be merged into the OCC or perhaps made a division within it. Mutual institutions and other specialized thrift lenders regulated by the OTS would continue to coexist with their stock counterparts.

The only thing worse than a compliance self-evaluation is no compliance law at all, which was the case prior to 1977 for CRA. Moreover, we have learned from past experience that CRA is best monitored and enforced with specialized compliance examiners and separate exams.



Specialized CRA examiners first existed at the FED in 1977 with the passage of that law. The other agencies, which operate under tighter budgetary restrictions than the money-creating FED, did not follow until and after 1989, CRA's watershed year. The OTS developed its specialized compliance program in 1989; it was followed by the FDIC in 1991 and the OCC a few years later.

A comparison of CRA ratings for the 15-month period both before and after the creation of the OTS specialized compliance function in 1989 shows dramatic results (Thomas, 1993). There was a roughly six-fold increase in the percentage of below-average ratings which jumped from 3.7% before the specialized program to 22.5% after it. The comparable proportion of above-average ratings decreased from 11.3% to 9.4%.

The differences were even more dramatic by removing the initial "transition" quarter under the new system, since the proportion of below- and above-average ratings for the 12 months after the change was 25.0% and 2.5%, respectively. This would mean a nearly seven-fold increase and nearly five-fold decrease in the percentage of below- and above-average ratings, respectively.

This evidence, although but for one federal regulator, suggests that the use of specialized compliance examiners results in much stricter enforcement of CRA defined in terms of a greater percentage of below-average and a lesser percentage of above-average ratings.

Based upon this experience, the recent shift by both the FDIC and OTS away from specialized compliance examiners and exams may result in the opposite effect, namely less strict enforcement of CRA. This is most likely to be the case with the OTS with its planned self-evaluation format, where the emphasis will be on the institutions not the regulators to ensure regulatory compliance. Less strict enforcement of CRA is not good public policy, especially in a grade inflationary environment.

The FDIC and especially the OTS compliance consolidations suggest that it may be time to revisit the proposal (see Tables 5 and 6) to consolidate the compliance function of all four regulators into an FFIEC-style "super-regulator" for compliance. This would be similar to past proposals to create an independent "super-regulator" for safety and soundness purposes (Thomas, 1994).

### **Other Key Reform Issues**

Community groups are correct in asking for a fix to the rampant grade inflation problem; more

credit for originated vs. purchased loans; a fifth “High Satisfactory” overall rating; a repeal of the longer GLB exam cycles; and, an expansion of CRA, at least to credit unions. This latter recommendation is important as the proportion of home purchase loans made by CRA-covered institutions continues to fall, with less than 30% of home purchase mortgages being subject to intensive CRA review (Harvard University, 2002).

Many of the CRA reforms championed by community groups are found in The CRA Modernization Act of 2001. According to NCRC, they have been the “lead organization” for the introduction of this proposed legislation (NCRC, 2002B). The congressional sponsors of this proposal are essentially the same members who signed the above-referenced “NCRC Sample Letter on the CRA ANPR,” that was reprinted on October 16, 2001 on congressional letterhead and submitted to the regulators as a CRA reform comment.

This legislation would extend CRA to insurance companies, securities firms, and holding company affiliates. This proposed legislation also contains CRA rating penalties for institutions engaging in predatory lending; a fifth overall “High Satisfactory” rating; a repeal of the longer CRA exam cycles of GLB; and, additional data collection and reporting requirements.

Among the most controversial portions of this proposal is an effort to make CRA a race-based law and a repeal of the GLB sunshine requirements. For these and other reasons, there is little chance that this proposal will be enacted into law.

The best way to “modernize” CRA is to reform it in a manner responsive to all interests in the CRA Triangle, and it is respectfully suggested that the recommendations in Table 9 are optimal in this regard.

## **CONCLUSION**

CRA’s success has been in its simplicity, and this was somewhat forgotten during the previous 1993–95 reform process with the creation of separate Investment and Service Tests on top of the lending ones. Good public policy in CRA must be focused on LMI lending, the purpose of the 1977 law.

As was the case with the last reform process, the bank regulators, Congress, and the Administration hopefully will see to it that the on-going dynamic tension between industry and community interests will result in balanced reforms.

It is more important than ever that this important public policy deliberation be conducted with a full view of the potential conflicts and constraints of each of the corners of the CRA Triangle as described above. Many of these issues did not exist during the last reform process, but they are most relevant today.

It is respectfully suggested that the reform recommendations in Table 9, especially the streamlined large retail bank exam, are optimal in the sense that they represent an objective and balanced perspective of both community and industry interests with full recognition of all relevant conflicts and constraints.

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Figure 1  
The CRA Triangle

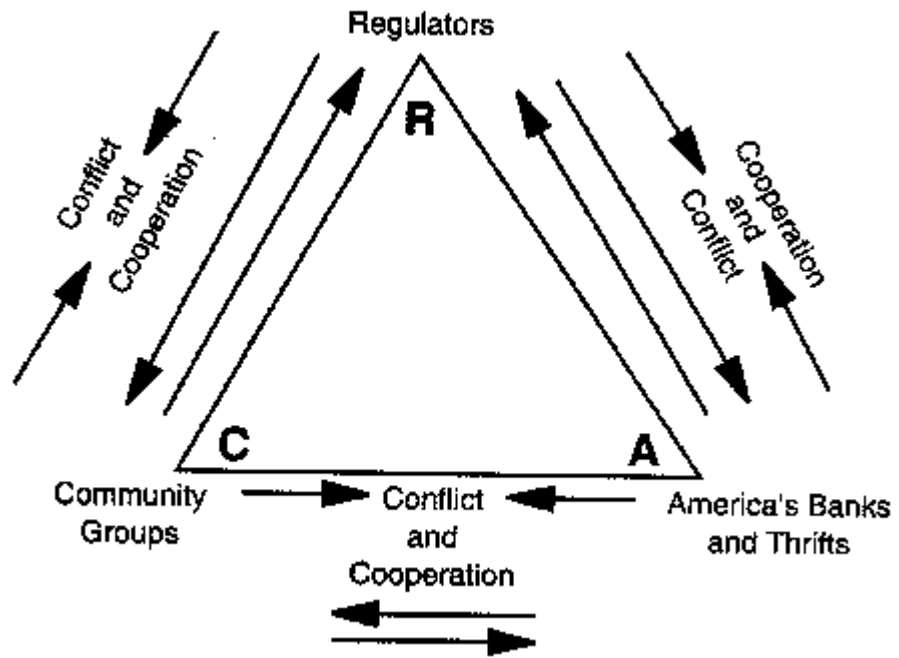
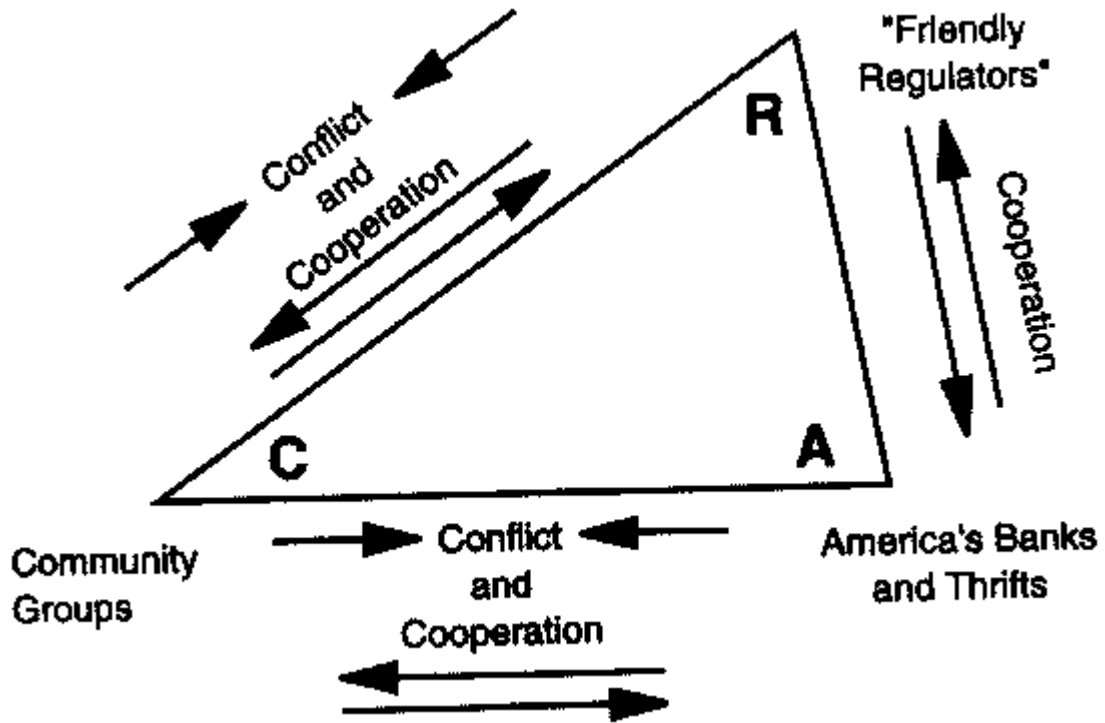




Figure 2  
FED-Distorted CRA Triangle



## Figure 3 Top Ten New CRA Mistakes in the CRA Triangle

### TOP TEN NEW CRA MISTAKES BY COMMUNITY GROUPS

1. *"Selling out" by publicly supporting mergers of banks that have "bought" the group (and its integrity)*
2. *Using direct or indirect "extortion" techniques to obtain direct or indirect funding for a community group in exchange for not protesting a merger or other activity*
3. *Being the first "ambulance-chasing" community group to rush in to "cut a deal" with a big bank announcing a merger and then publicly supporting it*
4. *Not publicly disclosing all direct and indirect sources of funds (hard and "soft" money) from a bank or its affiliate*
5. *Indiscriminately attacking all banks as being "bad guys," without making a legitimate attempt to identify the good and truly outstanding CRA banks that are making a difference*
6. *Focusing exclusively on CRA and fair lending issues without being mindful of the public policy implications of critical "big-picture" financial institution topics*
7. *Concentrating on minority rather than LMI lending data in CRA (as compared to fair lending) analyses*
8. *Not taking a serious stand challenging a merger or other bank activity which the group truly believes is counter to the public interest*
9. *Representing oneself as a community group activist or leader when the real goal is personal advancement or some other non-community agenda*
10. *Failing to organize and support a truly independent and non-industry funded national bank consumer advocacy organization*

### TOP TEN NEW CRA MISTAKES BY REGULATORS

1. *Forgetting that federal bank regulators must first and foremost "regulate and enforce" the (CRA) law*
2. *Getting far too close and friendly to certain banks*
3. *Misallocating resources among the four regulators*
4. *Engaging in a CRA "competition in laxity" with other regulators*
5. *Allowing personal subjectivities to cloud and sometimes cover up the facts*
6. *Permitting the ultimate new CRA loophole of approving any "certain special purpose bank" CRA exemption*
7. *Falling into the credit allocation and unnecessary government intervention trap by requiring higher and more lending and other goals for strategic plan approvals.*
8. *Instead of doing too little in the area of CRA and fair lending enforcement, going off the deep end by doing way too much*
9. *Forgetting the focus of the new CRA on LMI borrowers vs. areas and very small (below \$100,000 in revenues) and small businesses and farms vs. mid-sized and large ones*
10. *Ignoring the principle of "fair banking" in the merger process*

### TOP TEN NEW CRA MISTAKES BY BANKS

1. *Spending more time on CRA "bashing" than CRA compliance*
2. *Choosing the strategic plan option or failing to withdraw a plan once it has been submitted*
3. *A small bank, even one with low loan-to-deposit or other ratios, choosing anything but the streamlined small bank exam*
4. *Truly special-purpose banks failing to apply for a LPB or WB designation*
5. *Not preparing an internal self-assessment using the detailed new CRA exam procedures*
6. *Improperly "managing" the new CRA exam process*
7. *Inappropriate handling of legitimate CRA public file requests*
8. *Not integrating the Qualified Investment test into the bank's overall investment and corporate contributions plan*
9. *Misallocating compliance budgets*
10. *Letting CRA "run the bank" instead of running the bank according to its business plan and complying with CRA*

Source: Chapter 16, The CRA Handbook (McGraw-Hill, 1998).

**Table 1  
Comparison of Old and "New" CRA Proposals and Final 1995 Regulations**

"Old" CRA Regulations	December 1993 Proposal	September 1994 Proposal	May 1995 Final "New" CRA Regulations
One test with 12 assessment factors applies to all institutions.	Separate tests for small and large retail institutions.	Separate tests for small and large retail as well as wholesale and limited-purpose institutions.	Separate tests for small and large retail as well as wholesale and limited-purpose institutions.
No streamlined assessment method for smaller institutions.	Independent banks and thrifts with total assets of under \$250 million or members of a holding company with total banking and thrifts assets of less than \$250 million could be evaluated under streamlined Procedures, if eligible. Under the lending test, a 60 percent loan-to-deposit ratio and a good loan mix, among other things, would be presumed "satisfactory".	The streamlined assessment method would be used for evaluating small institutions, unless the bank or thrift requests an alternative assessment method or is operating under an approved Strategic plan. The loan mix and 60 percent loan-to-deposit presumptive ratio for a "satisfactory" rating would be eliminated.	Independent banks and thrifts with total assets of under \$250 million or members of a holding company with total banking and thrift assets of less than \$1billion would be evaluated under streamlined procedures, if eligible. The streamlined method would be used for evaluating small institutions, unless they request an alternative assessment method or are operating under an approved strategic plan.
No separate test for large retail institutions.	Three assessment tests—lending, investment, and service—for all large retail institutions.	Three assessment tests—lending, investment, and service—for all large retail institutions.	Three assessment tests—lending, investment, and service—for all large retail institutions.
No separate test for wholesale and limited-purpose institutions.	Wholesale and limited-purpose institutions evaluated primarily under the investment test.	Wholesale and limited-purpose institutions evaluated primarily under a new community development test.	Wholesale and limited-purpose institutions evaluated primarily under a new community development test.
No alternative assessment methods	Institutions could elect evaluation based on a preapproved two-year strategic plan developed by the bank or thrift with input from the local community.	Strategic plan option is revised to provide greater clarification of plan development process, provisions for community input, approval standards and goal specifications. Maximum plan term is lengthened to five years, with annual interim Measurable goals required. Plan amendment procedures are included.	Strategic plan option is retained. Institutions required to describe informal efforts to seek public suggestions. Institutions may elect alternative assessment method if it fails to meet substantially its planned goals for a "satisfactory" rating.
Determination of overall rating is subjective without any weighting of assessment factors.	For retail institutions, the rating under the lending test would form the basis for the composite rating; the rating could then be increased or decreased based on extraordinarily weak or strong performance under the service and investment tests.	A retail institution must be rated satisfactory or better under the lending test to receive an overall rating of satisfactory. The effect of the service and investment test on the overall rating would no longer be limited to situations where service or investment performance is extraordinarily weak or strong.	A retail institution must be rated low satisfactory or better under the lending test to receive an overall rating of satisfactory. The effect of the service and investment tests on the overall rating is not limited to situations where service or investment performance is extraordinarily weak or strong.
Institutions assessed on their method of delineating the "local community". The "delineated community" is defined as the contiguous area surrounding each office or group of offices.	Geographic area around each office or group of offices where an institution makes the bulk of its loans would define its "service area". Service area must be broad enough to include low-and moderate-income (LMI) areas. Institutions providing services in multiple MSAs or across state lines would have separate service areas for each market.	The "service area" of a retail institution would have to include the local areas around its deposit taking facilities in which it has originated or has outstanding a significant number of loans and all other areas equidistant from those facilities. Service areas must include entire census tracts and block numbering areas. The LMI requirement is removed. Institutions not assessed on method of service area delineation.	The "assessment area" of a retail institution would have to include the local areas around its deposit taking facilities in which it has originated or purchased a substantial portion of its loans. Assessment areas must consist generally of one or more MSAs or contiguous political subdivisions and must include full census tracts and block numbering areas. Institutions not assessed on method of assessment area delineation.

(Continued)

**Table 1 (Continued)**

"Old" CRA Regulations	December 1993 Proposal	September 1994 Proposal	May 1995 Final "New" CRA Regulations
No market share provisions.	A "market share screen" under the lending test would establish a rebuttable presumption that an institution's CRA performance was at a certain level based on market share of loans in middle-income and upper-income areas compared to market share of loans in lower-income and moderate-income areas.	Explicit market share language has been eliminated from the regulation. Market share analysis is one of a broad variety of comparisons that examiners would use where appropriate in evaluating performance under the lending test.	Explicit market share language has been eliminated from the regulation. Market share analysis is one of a broad variety of comparisons that examiners would use where appropriate in evaluating performance under the lending test.
Institutions are required to prepare lengthy CRA statements by an actively participating board and prepare documentation of meetings, marketing, outreach, and credit needs ascertainment efforts.	Emphasis is placed on performance over process— institutions would no longer be required to devote resources to "documenting the files."	Emphasis would remain on performance over process.	Emphasis would remain on performance over process.
Enforcement tools limited to denial or conditioning of corporate applications filed by institutions with poor CRA performance or substantial unresolved CRA protests.	In addition to taking CRA performance into account when acting on applications, regulators would enforce CRA compliance in the same manner as any other regulation and could impose formal enforcement actions for "substantial noncompliance" ratings (which would be automatic upon the third consecutive "needs to improve" or lower rating.)	In addition to taking CRA performance into account when acting on applications, regulators would enforce CRA compliance in the same manner as any other regulation and could impose formal enforcement actions for "substantial noncompliance" ratings (which would be automatic upon the third consecutive "needs to improve" or lower ratings.)	December 1994 DOJ opinion prevents imposition of formal enforcement actions. Consequently, enforcement tools limited to denial or conditioning of corporate applications filed by institutions with poor CRA performance. Automatic downgrading of third "needs to improve" rating eliminated.
No publication of scheduled CRA exams.	Bank regulators required to publish quarterly scheduled CRA exams.	Quarterly published lists of scheduled CRA exams retained.	Quarterly published lists of scheduled CRA exams retained.
No race or gender data collected for consumer, small business, or small farm loans.	No race or gender data collected for consumer, small business, or small farm loans.	Large banks and thrifts would have to collect race, ethnicity and gender data on small business and small farm loans.	No race or gender data collected for consumer, small business, or small farm loans.
No data collected and reported on the geographic distribution of loans or the race, ethnicity and gender of borrowers, other than data on mortgages reported pursuant to the Home Mortgage Disclosure Act (HMDA).	Large banks and thrifts would be required to collect and report data on the geographic distribution of housing, consumer, small business and farm loans, and on loan applications, denials, originations, purchases, sales and retirements. They would also report data on the size of the businesses to which loans were made. These new reporting requirements would be in addition to existing HMDA reporting requirements and Call Report requirements for small business and farm loans.	Agencies would base their analysis of mortgages lending on the data already reported under HMDA. However, large institutions reporting under HMDA, as well as small institutions who elect evaluation under the lending, investment and service tests, would also be required to report data on home mortgage loans made outside of MSAs. Large banks and thrifts would collect and report certain data on the geographic distribution of and the race, ethnicity and gender of small business and small farm borrowers who have loans that are currently aggregated on bank Call Reports. Some data would be reported by loan size and would include an indication of whether the business or farm had gross annual revenues of more or less than \$1 million. Aggregate data on small business and small farm loans and community development loans would be included in an institution's Public file. The agencies would not make any aggregate data available to the public.	Agencies would base their analysis of mortgage lending on the data already reported under HMDA. However, large institutions reporting under HMDA, as well as small institutions who elect evaluation under the lending, investment and service tests, would also be required to report data on home mortgage loans made outside of MSAs. Large banks and thrifts (and small ones that elect such evaluation) must collect and report certain data on the geographic distribution of small business and small farm borrowers. These data must be reported by loan size and include an indication of whether the business or farm had gross annual revenues of more or less than \$1 million. The agencies rather than institutions will prepare annual and business loan data by geography for each reporting institution and aggregate statements for each MSA and the non-MSA portion of each state. Although there are no reporting requirements for consumer lending, an institution with a substantial majority of its business of this type will have such lending evaluated under the lending test.

**Table 2  
Comparison of “Old” and “New” CRA  
Assessment Factors and Performance Standards**

“Old” CRA	New CRA			
	Small Bank Test	Large Retail Bank “LIBS” Test	Wholesale and Limited-Purpose Banks Community Development Test	Strategic Plan Test
<b>Lending Test</b>				
Assessment Factor	Lending Performance Assessment Criteria	Lending Test	CD Loans	Lending Goals
I,J- Origination of loans and participation in government loan programs	Loan-to-deposit ratio	Lending activity levels responsive to AA credit needs	Responsiveness to credit and community economic development needs in AA	Measurable goals for helping to meet AA credit needs, particularly those of LMI geographies and individuals. Goals must be responsive to AA characteristics: public comments; and, the banks capacity and constraints, product offerings and business strategy.
E- Geographic distribution of loans	% loans in AA	% loans in AA		
	Borrower distribution by income and business/ farm size in AA	Borrower distribution by income and business/ farm size in AA		
	Geographic distribution of loans in AA	Geographic distribution of loans in AA		
		Use of innovative and/or flexible lending practices	Level of CD lending*	
H- Participation and investments in CD projects		CD lending activities	Use of innovative or complex CD loans**	
<b>Investment Test</b>				
Assessment Factor	Optional Investment Test to Upgrade “Satisfactory” Rating	Investment Test	CD Investments	Investment Goals
H- Participation and investments in CD project	Investment record enhances credit availability in AA	Amount of qualified CD investments and grants	Level of qualified investments*	Preferably measurable investment goals that are responsive to AA characteristics and credit needs, particularly those of LMI geographies and individuals; public comments; and, the bank's capacity and constraints, product offerings and business strategy.
		Use of innovative and/or complex qualified investments to support CD	Use of innovative or complex qualified investments**	
		Responsiveness to credit and community economic development needs	Responsiveness to credit and community economic development needs in AA	

(Continued)

**Table 2  
(Continued)**

"Old" CRA	New CRA			
	Small Bank Test	Large Retail Bank "LIBS" Test	Wholesale and Limited-Purpose Banks Community Development Test	Strategic Plan Test
<b>Service Test</b>				
Assessment Factor	Optional Service Test to Upgrade "Satisfactory" Rating	Service Test	CD Services	Service Goals
G- Record of providing services at offices	Record of providing delivery systems and other services enhances credit availability in AA	Accessibility of delivery systems to all portions of the AA		Preferably measurable service goals that are responsive to AA characteristics and credit needs, particularly those of LMI geographies and individuals; public comments; and, the bank's capacity and constraints, product offerings and business strategy.
H- Participation and investments in CD projects		Record of opening and closing offices		
		Reasonableness of business hours and services in AA		
		Level of CD services		
			Use of innovative or complex CD services**	
<b>Miscellaneous Tests</b>				
D- Practices intended to discourage loan applications	Practices reviewed but not rated	Practices reviewed but not rated	Practices reviewed but not rated	Practices reviewed but not rated
F- Prohibited discrimination or other illegal practices	Practices reviewed but not rated	Practices reviewed but not rated	Practices reviewed but not rated	Practices reviewed but not rated
L- Other factors regarding credit needs	Record of taking action on substantiated complaints	Response to complaints reviewed but not rated	Response to complaints reviewed but not rated	Response to complaints reviewed but not rated
K- Institution's ability to meet community credit need	Considered in "Performance Context"	Considered in "Performance Context"	Considered in "Performance Context"	Considered in "Performance Context"
A- Ascertain community credit needs	Considered in "Performance Context"	Considered in "Performance Context"	Considered in "Performance Context"	Considered in "Performance Context"
B- Marketing and special programs to enhance credit awareness	Considered in "Performance Context"	Considered in "Performance Context"	Considered in "Performance Context"	Considered in "Performance Context"
C- Board of directors' participation	Assessment Factor not reviewed or rated	Assessment Factor not reviewed or rated	Assessment Factor not reviewed or rated	Assessment Factor not reviewed or rated
Reasonableness of delineated community evaluated as "13th" assessment factor	Reasonableness of delineated assessment area not evaluated as separate performance criteria but must meet stated requirements	Reasonableness of delineated assessment area not evaluated as separate performance criteria but must meet stated requirements	Reasonableness of delineated assessment area not evaluated as separate performance criteria but must meet stated requirements	Reasonableness of delineated assessment area not evaluated as separate performance criteria but must meet stated requirements
* Part of one performance standard ** Part of one performance standard				

Source: The CRA Handbook (McGraw-Hill, 1998).

**Table 3**  
**Excerpts From Sample “Sunshine” Filing by Selected National Banks**  
**Reported Filings of \$100,000 or More to Community Groups**  
**2001 Reporting Cycle**

Name of Bank	Community Group	“Sunshine” Filing
Bank of America, NA	ACCION	\$100,000
	CPLC	100,000
	The Greenlining Institute	200,000
	ACORN	350,000
	Enterprise Foundation	550,000
Bank of China	Neighborhood Housing Services of NYC, Inc.	400,000
Citibank, N.A.	Enterprise Foundation	325,000
	ACCION	345,000
	NY Assn. For New Americans	125,000
First Union National Bank	ACORN	100,000
Fleet Boston Financial	Initiative for a Competitive Inner City	150,000
	MA. Affordable Housing Alliance	298,500
Union Bank of CA, N.A.	Habitat for Humanity	125,000
	Neighborhood Housing Services (various)	332,400
	The Greenlining Institute	130,000
Wells Fargo Bank, N.A., (various)	Habitat for Humanity	470,604
	National Community Reinvestment Coalition	250,000

Note: Above filings for selected community groups by selected national banks.

Source: OCC CRA Sunshine report as of October 17, 2001

**Table 4**  
**Excerpts From Sample "Sunshine" Filing by Community Group**  
**The Greenlining Coalition**  
**Fiscal Year Ending November 30, 1999**

***Financial Services Contributions***

<b>Name of Bank or Thrift</b>	<b>Contributions</b>
Bank of America*	\$209,500
Cal Fed	69,500
FNMA Foundation	59,500
Washington Mutual Foundation	150,000
Manufacturer's Bank	4,750
Wells Fargo Foundation	260,000
Sanwa Bank	9,500
Washington Mutual	9,500
Union Bank	94,500
Bank of the West	39,500
<i>Total Financial Services Contributions</i>	<i>\$906,250</i>

\*Form 990 also reports notes payable to Bank of America Foundation at 3% APR.

***Selected Financial Indicators***

Total Financial Services Contributions (above)	\$906,250
Non-bank firms (e.g., AT&T)	290,500
"Other Contributions"	75,590
Total Contributions	1,272,340
Receipts From Program Fees, Conference Revenue, and Other Sources	1,040,727
Other Revenue	214,323
Total Revenue	2,527,390
Total Expenses	1,954,625
<i>Note: Compensation and Contributions to Top Three Employees:</i>	
<i>Executive Director</i>	<i>137,146</i>
<i>Legal Counsel</i>	<i>140,958</i>
<i>Asst. Executive Director</i>	<i>82,500</i>
Excess ("Net Income") Contribution to Net Assets ("Net Worth") For Tax Exempt	572,765

***Contributions to Minority and Diversity Programs***

<b>Bank or Thrift Contributions</b>	<b>Purpose</b>	<b>Amount</b>
Citigroup	Diversity	\$9,500
Citigroup	General Funds (Conference)	5,000
Bay View Capital	General Funds (Conference)	15,000
Washington Mutual	Leadership Academy, Economic Development, and Diversity	120,000
Washington Mutual	General Funds (Conference)	30,000
Cal Fed	General Funds (Conference)	30,000
Cal Fed	Leadership Academy and Diversity Partnership	50,000
<i>Total</i>		<i>\$259,500</i>

Source: June 15, 2001 Sunshine Regulations 2000 Annual Report to OTS, including IRS Form 990 for Tax Exempt Organizations



**Table 5**  
**CRP Proposals for CRA Reform\***

- 1. Expand CRA to Nonbanks**
  - A. Expand CRA to credit unions using same arguments as to why CRA is required for small community banks (p.352)
  - B. Develop CRA-type requirements for non-depository financial institutions (pp.352-54)
    - (1) Money market and other mutual funds
    - (2) Mortgage bankers
    - (3) Consumer finance companies
    - (4) Insurance companies
    - (5) Other financial intermediaries (e.g., Merrill Lynch, American Express, pension funds, etc.)
- 2. More Objective, Quantitative, and Structured CRA Performance Evaluations**
  - A. Comparative Ratio Analysis (p.354)
    - (1) Loan-to-deposit ratios (relative to loan quality)
    - (2) Percent of loans in delineated community
    - (3) Percent of loans in low- and moderate-income (“LMI”) areas
    - (4) “CRA loans” as percent of all loans and assets
    - (5) Other ratios
  - B. Comparative HMDA analysis (p.354)
  - C. Loan analysis (pp. 354-55)
    - (1) Minimum loan amounts, if any
    - (2) Special fees or unfavorable terms on small loans, if any
    - (3) Average loans vs. deposit size
    - (4) Government loan programs offered and amount extended
    - (5) Other calculations
  - D. Checklist (“yes/no”) questions (p.355)
    - (1) Lifeline checking?
    - (2) Free government check cashing?
    - (3) Office closings in low/mod areas?
    - (4) Any technical or substantive compliance violations?
    - (5) Other questions
- 3. Greater Consistency in CRA Regulation and Enforcement Among the Four Regulators and Among Different Regions of the Same Regulator**
  - A. More consistent CRA ratings (p.355)
  - B. More consistent CRA enforcement efforts (P.355)
  - C. More consistent length and style of public performance evaluations (pp. 355-56)
  - D. Modified CRA standards for specialized banks (p.356)
    - (1) Wholesale banks
    - (2) Foreign banks
    - (3) Credit card banks
    - (4) Not private or business niche banks

(Continued)

**Table 5 (Continued)**  
**CRP Proposals for CRA Reform\***

- E. Publicly disclosed CRA appeals process, preferably centralized at FFIEC, available for banks and community groups (p.357)

**Note:** "Safe harbor" or similar exemption not considered as a feasible option.

**4. Fifth "Good" CRA Rating and Rating Guidelines**

- A. Five-tier CRA rating system with 'good" rating added (pp. 357-58)
- B. General guidelines on CRA ratings distribution of above-average, average, and below-average categories. For example, is current 10%- 80%- 10% appropriate or should it be 25%- 50%- 25%? (p.358)
- C. Guidelines on minimum and maximum CRA ratings for assessment factor D and F compliance violations. For example, outstanding banks have no violations of any type and banks with "substantive" violations rate no better than needs improvement (p.358)
- D. Guidelines on minimum and maximum CRA rating based on key ratios. For example, persistent and unjustified very low net loan-to-deposit ratios (such as 15-25% or less) result in below-average rating (pp.369-70)
- E. Guidelines on what does and does not qualify for CRA "credit." For example, CRA credit for contributions to low/mod housing organizations but not general charities (p.370)

**5. Specialized Compliance Examiners at OCC (pp. 358-59)**

**6. Aggressive Training of Compliance Examiners in CRA and Safety and Soundness Through Individual Agency and Joint FFIEC Programs**

- A. Require CRA examiners to read other public performance evaluations (p.359)
- B. Require CRA examiners to accompany safety and soundness examiners on a rotating basis for training (p.359)

**7. Centralize All Compliance Functions in New Federal "Super-Regulator"**

- A. Pilot CRA joint examination program through FFIEC with representatives from four agencies (pp.359-60)
- B. CRA "swat team" approach of examining all banks and thrifts in one community at same time with interviews, seminars, and publicly disclosed ratings (p.360)
- C. Published compliance schedule with exam frequency being a function of last CRA rating: 24 months for outstanding rating; 18 months for new "good" rating; 12 months for satisfactory rating; 9 months for needs improvement rating; and, 6 months for substantial noncompliance rating (p.360)
- D. Published no-charge weekly listing of completed CRA ratings (p.360)
- E. Toll-free 800 "hotline" for any CRA questions or complaints (p.360)

**8. Change CRA Emphasis From "Including" Low- and Moderate-Income "Areas" to "Especially" Low- and Moderate-Income "People" (pp.361-62)**

(Continued)

**Table 5 (Continued)**  
**CRP Proposals for CRA Reform\***

- 9. Eliminate Unnecessary and Irrelevant CRA Documentation and Paperwork**
  - A. Reevaluate CRA public file requirements (p.362)
  - B. Reevaluate CRA statement requirements (p.362)
  - C. See CRA Cost/Benefit Matrix for distinction between those activities that primarily benefit CRA rating (i.e., documentation) and those that also benefit the community (p.331 and p.362)
- 10. Consider “CRA Assessment” Proposal- A Major Restructuring of CRA System With Specific Monetary Incentives for Good Performance and Disincentives for Bad Performance (pp.362-63 and pp.367-71)**
- 11. Expanded Disclosure of CRA Ratings and Performance Evaluations**
  - A. Objective study (e.g., by General Accounting Office) to determine extent of relevant nonconfidential information being excluded from CRA public performance evaluations but included in confidential portion of examinations (pp.363-64)
  - B. Regularly (e.g., monthly or quarterly) published listing of the results of the evaluations of the Community Support Statements (CSS) of Federal Home Loan Bank members (p.364)
  - C. Reevaluate social costs and benefits of current CSS program at Federal Home Loan Banks and determine if comparable program involving Fed’s discount window is needed (pp.364-65)
  - D. Future consideration of public disclosure of safety and soundness ratings and nonconfidential portion of examinations (p. 365)
  - E. Require banks and regulators to maintain and make available upon request copies of all past public (e.g., post-June 30, 1990) CRA performance evaluations (p.365)
- 12. Disclosure of Individual Assessment Factor and Performance Category Ratings in Public Performance Evaluations so Banks and the Community Alike Will Know How a Final Rating Was Determined (p. 365)**
- 13. More Timely Disclosure of CRA Ratings and Performance Evaluations**
  - A. Require regulators to transmit completed CRA rating and performance evaluations within specified time (e.g., 45 total days) after exit interview (p.365)
  - B. Require public disclosure by bank of CRA rating and performance evaluation upon receipt of them (p. 365)
  - C. Require banks to publish CRA rating and availability of public performance evaluation in local paper of wide circulation within short period (e.g., five business days) of receipt (p.366)
  - D. Require regulators to publish compliance examination schedule (p.366)

(Continued)

**Table 5 (Continued)**  
**CRP Proposals for CRA Reform\***

- 14. CRA Ratings and Performance Evaluations for Individual Banking Markets**
  - A. Require separate CRA ratings and performance evaluations by state, at a minimum, for interstate thrifts (e.g., Great Western) (p.366)
  - B. Require separate CRA ratings and performance evaluations by banking market for large statewide banks if they are one of the largest (e.g., top 5) banks in the market (pp.366-67)
  
- 15. Publicly Disclosed Written Guidelines on Conditions for Issuing CRA-Related Informal vs. Formal Enforcement Actions, Conditional Approvals vs. Denials of Branch and Merger Applications, Civil Money Penalties, and Justice Department Referrals (p. 367)**

\*Page references refer to discussion in Community Reinvestment Performance, (CRP) by Kenneth H. Thomas (Probus Publishing, Chicago, 1993)

**Table 6**  
**The CRA Handbook (Chapter 16) Proposals for CRA Reform**

1. The most important step the four federal regulators can take to begin the elimination of the systemic new CRA grade inflation documented here is a complete retraining of the CRA examination force to better prepare them to do their job under the new regs.
2. New CRA grade inflation by friendly and subjective examiners can be reduced with the immediate implementation of a comprehensive PE quality control program, beginning with a revised "fill-in-the-blanks" style PE with minimum data and analysis requirements.
3. CRA should be expanded to credit unions at a minimum and gradually to other financial institutions as well as nonfinancial companies affiliated with banks.
4. The most important step that Congress could take to improve CRA enforcement, rating and exam consistency among regulators is to require an FFIEC-style joint compliance function.
5. All new CRA exemptions that have been granted should be rescinded, and all other new CRA loopholes identified in this analysis should be eliminated.
6. Federal bank regulators must open certain closed-door CRA approval and appeal processes as well as improve the general level of disclosure of publicly available documents via regulatory Web sites.
7. The small bank streamlined exam should be expanded to include mandatory investment and service tests and additional disclosures and ratings similar to the large bank exam.
8. The large retail bank exam should have additional rating component disclosures as well as the mandatory calculation of the annual qualified investments (QIs)–to–assets or “QITA” ratio within the investment test.
9. The CD test for special purpose banks should be made more objective and structured along the lines of the large retail bank exam, with the required calculation of the annual CD loans plus QIs-to-assets or “LAQITA” ratio.
10. The plug should be pulled on the entire strategic plan option, and all banks with approved plans should be evaluated on the basis of their back-up procedures.

**Table 7  
Selected Bank and Thrift Industry Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose (LP) and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development (CD) Activities							
American Bankers Association (all banks)	Large bank exam has increased compliance burden; do not require banks to demonstrate that some CRA activities have been "innovative" or "complex"; annual review of CRA ratings for more consistency among agencies; PE should clearly show date exam began and ended as well as review period	Treat originations and purchases identically; keep predatory lending issues as part of fair lending exam rather than CRA exam	Eliminate and make investments substitutable for loans; return focus of CRA to credit rather than CD and investments; investment test is #1 CRA problem for large banks; qualified investments are limited, expensive with "CRA premium", and create documentation burden; investment test not authorized by CRA; no statutory authority for this test	Depends too heavily on branches; broader definition of service to include LMI financial education and non-traditional banking; no statutory authority for this test	No need for separate test; expand definition of CD activities to include all revitalization and stabilization activities, regardless of location	Eliminate optional investment test; increase independent small bank size minimum to \$1 billion; remove holding company definition	Greater flexibility in definition of special purpose banks so more banks can use this test; consider this flexible test for retail banks; more liberal consideration of qualified investments; credit for non-local CD activities	Retain this option for flexibility; only community groups within AA should have standing to comment on plan; more consistent treatment among regions	Examiners must provide banks with more information on PC, including peer comparisons and possibly mandatory pre-exam consultations	Maintain current approach; flexibility to designate larger AAs to include states and regions rather than just MSAs	Maintain current approach for flexibility	End current data collection requirements or apply only to banks with 250 or more reportable loans; strongly opposes any more data collection or reporting; current small business and farm lending data collection and reporting inconsistent with CRA
America's Community Banks (mainly thrifts)	More examiner training and guidance; need incentives to achieve higher ratings	Grant same weight to purchased loans as originated ones	Must be eliminated, revised, or its relative importance reduced or even made optional for "extra credit"; ignores type of investment by giving more credit to easy investment vs. partnering with community group			Increase in size definition of small independents to \$1 billion and holding companies to \$5 billion in assets is most important reform proposal		Maintain it as flexible alternative for nontraditional banks like internet ones; promote more at regional or local level	Competition must be more realistically considered; examiners must provide specific quantifiable goals	Separate AA designation for internet banks; credit for loans and investments outside AA as long as AA needs met	Maintain present optional approach	Data collecting and maintaining public files are a burden; not convinced collected data are useful
California Bankers Association	Inconsistency and uncertainty of CRA exams and ratings across agencies and elsewhere require examiner training and better pre-exam communications; innovative and complex CRA activities should not be required for Outstanding rating	Large bank exam should be primarily based on qualifying loans with the option of investment or service activity; maintain credit for originations as well as purchases; do not include predatory lending concerns in PE as they should be covered in fair lending exam.	Remove as required test; expand scope of qualified investments			Raise small bank cutoff to \$1 billion in assets			Examiner must obtain bank's concurrence on elements of PC as early as possible	Examiners do not question bank's designation of AA		Streamlined data requirements for banks making a small number of covered loans

**Table 7**  
**Selected Bank and Thrift Industry Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose (LP) and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development (CD) Activities							
California Federal Bank	Incentives for Outstanding rating such as streamlined CRA exam or application review; overemphasis on quantitative measures causes very good but smaller projects to be overlooked	Less quantitative emphasis, especially in areas with limited CRA product; better developed benchmarks in evaluations; review lending practices in context of fair lending exam; letters of credit should count equally as loans; equal treatment of purchased and originated loans	Ineffective and often problematic; combine with lending test OR replace with CD test; greater recognition of credit for written-off equity investments	Largely been effective but needs updating for alternative delivery channels; expand CD services to include non-financial activities	More inclusive definition of CD; expand double-counting of affordable multifamily lending under both HMDA and CD		Should be option for large retail institutions	Current process arduous and related risks too great	Has not been effectively used, especially when excess competition for limited CRA product; must be more consistent among agencies; components of PC should be shared with bank to create a dialog	Current approach is sufficient and reasonable	Maintain current approach as being consistent with statute	No changes to data collection; systems in place and function well; public file only at main office since minimal requests (five or less per year) and long PE (450 pages)
Consumers Bankers Association (mainly large banks)	No major rewrite; more incentives if get Outstanding rating; greater agency consistency; greater opportunity to shift among investment, lending, and service tests to meet local needs	Equal treatment of purchases and originations; consistent consideration of letters of credit	Limited number of investments, and heavy competition for them results in low returns; many investments essentially become grants; unrealistic expectations and ultimately too costly	More weight to alternative delivery channels besides branches	Credit for more activities, even non-LMI related; credit for non-AA CD activities if meet AA needs		Greater flexibility in definition of special purpose banks		More and better use	Credit for lending outside AA if meet needs within; delineate AAs around deposit facilities only	Retain current approach	Agencies badly underestimate compliance cost and time, but they are coming down with time; no additional requirements needed
FleetBoston Financial	More detailed examiner guidance on qualitative factors	Keep at 50%; include letters of credit for CD loans	Eliminate; limited number of investments with pricing problems; considerable overlap with CD loans; evaluate as part of new CD test	Reduce to 20%	New test at 30%				Must be given more consideration	Credit for all activities outside of AA as long as adequately met needs within AA	Maintain flexibility of current approach	Current data collection and reporting is huge burden and expensive undertaking but effective; no additional requirements needed
Independent Community Bankers of America (mainly small banks)	Better exam procedures and training; public file only available at main office; address industry perception that Outstanding rating is out of reach for small banks	Prefer identical treatment of purchased and originated loans, but possible discounting of purchased loans far outside AA	Less emphasis on investments and more on loans; one recommended solution is elimination of investment test and making it optional for extra credit; credit for investments outside of AA; expand qualified investments to include municipal development bonds	Consider alternative delivery systems such as the internet and special purpose deposit accounts; credit for CD services even if not financially related	Better definition of CD activities; credit for any economic development activity, even if not LMI related				More fully shared with banks before and during exam; especially important in loan-to-deposit ratio evaluation	Maintain current approach with greater latitude to designate LMI areas		Eliminate since costs cannot justify benefits

**Table 7  
Selected Bank and Thrift Industry Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose (LP) and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development (CD) Activities							
Massachusetts Bankers Association	Lending and service tests are paramount; investment test should be secondary, optional and sometimes unnecessary; only use innovative and complex criteria to improve rating		Eliminate as required benchmark and make use and weighting of it at discretion of bank		Restrict CD concept to investments rather than loans or services	Extend small bank designation to assets of \$1 billion or less				AA concept is neither useful nor practical and increasingly irrelevant; CRA credit for LMI loans anywhere in state, regardless of AA; flexibility to designate regional or statewide AAs		Strongly oppose any new requirements; existing requirements, except for HMDA, should be optional; existing CRA data of little value
The Financial Services Roundtable (100 largest financial companies)	Member companies split, but most see no need for major reform but only "tweaking"; more flexibility during exams and less emphasis on requiring "innovative" and "complex" activities	No change to current treatment of purchases vs. originations; consideration of letters of credit; consideration of "harmful" and "abusive" lending practices too subjective and counterproductive	Several members favor elimination of test or at least subsuming in Lending Test so investments substitutable for loans; some members would like all three tests counted equally; recommends choice between existing system and a modified CD test that allows more flexibility	Credit for ATMs used by LMI people; more consideration for flexible and innovative deposit accounts			Broader definitions to include those with alternative, non-branch delivery systems			Most members feel no need to change, but some want more flexibility if don't use branches	Maintain current approach for flexibility	Current requirements unduly burdensome and data of minimal use; eliminate current data collection requirements; strongly oppose any new requirements; make public file available at just one central location
Utah Bankers Association		Make more flexible and less reliant on quantitative measures; do not require CD investments and services to get a Satisfactory rating	Make optional and count investments for extra credit or as a substitute for loans; expand scope of qualified investments	Count services for extra credit or as a substitute for loans	Broaden scope of CD investments and services to benefit entire community not just LMI areas		Make easier to qualify as LP institution by eliminating requirement of offering credit cards or car loans exclusively	Make easier to apply for and modify		Continue definition based on area around offices; exclude areas where bank has no presence		Discontinue CRA reporting of small business loans; reports of little value and extremely costly

Source: Individual organizations



**Table 8  
Selected Community Group Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development Activities							
ACORN	Upgrade ratings standards to reduce grade inflation	Consider quality as well as quantity of loans; penalize lenders with originated or purchased loans with abusive or predatory terms; evaluate pricing to make sure prime borrowers do not have subprime rates or terms; count purchases much less than originations	Maintain; more weight to grants; no credit for MBS with underlying predatory features	Maintain; quantify use of low-cost banking services such as lifeline banking accounts; banks partnering with check cashers or payday lenders receive below satisfactory rating on Service Test	Opposed to separate CD test	Maintain existing size requirements			Contact local groups and residents to ascertain community needs	Include entire MSA; nontraditional banks define AAs based on substantial share of loans (defined as 0.5%)	Eliminate optional treatment of affiliates	Report current data quarterly rather than annually; separate data on prime vs. subprime mortgages; require HMDA-like small business data
California Reinvestment Committee	Fifth "High Satisfactory" overall rating; Low Satisfactory banks must submit public improvement plan; use qualitative factors only to improve satisfactory rating; revise CRA to focus on race as well as income	Credit for multi-family lending in low income areas only if to LMI tenants; no loan should count more than once; penalize any predatory or payday lending; little to no credit for subprime lending	Maintain test; loan purchases get credit only under Investment Test; most credit for contributions and less credit for MBS	Consider fees in service test; better description of CD services in PE; banks must provide lifeline banking products	Include race as factor in defining CD; no credit for CD services outside of AA	Maintain existing size requirements; require Service Test for all small banks; require CD lending and investments for Outstanding rating for banks in \$100-250 million range	Do not expand definition of banks here; do not apply to other banks	Keep this option but increase community input and review	Examiners should make at least 20 community contacts per MSA	Banks that lend or take deposits from a significant portion of MSA market should have CRA responsibilities there; compare LMI to non-LMI aggregate market share for internet and insurance related banks	Include activities of all subsidiaries and affiliates	Require HMDA-like small business data; report CD loan and investment data by census tract
Center for Community Change	Too much emphasis on performance of large banks in urban centers vs. rural areas; increased use of community group contacts during exams	Credit to move subprime borrowers to prime market; deny CRA credit for any predatory loans	Maintain	Maintain but increase quantitative analysis and rigor	Do not develop separate CD test; limit CRA credit to LMI activities	Maintain existing size requirements; more detailed performance data should be in PE; tougher loan to deposit standards in rural areas	Too much discretion in designations; clearer standards required	Not an effective evaluation method; rarely used or considered	Include more information on PC to make PEs more useful	Require AA to include all areas where substantial deposits or loans	Once a bank elects to have any affiliate's activity considered, then the activity of all other affiliates must be considered	Report small business data in HMDA format; report CD loans on census tract basis; analyze prime and subprime loans separately; report qualified investments by category and amount; improve access to non-metro mortgage lending data

**Table 8  
Selected Community Group Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development Activities							
Community Reinvestment Association of NC	Conduct CRA, fair lending, and safety and soundness exams concurrently; incentives to increase prime lending; don't provide excess credit for "innovative" programs; fifth overall High Satisfactory rating; Low Satisfactory or lower rating requires improvement plan with public comment period; apply GLB restriction that all banks with failing ratings cannot expand into the securities or insurance business to both acquiring and acquired banks; public hearings on any proposed CRA reforms	Evaluate subprime lending; consider minorities in exam like LMI borrowers; purchased loans not counted as much as originated ones; no credit for payday lending		Disclosure of checking and savings accounts with fee information;		Maintain existing size requirements; more detailed data requirements and analysis; require Investment and Service Tests for small banks				Must include communities in which a great majority of bank lending occurs	Include activities of non-depository affiliates	Supports FED proposal to enhance HMDA data to include APRs and fees; lift Reg B prohibition on reporting of race and gender small business data; report aggregated CD data by tract
Delaware Community Reinvestment Action Council, Inc.	Conduct CRA, fair lending, and safety and soundness exams concurrently; emphasis on quantitative criteria; "innovative" programs do not compensate for otherwise bad performance; fifth "High Satisfactory" overall rating; Low Satisfactory banks must submit public improvement plan; GLB expansion restriction due to poor CRA ratings applies to both banks in a deal; public hearings to discuss CRA reform	Penalize lenders for making predatory loans; subprime lenders must show that no credit worthy borrower was offered subprime loan; purchased loans not given same weight as originated ones	Maintain as there is a need for equity investments in LMI areas	Data on number of checking and savings accounts by income and minority status and location; include fees and cost of deposit services; CRA credit for affordable services to LMI areas				Community outreach efforts by bank does not constitute performance assessment	Examine those communities in which a great majority of a bank's loans are made	CRA exams should cover all activities of non-depository affiliates	HMDA analysis of lending to minorities must be included; supports FED's proposed addition of rate and fee data on HMDA reports; race and gender data on small business loans	

**Table 8  
Selected Community Group Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development Activities							
National Community Reinvestment Coalition	Add fifth overall rating of High Satisfactory; overall ratings of Low Satisfactory or less require public improvement plan with comment period; strengthen CRA enforcement; additional prompt disclosure of CRA appeals; emphasize quantitative approach; conduct CRA, fair lending, and safety and soundness exams concurrently	Subprime lending does not count as much as prime lending; severe penalties for any predatory lending; explicit consideration of minorities just like LMI people and areas	Needed since LMI areas have shortage of equity investments for small businesses; quantitative benchmark such as ratio of CD investments to assets; also use ratio of nonprofit grants to assets; more credit to investments with better LMI impact	Must be more rigorous due to grade inflation; require new data on savings and checking accounts; require branch distribution data in PEs; include data on cost of services; no credit for payday lending; only allow credit for alternative delivery systems or CD services if impact LMI borrowers	Banks have discretion to consider CD loans as qualified investments without securitizing them; no expansion of credit for CD activities outside of broader regional or statewide area including AA	Do not allow any more banks to qualify for this test; make optional Investment and Service Tests mandatory; propose minimum 75% loan-to-deposit ratio for satisfactory rating	Do not apply to retail banks including branchless or internet ones; tighten application standards to avoid further inappropriate qualifications	Eliminate	Regulators should inform community groups of names of banks when seeking public input; regulators should also seek out groups besides those recommended by examined bank	Must include communities in which a great majority of bank lending occurs; expand definition to include areas where bank or affiliates have branches, ATMs, or more than 0.5% of loan market	Require all lending and banking activities of non-depository bank affiliates to be covered	Expand current requirements to include more detailed data; supports FED proposal to enhance HMDA data to include APRs and fees; lift Reg B prohibition on reporting of race and gender small business data; report aggregated CD data by tract
National Congress for Community Economic Development	Use qualitative factors only to upgrade bank if high satisfactory rating; Outstanding rating denied if bank rated Needs to Improve on any component test; Satisfactory rating only if no Substantial Noncompliance rating in any component test	Qualitative analysis of lending for costs and abusive terms; consider number of loans besides amount; originations given more weight than purchases; include neighborhood race data in geographic distribution; penalty for predatory lending but bonus for "referring up" subprime customers"	Maintain; distinguish between low- and high-risk investments; measure bank grants relative to bank earnings; review investments for underlying predatory features	Maintain; quantify use of low-cost banking services such as lifeline banking accounts; banks partnering with check cashers or payday lenders receive below satisfactory rating on Service Test; require more quantitative measures of alternative services	Do not make separate test; count CD credit under Investment or Lending Tests; narrow current CD definition to focus on LMI and race	Maintain existing size requirements	Current definitions inadequate as some "special purpose" banks are retail banks	Not currently a viable alternative and needs reform, if not elimination	Separate test;	Penalize rating for banks involved with payday lenders, check cashers, or other fringe financial services, even if done outside AA; in addition to current definition, AA should also include areas where significant portion of deposits or loans emanate	All lending and banking activities of non-depository affiliates must be included in CRA exams	Report small business data in HMDA format; report CD loans on census tract basis; analyze prime and subprime loans separately; report qualified investments by category and amount; improve access to non-metro mortgage lending data

**Table 8  
Selected Community Group Comments on 2002 CRA Reform**

Source of Comment	General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests				Small Institution: The Streamlined Small Institution Evaluation	Limited Purpose and Wholesale Institutions: The Community Development Test	Strategic Plan	Performance Context (PC)	Assessment Area (AA)	Activities of Affiliates	Data Collection and Maintenance of Public Files
		Lending Test	Investment Test	Service Test	Community Development Activities							
Neighborhood Reinvestment Corporation	Add fifth overall rating of High Satisfactory	Focus more on quality rather than quantity of lending, especially as related to predatory loans; bonus credit for low-cost alternatives to payday lending	Increase weighting in certain cases; encourage substantive grants or investments in nonprofits	Evaluate whether retail banking services easily accessible by LMI people and areas		Drop loan-to-deposit ratio test		Greater specificity on CD plans needed prior to merger approval		Internet and similar banks with nontraditional delivery systems should be evaluated on basis of location of deposits and other activities (e.g., define AA as all MSAs where 5% or more of deposits emanate)	Review subprime and predatory lending of affiliates in AA, without expanding scope of CRA to other non-regulated activities	Better information on small business lending, rural lending, pricing, and fees; subprime vs. predatory loan analysis
The Greenlining Institute	Include insurance company activities related to covered banking activities; add High Satisfactory overall rating; give out more Needs to Improve ratings; reward leadership efforts by banks; public hearings for all mergers of \$1 billion or more in assets if either party has below average component test rating		Bonus credits for key grants								Include activities of all subsidiaries and affiliates	CRA exams should not be colorblind – include race and ethnic data; examine and report diversity of Board, managers, and key CRA officers
Woodstock Institute	Tougher overall rating requirements based on component test ratings	More weight for originations vs. purchases; include race as well as income criteria; evaluate quality as well as quantity of lending; examine subprime lending for predatory features, which result in low rating; evaluate all home-secured loans not just mortgage loans	Minimum Low Satisfactory rating on this test for overall passing rating; distinguish investments based on risk and return; review MBS for underlying predatory features	Minimum Low Satisfactory rating on this test for overall passing rating; consider distribution of bank accounts by income, race, and geography; Outstanding rating on this test requires lifeline banking, multiple delivery systems, or account alternatives as well as innovative and complex services; internet or trust banks can provide CD services and investments	More restrictive CD definition	Maintain existing size requirements	More restrictive definitions to qualify; bank is "retail" if more than 0.5% market share of any product	Eliminate	Consider community group input; inform both banks and community groups of PC in advance of exam	Expand by allowing banks to base AA not just on branch locations but also on location of significant (0.5% or more market share) portion of deposits or loans	Include affiliate's lending; at a minimum, banks should "use all or none" approach for affiliates	Maintain existing requirement but make tougher; revise small business reporting format to be similar to HMDA; require race and gender data for small businesses; more detailed CD lending data; require detailed reporting for investments and services; more detailed reporting of existing CRA data

Source: Individual community groups

**Table 9  
Optimal CRA Reform Recommendations**

General Comments	Large Retail Institutions: The Lending, Service, and Investment Tests			
	Lending Test	Investment Test	Service Test	CD Activities
<p>1. Return focus of CRA exam and rating to LMI lending</p> <p>2. Reduction of grade inflation through joint agency examiner education</p> <p>3. Expansion of CRA to at least credit unions</p> <p>4. More objective, quantitative, and structured PEs, with exception of new qualitative lending criterion</p> <p>5. Goal of FFIEC centralized compliance function</p> <p>6. Greater consistency in exam and rating procedures among regulators and individual regions</p> <p>7. Fifth "good" or High Satisfactory rating</p> <p>8. More detailed rating guidelines and PE disclosure of individual performance rating factors (i.e., ratings matrix)</p> <p>9. Specialized compliance examiners and staff with separate exams</p> <p>10. Continued focus on LMI areas and people with no consideration of race</p> <p>11. Better and more timely disclosure of ratings, PEs, and appeals</p> <p>12. No CRA exemptions for federally-insured depositories</p> <p>13. Return to pre-GLB, more frequent, tiered exam schedule based on ratings, ranging from 6 months (worst rating) to 24-30 months (best rating)</p> <p>14. Require that both the acquirer and acquiree in a bank deal have passing (i.e., Satisfactory or better) overall CRA ratings</p> <p>15. Equal treatment of LMI-related outstanding loans and investments vs. new ones made during review period; no penalty for longer term instruments</p> <p>16. Time-sensitive evaluation (and pro-rata weighting) of CRA performance over the entire review period, without emphasizing most recent CRA activities; limited pro-rata credit for any new CRA activities within six months of exam start date with disclosure of same in PE</p> <p>17. Require all community groups and coalitions involved with CRA to make sunshine filings disclosing details of all IRS Form 990 schedules showing contributor names and amounts for current and past years</p> <p>18. More fact-based documentation of conclusions in PE, including mandatory use of standardized tables of performance data PEs that are as least as comprehensive as those developed by the OCC</p> <p>19. All agencies should adopt all 10 recommendations to improve PEs found in the OTS Office of Inspector General Report (see Office of Inspector General, U.S. Department of the Treasury, 2001)</p> <p>20. Greater CRA data availability and ease of access (with optional e-mail notification list for specific banks or areas) from FFIEC and agency web sites with announcement of upcoming exams, recent ratings, related enforcement actions, reform comments, FOIA requests and responses, appeal files, special purpose bank designation applications, and GLB sunshine reports</p> <p>21. More descriptive information in all PEs about scope of exam, including starting and ending dates, review period, products reviewed, AAs covered, and even chief examiner's initials or identifying number for accountability</p> <p>22. Mandatory review and potential reform of CRA five years after the complete transition to the present reforms; if the reforms due out in 2002 are fully transitioned by the end of next year, the next reform should occur in 2008</p>	<p>1. Addition of three new ratings factors: LMI credit-related investments, LMI credit-related CD services, and LMI credit-related retail banking services</p> <p>2. Expansion of innovative/flexible rating factor to more comprehensive "Qualitative Lending" one which also includes consideration of any predatory or other adverse LMI credit practices as well as "referring-up" of subprime borrowers</p> <p>3. 10 rating factors evaluated under current 5 ratings (50 cells in ratings matrix) with ratings matrix disclosed in PE</p> <p>4. Reduced credit for purchased loans in AA vs. originated loans to reflect additional costs and risks associated with originations; mandatory PE disclosure of amount of purchased vs. originated loans in AA</p> <p>5. No credit for purchased loans if double counting or evidence of "loan swapping" among banks</p> <p>6. Continue current treatment of letters of credit with notation of their volume</p>	<p>1. Eliminate and make part of lending test</p> <p>2. Only consider LMI credit-related investments with documentation of same in PE</p> <p>3. Initially make this test a mandatory lending factor, with possibility of making optional as in case of small bank test</p> <p>4. Credit for all LMI-related qualified investments outside AA, as long as LMI credit needs in AA being met</p> <p>5. Limited credit for "over-the-counter" purchased LMI-related securities, especially MBS, bonds, and minority bank CDs with mandatory PE disclosure of same</p> <p>6. Credit for all LMI credit-related qualified investments held during review period, including long-maturity ones that blanket the review period</p>	<p>1. Eliminate and make part of lending test</p> <p>2. Only consider LMI credit-related services with documentation of same in PE</p> <p>3. Initially make this test a mandatory lending factor, with possibility of making optional as in case of small bank test</p> <p>4. Credit for all LMI-related CD services outside AA, as long as LMI credit needs in AA being met</p>	<p>1. Part of lending test</p> <p>2. Maintain current CD definitions</p> <p>3. Credit for all LMI-related CD activities outside of AA, as long as LMI credit needs in AA being met</p>

(Continued)

**Table 9  
Optimal CRA Reform Recommendations**

<b>Small Institution: The Streamlined Small Institution Evaluation</b>	<b>Limited Purpose and Wholesale Institutions: The CD Test</b>	<b>Strategic Plan (SP)</b>	<b>Performance Context (PC)</b>	<b>Assessment Area (AA)</b>	<b>Activities of Affiliates</b>	<b>Data Collection and Maintenance of Public Files</b>
<p>Double current size minimum to \$500 million for independents and \$2 billion for holding companies</p>	<ol style="list-style-type: none"> <li>1. More consistent definitions to insure special purpose qualification</li> <li>2. Only consider activities that can be documented as LMI related</li> <li>3. Credit for LMI-related CD activities outside of AA, as long as LMI credit needs in AA being met</li> <li>4. Stricter application and disclosure of performance rating factors and matrix to reduce grade inflation</li> <li>5. Limited credit for banks electing single CD activity, especially purchased investments, when performance context dictates potential for additional CD activities</li> <li>6. Retain innovative and complex considerations, especially for banks with single CD activities</li> </ol>	<ol style="list-style-type: none"> <li>1. Eliminate SP option</li> <li>2. Banks currently under SPs will use elected back-up exam method</li> </ol>	<ol style="list-style-type: none"> <li>1. More explicit use prior to and during exam as well as in PE</li> <li>2. Required PE description of how PC applied in weighting performance rating factors and the resultant impact on overall rating</li> </ol>	<ol style="list-style-type: none"> <li>1. Retain existing AA approach</li> <li>2. Credit for LMI-related CD activities, especially LMI lending, outside of AA for all banks, not just nontraditional ones with alternative delivery systems, as long as local LMI credit needs being met</li> <li>3. PC analysis of nontraditional banks with alternative delivery systems and very small portion of loans in AA will result in lower weighting of AA loan percentage rating factor relative to other performance factors, especially nonlocal LMI lending</li> </ol>	<p>Mandatory rather than optional CRA treatment of affiliates</p>	<ol style="list-style-type: none"> <li>1. Continue all existing data collection and reporting requirements</li> <li>2. Maintain current public file requirement</li> <li>3. Do not consider or require any race data under CRA</li> </ol>

Source: K.H. Thomas, Ph.D.

# Proposed Rules

Federal Register

Vol. 66, No. 139

Thursday, July 19, 2001

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## DEPARTMENT OF THE TREASURY

### Office of the Comptroller of the Currency

#### 12 CFR Part 25

[Docket No. 01-16]

RIN 1557-AB98

## FEDERAL RESERVE SYSTEM

#### 12 CFR Part 228

[Regulation BB; Docket No. R-1112]

## FEDERAL DEPOSIT INSURANCE CORPORATION

#### 12 CFR Part 345

RIN 3064-AC50

## DEPARTMENT OF THE TREASURY

### Office of Thrift Supervision

#### 12 CFR Part 563e

[Docket No. 2001-49]

RIN 1550-AB48

### Community Reinvestment Act Regulations

**AGENCIES:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS).

**ACTION:** Joint advance notice of proposed rulemaking.

**SUMMARY:** The OCC, Board, FDIC, and OTS (collectively, "we" or "the agencies") are beginning a review of our Community Reinvestment Act (CRA) regulations. This advance notice of proposed rulemaking (ANPR) seeks public comment on a wide range of questions as part of our review. We also welcome comments discussing other aspects of the CRA regulations and suggesting ways to improve the efficacy of the regulations.

**DATES:** Comments must be received by October 17, 2001.

**ADDRESSES:** *OCC:* Please direct your comments to: Docket No. 01-16, Communications Division, Public Information Room, Mailstop 1-5, Office of the Comptroller of the Currency, 250 E Street, SW., Washington, DC 20219. You can inspect and photocopy all comments received at that address. In addition, you may send comments by facsimile transmission to fax number (202) 874-4448, or by electronic mail to [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).

*Board:* Comments should refer to Docket No. R-1112 and should be mailed to Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551, or mailed electronically to [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Comments addressed to Ms. Johnson may also be delivered to the Board's mailroom between 8:45 a.m. and 5:15 p.m., and to the security control room outside those hours. Both the mailroom and the security control room are accessible from the Eccles Building courtyard entrance, located on 20th Street between Constitution Avenue and C Street, NW. Members of the public may inspect comments in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. on weekdays.

*FDIC: Mail:* Written comments should be addressed to Robert E. Feldman, Executive Secretary, Attention: Comments/OES, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.

*Delivery:* Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m.

*Facsimile:* Send facsimile transmissions to fax number (202) 898-3838.

*Electronic:* Comments may be submitted to the FDIC electronically over the Internet at <http://www.fdic.gov/regulations/laws/publiccomments/index.html>. The FDIC has included a page on its web site to facilitate the submission of electronic comments in response to this ANPR concerning the CRA regulations (the EPC site). The EPC site provides an alternative to the written letter and may be a more convenient way for you to submit your comments or suggestions

concerning the ANPR to the FDIC. If you submit comments through the EPC site, your comments will receive the same consideration that they would receive if submitted in hard copy to the FDIC's street address. Like comments or suggestions submitted in hard copy to the FDIC's street address, EPC site comments will be made available in their entirety (including the commenter's name and address if the commenter chooses to provide them) for public inspection. The FDIC, however, will not use an individual's name or any other personal identifier of an individual to retrieve records or information submitted through the EPC site. You will be able to view the ANPR directly on the EPC site and provide written comments and suggestions in the spaces provided.

You may also electronically mail comments to [comments@fdic.gov](mailto:comments@fdic.gov).

*Public Inspection:* Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17th Street, NW., Washington, DC 20429, between 9:00 a.m. and 4:30 p.m. on business days.

*OTS: Mail:* Send comments to Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention Docket No. 2001-49.

*Delivery:* Hand deliver comments to the Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9:00 a.m. to 4:00 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention Docket No. 2001-49.

*Facsimiles:* Send facsimile transmissions to FAX Number (202) 906-6518, Attention: Docket No. 2001-49.

*E-Mail:* Send e-mails to [regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov), Attention Docket No. 2001-49 and include your name and telephone number.

*Public Inspection:* Comments and the related index will be posted on the OTS Internet Site at <http://www.ots.treas.gov>. In addition, you may inspect comments at the Public Reference Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the material you will be requesting will assist us in serving you.) Appointments will be scheduled on business days

between 10:00 a.m. and 4:00 p.m. In most cases, appointments will be available the next business day following the date a request is received.

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**SUPPLEMENTARY INFORMATION:**

**Introduction**

The Federal financial supervisory agencies are jointly undertaking a review of our CRA regulations, in fulfillment of our commitment to do so when we adopted the current regulations in 1995. See 60 FR 22156, 22177 (May 4, 1995). This ANPR marks the beginning of our assessment of the effectiveness of the regulations in achieving their original goals of (1) emphasizing in examinations an institution's actual performance in, rather than its process for, addressing CRA responsibilities; (2) promoting consistency in evaluations; and (3) eliminating unnecessary burden. Any regulatory changes that we determine to be necessary to improve the regulations' effectiveness will be made in a rulemaking after completion of this review.

With our initiation of this comprehensive review of the regulations, we seek to determine whether, and if so, how, the regulations should be amended to better evaluate financial institutions' performance under the CRA, consistent with the authority, mandate, and intent of the statute. We encourage comments from the industry and the public on all aspects of this ANPR, as well as other concerns regarding the regulations that may not be represented, in order to ensure a full discussion of the issues.

**Background**

In 1977, Congress enacted the CRA to encourage federally insured banks and thrifts to help meet the credit needs of their entire communities, including low-and moderate-income neighborhoods, consistent with safe and sound banking practices. 12 U.S.C. 2901 *et seq.* In the CRA, Congress determined that:

(1) Regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;

(2) The convenience and needs of communities include the need for credit services as well as deposit services; and

(3) Regulated financial institutions have continuing and affirmative obligation[s] to help meet the credit needs of the local communities in which they are chartered. (12 U.S.C. 2901(a).) Further, Congress directed the agencies to assess an institution's record of meeting the credit needs of its entire community, and to consider that record when acting on an application for a deposit facility.

In 1993, we initiated a reform of our CRA regulations. The goal of the reform was to develop revised rules that would clarify how we would evaluate the performance of the institutions we supervise. It also was our goal to develop a new system of evaluating financial institutions' records with respect to CRA that would focus primarily on objective, performance-based assessment standards that minimize compliance burden while stimulating improved performance.

After holding seven public hearings and publishing two proposed rules, we jointly issued final rules (the "regulations") on May 4, 1995 (60 FR 22156). See 12 CFR 25, 228, 345, and 563e, implementing 12 U.S.C. 2901 *et seq.* We published related clarifying documents on December 20, 1995 (60 FR 66048) and May 10, 1996 (61 FR 21362). To assist financial institutions and the public, we have also provided

interpretive guidance about the regulations in the form of questions and answers published in the **Federal Register**. See 65 FR 25088 (April 28, 2000).

Under the regulations, the agencies evaluate a financial institution through a performance-based examination, the scope of which is determined by the institution's size and business strategy. Large, retail-oriented institutions are examined using the lending, investment, and service tests. Small institutions are examined using a streamlined small institution test. Wholesale and limited purpose institutions are examined under a community development test. And, finally, all institutions have the option of being evaluated under a strategic plan. No matter which evaluation method is used, each institution's performance is evaluated in a "performance context" that examiners factor into their CRA evaluations. The performance context includes consideration of factors such as each institution's business strategy and constraints, as well as the needs of, and opportunities afforded by, the communities served.

As stated, our goal was to make CRA examinations more objective and performance-based. To this end, the regulations require large institutions to collect, report, and disclose data on small business, small farm and community development loans, as well as limited data about home mortgage lending outside metropolitan statistical areas (MSAs), if the institution is subject to the Home Mortgage Disclosure Act (HMDA).

**Issues for Comment**

A fundamental issue for consideration is whether any change to the regulations would be beneficial or is warranted. Industry representatives, community and consumer organization representatives, members of Congress, and the public have discussed the regulations with the agencies over the years, e.g., during examinations, in the application process, at conferences, and at other meetings. Some suggest that the regulations work reasonably well and that little or no change is necessary. Others suggest that more extensive changes may be needed to reflect the significant changes in the delivery of services and expansion of products offered by financial institutions as a result of new technologies and financial modernization legislation. Still others advise that regulatory changes are inherently burdensome, so the benefit of any change should be weighed against the cost of effecting the change.



The following discussion identifies some of the issues that may warrant our review. The discussion is by no means exhaustive of all the issues that could be raised or the viewpoints that could be expressed. Commenters are invited to respond to the questions presented and to offer comments or suggestions on any other issues related to the CRA regulations, including developments in the industry that may impact how we evaluate CRA performance in the future. The agencies also welcome suggestions on what, if any, other steps we might undertake instead of, or in addition to, revising the regulations.

### 1. Large Retail Institutions: Lending, Investment, and Service Tests

Large retail institutions are subject to the lending, investment, and service tests. These tests primarily consider such things as the number and dollar amount of loans, qualified investments, and services, and the location and recipients of these activities. The tests also call for qualitative consideration of an institution's activities, including whether, and to what extent, loans, investments, and services are responsive to community credit needs; whether and to what extent they are innovative, flexible, or complex activities; and, in the case of investments, the degree to which the investments are not routinely provided by private investors. Thus, the regulations attempt to temper their reliance on quantitative factors by requiring examiners to evaluate qualitative factors, because not all activities of the same numerical magnitude have equal impact or entail the same relative importance when undertaken by different institutions in different communities.

Nonetheless, because the tests first consider the number and dollar amount of loans, investments, or services, some are of the opinion that CRA evaluations have become simply a "numbers game." They question whether the regulations strike the right balance between evaluation of the quantity and quality of CRA activities. They suggest, for example, that the regulations provide too little consideration for an institution's focus on smaller projects "whether or not "innovative" "that are particularly difficult to carry out, but are especially meaningful and responsive to the institution's community.

Institutions' CRA ratings reflect the principle that lending is the primary vehicle for meeting a community's credit needs. In the 1995 preamble to the regulations, the agencies published a ratings matrix for examiners to use when evaluating large retail institutions under the lending, investment, and

service tests. Under this matrix, it is impossible for an institution to achieve a "satisfactory" rating overall unless it receives at least a "low satisfactory" rating on the lending test. The agencies continue to use this ratings matrix.

With respect to the emphasis placed on each category of an institution's activities, some question whether lending should be emphasized more than investments and services. They assert that a CRA evaluation should allow for adjustment of this emphasis in a manner that more nearly corresponds with the activities of the institution and the particular needs of its community. For example, they assert, if an institution does not significantly engage in retail lending and, therefore, makes few loans, the lending test should not receive more emphasis than the investment and service tests for that institution's CRA evaluation.

Others contend, however, that lending should always be stressed, because they believe that deposits derived from communities should be reinvested in those communities through loans. Still others assert that lending should be the *only* basis upon which institutions are evaluated.

Finally, with respect to the three tests, some have argued that an institution's record of providing services should be given more emphasis than it currently is given. Others assert that providing services is not relevant to assessing whether an institution is meeting the credit needs of its community.

- Do the regulations strike the appropriate balance between quantitative and qualitative measures, and among lending, investments, and services? If so, why? If not, how should the regulations be revised?

A. *Lending test.* The agencies evaluate an institution's lending performance by considering the number and amount of loans originated or purchased by the institution in its assessment area; the geographic distribution of its lending; characteristics, such as income level, of its borrowers; its community development lending; and its use of innovative or flexible lending practices to address the credit needs of low- or moderate-income individuals or geographies in a safe and sound manner.

One aspect of the lending test that some have raised with the agencies is that the regulations allow equal consideration for loan originations and purchases. Some assert that only loan originations should be considered in an institution's evaluation. Supporters of this position maintain that consideration of loan purchases does not encourage institutions to increase capital in their communities. Rather,

they believe equal consideration may prompt institutions to buy and sell the same loans repeatedly to influence their CRA ratings. On the other hand, some contend that loan purchases free up capital to the selling institution, thus enabling it to make additional loans. Still others argue that both purchases and originations should be considered, but originations should be weighted more heavily because they require more involvement by the institution with the borrower.

A related issue focuses on how the agencies should treat secondary market activity. The regulations currently capture purchased loans under the lending test and purchased asset-backed securities under the investment test. Some find this distinction to be artificial, and propose that purchased loans and purchased asset-backed securities should be captured under the same test, although they differ on which test should be used.

In addition, some are concerned that the regulations generally seem to provide consideration of loans without regard to whether the lending activities are appropriate. They recommend that a CRA examination also should include consideration of whether certain loans contain harmful or abusive terms and, therefore, do not help to meet community credit needs.

- Does the lending test effectively assess an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

B. *Investment test.* The agencies evaluate large retail institutions' performance under the investment test based on the dollar amount of qualified investments, their innovativeness or complexity, their responsiveness to credit and community development needs, and the degree to which they are not routinely provided by private investors. The agencies included the investment test in CRA evaluations in recognition that investments, as well as loans, can help meet credit needs.

With respect to whether it is appropriate to evaluate institutions' investment activities, some suggest that investments by financial institutions are invaluable in helping to meet the credit needs of the institutions' communities, particularly in low- and moderate-income areas. Still others assert that the agencies should only consider investment activities to augment institutions' CRA ratings. In their view, although investments may help an institution to meet the credit needs of its community, particularly in low- and moderate-income areas, CRA ratings should be based primarily on lending

activity. Others state, however, that it is inappropriate for the agencies to evaluate investments under the CRA as a means of meeting credit needs.

The availability of qualified investments has also been an issue of concern to some. Although some have observed that since the regulations went into effect, the market of available CRA-related investments has grown and continues to grow, others assert that appropriate investment opportunities may not be available in their communities. Further, some of the retail institutions subject to the investment test have indicated that, in some cases, it has been difficult to compete for investment opportunities, particularly against much larger institutions.

In addition, some have raised concerns that the innovative and complex elements of the investment test lead to a constant demand to change programs, even where existing programs are successful, just to maximize CRA consideration. Others have asked the agencies to reduce the uncertainty of how investments will be evaluated in an examination.

- Does the investment test effectively assess an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

C. *Service test.* Under the service test, the agencies consider an institution's branch distribution among geographies of different income levels, its record of opening and closing branches, particularly in low- and moderate-income geographies, the availability and effectiveness of alternative systems for delivering retail banking services in low- and moderate-income geographies and to low- and moderate-income individuals, and the range of services provided in geographies of all income levels, as well as the extent to which those services are tailored to meet the needs of those geographies. The agencies also consider the extent to which the institution provides community development services and the innovativeness and responsiveness of those community development services.

The criteria for evaluating retail services have led to discussion on the test's effectiveness. Some argue that the service test depends too heavily on the provision of brick and mortar banking services, particularly when one considers that many services are now provided by telephone, mail or electronically. Others assert that brick and mortar banking facilities should be weighted heavily because they are necessary, especially in low- and moderate-income neighborhoods where

consumers may not have access to electronic banking services. These issues have led some to propose that the evaluation should consider not only the delivery method and type of service, but also the effectiveness of the delivery method, i.e., the extent to which low- and moderate-income persons actually use the services offered. In addition, some have suggested that the test should provide more consideration for flexible and innovative deposit accounts.

As for community development services, such as providing technical assistance on financial matters to nonprofit organizations serving low- and moderate-income housing needs, some suggest that these services are not given adequate consideration. In particular, they state that community development services are often a critical component of delivering or supporting activities considered under the lending test. Some also argue, however, that there is no incentive for an institution to engage in what might be labor intensive endeavors because community development services are only a small component of its overall evaluation. Others suggest that community development services should be evaluated within the context of other community development activities, such as lending and investments, because evaluating them separately could result in artificial designations and may not give adequate consideration to the integral relationship among the activities. Still others suggest that the community development and retail services components should be combined. See related discussion in 1.D.

- Does the service test effectively assess an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

D. *Community development activities of large retail institutions.* Under the regulations, "community development" means affordable housing (including multifamily rental housing) for low- or moderate-income individuals; community services targeted to low- or moderate-income individuals; activities that promote economic development by financing small businesses and farms; and activities that revitalize or stabilize low- or moderate-income geographies.

The definition of "community development" has spurred discussion since the regulations were published. Some assert that the definition of "community development" is not broad enough to cover the full range of activities that should receive favorable consideration. For example, some indicate that many projects intended to

revitalize or stabilize rural communities do not qualify under the current regulatory definition of community development because they are not located in low- or moderate-income geographies, as defined in the regulations. Others assert that the definition does not adequately value activities benefiting communities or projects involving persons with a mix of incomes.

Issues also have arisen with respect to the geographic location of an institution's community development activities. For large retail institutions, the agencies consider community development activities in their assessment areas or a broader statewide or regional area that includes their assessment areas. Some suggest that large retail institutions should receive full consideration for community development activities anywhere they are conducted, as long as the institutions have adequately addressed the needs of their assessment areas.

They contend that such consideration should be similar to the consideration of community development activities given wholesale and limited purpose institutions that are evaluated under the community development test. Others express concern, however, that if retail institutions are given the opportunity to receive consideration for community development activities outside their assessment areas and the broader statewide or regional areas that include their assessment areas, such an opportunity may be interpreted as a requirement to serve these areas. Still others argue that allowing activities further afield to receive consideration would diminish institutions' incentives to serve their own communities.

As discussed above, the community development loans, qualified investments, and community development services of large retail institutions are considered separately under the lending, investment, and service tests, respectively. Some suggest this evaluation method leads institutions to be overly concerned with whether they have "enough" of each activity. They argue that all community development activities, whether loans, investments or services, should be evaluated in one separate test, rather than in the existing three tests. Under such a test, an institution would receive consideration for community development loans, investments, and services needed in its community, based on the opportunities that exist and the ability of the institution to respond.

- Are the definitions of "community development" and related terms

appropriate? If so, why? If not, how should the regulations be changed?

- Are the provisions relating to community development activities by institutions that are subject to the lending, investment, and service tests effective in assessing those institutions' performance in helping to meet the credit needs of their entire communities? If so, why? If not, how should the regulations be revised?

## 2. *Small Institutions: The Streamlined Small Institution Evaluation*

A "small institution" is defined as an institution with total assets of less than \$250 million that is independent or is affiliated with a holding company with total bank and thrift assets of less than \$1 billion as of the two preceding year ends. Some suggest that the asset thresholds for being considered a small institution are too low. Others assert that holding company assets are irrelevant—if a bank has less than \$250 million in assets, it should be considered small even if it is affiliated with a large holding company. Still others suggest that holding company assets are relevant only if the holding company provides support for CRA activities or otherwise directs the CRA activities of an institution.

Small institutions are evaluated under a streamlined test that focuses primarily on lending. When evaluating a small institution, an agency considers its loan-to-deposit ratio; the percentage of loans in its assessment areas; its record of lending to borrowers of different income levels and businesses and farms of different sizes; the geographic distribution of its loans; and its record of taking action, if warranted, in response to written complaints about its performance in helping to meet credit needs in its assessment area(s).

The small institution performance standards generally have been favorably received. Some, however, express concerns that the small institution assessment method does not provide for adequate consideration of non-lending-related investments, retail-related services, or community development services. Others assert that the small institution performance standards do not adequately consider the activities small institutions are performing in their communities, particularly in highly competitive markets. Others say that the standards do not create a sufficient incentive for small institutions to seek out and make investments, provide new services, or strive for higher ratings. Some also argue that institutions evaluated under the streamlined method should not be eligible for an "outstanding" rating

based on their lending activities alone—that a small institution should be engaged in making investments and providing services in order to receive a rating higher than satisfactory.

- Do the provisions relating to asset size and holding company affiliation provide a reasonable and sufficient standard for defining "small institutions" that are eligible for the streamlined small institution evaluation test? If so, why? If not, how should the regulations be revised?

- Are the small institution performance standards effective in evaluating such institutions' CRA performance? If so, why? If not, how should the regulations be revised?

## 3. *Limited Purpose and Wholesale Institutions: The Community Development Test*

The community development test is the evaluation method used for limited purpose and wholesale institutions. A limited purpose institution offers only a narrow product line (such as credit card or motor vehicle loans) to a regional or broader market and must request and receive designation as a limited purpose institution from its regulatory agency. A wholesale institution is not in the business of extending home mortgage, small business, small farm, or consumer loans to retail customers, and similarly must obtain a designation as a wholesale institution.

Some question whether the definitions of limited purpose and wholesale institutions are appropriate. For example, they ask whether the definition of limited purpose should be expanded to a limited extent to capture retail institutions that offer more than a narrow product line on a regional or national basis.

Under the community development test, the agencies consider the number and amount of community development loans, qualified investments, or community development services; the use of innovative or complex qualified investments, community development loans, or community development services and the extent to which the investments are not routinely provided by private investors; and the institution's responsiveness to credit and community development needs. Wholesale and limited purpose institutions may receive consideration for community development activities outside of their assessment areas (or a broader statewide or regional area that includes their assessment areas) as long as they have adequately addressed the needs of their assessment areas.

Some question whether the community development test for

wholesale and limited purpose institutions is as rigorous as the lending, investment, and service tests are for large retail institutions. Others suggest that the community development test may be an appropriate test not only for limited purpose and wholesale institutions, but also for other types of institutions, such as branchless institutions that provide a broad range of retail services nationwide by telephone, mail, or electronically. Still others assert that the community development test may be an appropriate test for any retail institution.

- Are the definitions of "wholesale institutions" and "limited purpose institution" appropriate? If so, why? If not, how should the regulations be revised?

- Does the community development test provide a reasonable and sufficient standard for assessing wholesale and limited purpose institutions? If so, why? If not, how should the regulations be revised?

- Would the community development test provide a reasonable and sufficient standard for assessing the CRA record of other insured depository institutions, including retail institutions? If so, why and which ones, and how should the regulations be revised? If not, why not?

## 4. *Strategic Plan*

The agencies developed the strategic plan option to provide institutions with more flexibility and certainty regarding what aspects of their performance will be evaluated and what quantitative and qualitative measures will be applied. To exercise this option, an institution must informally seek suggestions from the public while developing its plan, solicit formal public comment on its plan, and submit the plan to its regulatory agency (along with any written comments received from the public and an explanation of any changes made to the plan in response to those public comments).

To be approved by an agency, a CRA strategic plan must have measurable goals and address how the institution plans to meet the credit needs of its assessment area, in particular, low- and moderate-income geographies and individuals, through lending, investments, and services, as appropriate. Although strategic plans should generally emphasize lending goals, the rule allows institutions the flexibility to choose a different emphasis, as necessary, given their business strategy and the needs of their community.

Strategic plans must contain goals that, if met, would constitute "satisfactory" performance. An

institution may also include goals that would constitute "outstanding" performance. Upon examination, an institution that substantially achieves its goals under its approved plan will receive the rating attributed to those goals in its plan.

Only a few institutions have used the strategic plan option. These institutions indicate that they prefer the certainty provided by having a strategic plan. On the other hand, others have said that they have chosen not to pursue this option because of concern about the public nature of the process and the plan itself, including concern that their competitors might obtain information about their business strategy. Some indicate that they have found it difficult to develop a strategic plan with measurable goals. These concerns have led some to suggest that the strategic plan option should be reformed, while others suggest that it should be eliminated.

Some suggest that a strategic plan allows non-traditional institutions, such as institutions that provide a wide range of products nationwide via the Internet or through other non-branch-based delivery systems, to set performance goals that better reflect the markets they serve. Some suggest that a strategic plan should be mandatory for certain non-traditional institutions, particularly an institution for which the vast majority of retail lending activity occurs outside of its assessment area as defined by the regulation. Others suggest that the strategic plan option could be used to blend existing assessment methods for different business lines within one institution, for example, in the context of a bank with a retail branch network in one part of the country and wholesale operations in another, or an Internet presence nationally.

- Does the strategic plan option provide an effective alternative method of evaluation for financial institutions? If so, why? If not, how should the regulations be revised?

##### 5. Performance Context

The regulations provide that an institution's performance under the tests and standards is evaluated in the context of information about the institution, its community, its competitors, and its peers. Such information may include, among other things, demographic data about the institution's assessment areas; the institution's product offerings and business strategy; lending, investment, and service opportunities in its assessment areas; any institutional capacity and constraints; and information about the institution's past

performance and the performance of similarly situated lenders.

Some assert that performance context provides a means to evaluate the qualitative impact of an institution's activities in a community, striking the right balance between the quantity and quality of an institution's activity. The appropriate information helps to assess the responsiveness of an institution's activities to community credit needs. Performance context may also provide insight into whether an activity involving a lower dollar amount could meet community needs to a greater extent than an activity with a higher dollar amount, but with less innovation, complexity, or impact on the community.

Others assert that consideration of a performance context may create uncertainty about what activities will be considered and how they will be weighted during a CRA examination. They contend that more specific and quantifiable measures are needed to understand CRA evaluations more fully, despite the quantitative and qualitative factors outlined in the regulations and interagency guidance.

On the other hand, others have raised concerns that prescribing performance ratios for institutions would result in rigid performance requirements, and thereby eliminate the advantages of a performance context analysis. They maintain that the performance context provides examiners with the latitude needed to conduct a meaningful evaluation. They contend this latitude is important given the different types of institutions and communities, and the wide variety of business, market, economic, and other factors that can affect an institution's ability to respond to community credit needs.

- Are the provisions on performance context effective in appropriately shaping the quantitative and qualitative evaluation of an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

##### 6. Assessment Areas

The regulations contain guidelines for institutions to use in defining their assessment areas. The assessment area is the geographic area in which the agencies will evaluate an institution's record of meeting the credit needs of its community. The regulations provide that an institution's assessment area should consist generally of one or more metropolitan statistical areas or one or more contiguous political subdivisions, and include geographies where the institution has its main office, branches, and deposit-taking ATMs, as well as

surrounding geographies where the institution has originated or purchased a substantial portion of its loans. An institution may adjust the boundaries of its assessment area to include only the portion of a political subdivision that it can reasonably expect to serve. However, an institution's assessment area may not reflect illegal discrimination and may not arbitrarily exclude low- or moderate-income geographies, taking into account the institution's size and financial condition.

Some indicate that the assessment area delineation in the regulations has proven appropriate for most institutions. They assert that assessment areas are appropriately limited to the geographic areas around an institution's main office, branches, and deposit-taking ATMs. They contend that this is an appropriate and practical way to give focus to an institution's responsibility to help meet the credit needs of its community. Further, they contend that an institution is most familiar with the areas in which it is physically located and is in the best position to help meet credit needs in those areas. Still others are concerned about setting expectations on where institutions should be conducting their business if assessment areas were to include areas in which the institutions are not physically located.

On the other hand, some assert that the regulations' designation of assessment areas "based upon the location of the main office, branches, and deposit-taking ATMs of an institution—ignores a variety of deposit acquisition and credit distribution channels used by an increasing number of institutions to serve the retail public, often reaching widely dispersed markets. They argue that these channels should be considered part of an institution's "community." Others suggest that the regulations' approach to assessment area may create a disincentive for institutions to engage in community development activities in low- and moderate-income communities and rural areas where they have no physical presence and which are not part of their assessment areas.

To address these and other concerns, some recommend that institutions be required to delineate geographically defined assessment areas wherever they deliver retail banking services, whether or not they have physical deposit-gathering branches or ATMs in each locale. Others suggest that the assessment area should not be limited to metropolitan statistical areas (MSAs), but that the regulations should allow statewide and even national assessment areas. Some others suggest that

assessment areas without a geographical delimitation should be allowed, such as one based on a type of customer—similar to the way an institution that predominantly serves military personnel is permitted by the statute to delineate its entire deposit customer base as its assessment area. Finally, some propose that the agencies should create a distinct evaluation method with respect to the assessment area for institutions that gather deposits and deliver products and services without using deposit-taking branches or ATMs, for example, those institutions that use the Internet almost exclusively to gather deposits and deliver products.

- Do the provisions on assessment areas, which are tied to geographies surrounding physical deposit-gathering facilities, provide a reasonable and sufficient standard for designating the communities within which the institution's activities will be evaluated during an examination? If so, why? If not, how should the regulations be revised?

#### 7. Activities of Affiliates

Under the lending, investment, and service tests and the community development test, an institution may elect to have activities of its affiliates considered as part of its own record of performance. An "affiliate" is defined as any company that controls, is controlled by, or is under common control with another company. Subsidiaries of financial institutions are considered affiliates under this definition.

Some assert that activities of affiliates, and in particular, subsidiaries of a financial institution, should always be considered in an institution's CRA evaluation. They contend that, because the regulations provide for consideration of affiliates' activities only at an institution's option, some institutions may book loans, make investments, and provide services for low- and moderate-income persons primarily in the institution, while offering other products and services more predominantly targeted to middle- and upper-income persons in their affiliates or by lending through consortia. Thus, they argue, institutions may be using their affiliates' activities to manipulate their CRA ratings. Others contend that if institutions can opt for consideration of affiliates' activities to enhance their CRA performance, their CRA performance should also be affected if their affiliates engage in abusive lending activities.

Others suggest that affiliate activities should be required to have a direct impact on an institution's assessment area. Still others assert that only the

activities of an insured depository institution should be considered in its CRA evaluation. Affiliate activities should be irrelevant, they argue, when rating an institution's CRA performance and should not be considered, even at the option of the institution. On the other hand, others have indicated that the current treatment of affiliate activities is appropriate because the CRA applies only to insured depository institutions.

- Are the provisions on affiliate activities, which permit consideration of an institution's affiliates' activities at the option of the institution, effective in evaluating the performance of the institution in helping to meet the credit needs of its entire community, and consistent with the CRA statute? If so, why? If not, how should the regulations be revised?

#### 8. Data Collection and Maintenance of Public Files

The regulations require large institutions to collect and report data on small business, small farm and community development lending, as well as limited data about home mortgage lending outside MSAs, if the institutions are subject to HMDA. The data requirements were designed to avoid undue data collection, reporting, and disclosure burden by: (1) Conforming data requirements to the extent possible with data already collected under HMDA, call reports, and thrift financial reports; (2) limiting data reporting to large institutions; and (3) making reporting of certain types of data optional.

Some question the agencies' authority to require collection and reporting of data under the CRA regulations. Others express concerns about the limitations of the data collected and reported. For example, small business and small farm data are aggregated at the census tract level, while community development loans are aggregated at the institution level. Still others question whether the collected and reported data are sufficiently detailed to be of use. Some also suggest that investment data, as well as data on lending, are necessary to properly evaluate institutions' performance under CRA.

Some indicate that collection of the required data and maintenance of a public file is burdensome and that very few interested parties ask to see the public files. However, others assert that institutions' public files provide valuable information for the public to use to monitor the extent to which they serve their communities.

- Are the data collection and reporting and public file requirements

effective and efficient approaches for assessing an institution's CRA performance while minimizing burden? If so, why? If not, how should the regulations be revised?

#### Conclusion

With this ANPR, we seek input to assist us in determining whether and, if so, how the CRA regulations should be revised. We welcome comments on all aspects of the CRA regulations and encourage all interested parties to provide their views. Hearing from parties with diverse viewpoints will help us to determine the most appropriate way to approach the review of the regulations.

#### Executive Order 12866

*OCC and OTS:* The agencies do not know now whether they will propose changes to the CRA rules and, if so, whether these changes will constitute a significant regulatory action under the Executive Order. This ANPR neither establishes nor proposes any regulatory requirements. OCC and OTS have submitted a notice of planned regulatory action to OMB for review. Because this ANPR does not contain a specific proposal, information is not available with which to prepare an economic analysis. OCC and OTS will prepare a preliminary analysis if they proceed with a proposed rule that constitutes a significant regulatory action.

Accordingly, we solicit comment, information, and data on the potential effects on the economy of any changes to the CRA rule that the commenter may recommend. We will carefully consider the costs and benefits associated with this rulemaking.

Dated: July 11, 2001.

**John D. Hawke, Jr.,**

*Comptroller of the Currency.*

Dated: July 12, 2001.

**Jennifer J. Johnson,**

*Secretary of the Board, Board of Governors of the Federal Reserve System.*

By order of the Board of Directors.

Federal Deposit Insurance Corporation.

Dated at Washington, DC, this 10th day of July, 2001.

**Robert E. Feldman,**

*Executive Secretary.*

Dated: July 10, 2001.

**Ellen Seidman,**

*Director, Office of Thrift Supervision.*

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