Office of Thrift Supervision's Community Reinvestment Act Performance Evaluations

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Contents

Abbreviations

CRA	Community Reinvestment Act
FFIEC	Federal Financial Institution Examination Council
GAO	U.S. General Accounting Office
LMI	Low- and moderate-income
OIG	Office of Inspector General
OTS	Office of the Thrift Supervision
PE	Performance Evaluation

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The Community Reinvestment Act (CRA) of 1977 was enacted to encourage depository institutions to improve access to credit and deposit services and to combat the practice of "redlining" certain communities. Under the Act, federal banking regulators evaluate the record of each insured depository institution on its performance in helping to meet the credit needs of the community in which it operates, consistent with safe and sound banking practices. In particular, this includes assistance to low- and moderate-income (LMI) neighborhoods. The Office of the Thrift Supervision (OTS) is responsible for ensuring that the 1,000 or more thrift institutions that it regulates comply with CRA.

The objective of our audit was to determine whether the Performance Evaluation (PE) reports prepared by OTS examiners provide an accurate measure of CRA performance of thrift institutions, henceforth referred to as thrifts in this report. We focused on factors affecting the CRA ratings mainly for large thrifts.

We conducted our fieldwork at OTS headquarters in Washington, D.C. and three OTS regional offices. At the regional offices, we reviewed a total judgmental sample of 41 CRA examinations and PE's, supporting workpapers, and other CRA related documents. The sampled thrifts had assets ranging from $54 million to $70 billion. We interviewed responsible regional CRA officials and field examiners. In addition, we met with a small number of thrift managers and community groups to get their perspective on CRA.

A detailed description of the objectives, scope and methodology is presented in Appendix 1.

Results in Brief

We found that OTS generally is carrying out its responsibilities under the Act. Specifically, OTS is conducting CRA examinations to assess thrift performance in meeting the credit and deposit needs of communities, taking into account CRA ratings when reviewing certain applications, and ensuring that CRA PE reports are available to the general public.

However, during our audit, we found that certain aspects of the CRA examination process could be improved. It was not clear in PE reports whether examiners addressed all of the regulatory criteria to rate each CRA component when summarizing conclusions about performance. We were also unable to form an opinion as to whether current law or regulation provides sufficient sanctions when thrifts have less than Satisfactory CRA ratings because the regulation lacks the specific evaluative criteria needed to do so. Regulations require OTS to take into account a thrift's CRA record when acting on an application. The regulations, however, do not specify how a thrift's CRA performance is to be taken into account or weighed in the application process.

In terms of CRA ratings, we were unable to validate the appropriateness of the lending ratings for eight (20%) of the 41 sampled PE's because the PE's lacked sufficient performance context information to explain the examiners' rationale for the ratings. For the remaining 33 thrifts in our sample, the PE's provided adequate information to support the assigned ratings. We were also unable to validate the appropriateness of the investment component ratings for 17 (41%) of 41 thrifts and we found apparent rating inconsistencies among thrifts. Regulations do not provide the necessary evaluative guidance for the investment component and PE's did not always discuss performance context for investments. Without this information, we could not validate how the investment ratings were derived, determine their appropriateness, or reconcile apparent inconsistencies. We also found limited instances where the investments component may have been rated higher than warranted.

Additionally, we found two aspects of the CRA examination process warranting attention. First, some examiners could have been more proactive in assessing community credit needs. Eight of the 41 PE's did not mention examiners meeting with community groups. Yet, these contacts are a primary means of identifying community credit needs. Second, in 30 of the 41 PE's, examiners did not compare the thrift's lending data in relation to the demographic make-up (i.e. number of LMI families in an assessment area) of the community. We believe such comparisons could enhance the PE in describing whether thrifts are meeting the needs of the community.

Finally, we found that the OTS examination approach to non-traditional thrifts (thrifts with a primary office in one community, but delivering products through non-branch systems to a broader area) may not be clearly conveyed to or consistently applied by OTS examiners. We recognize that current regulations may not adequately address the operations of non-traditional thrifts, however the OTS examination procedures lack written specificity to ensure consistent application.

We make 10 recommendations in this report to better ensure that PE reports provide an accurate assessment of CRA performance. Four recommendations are aimed at OTS seeking deliberations with the Federal Financial Institutions Examination Council (FFIEC) to consider revising CRA regulations or establishing additional guidance. Three recommendations deal with the need for more information in the PE's as to how ratings are derived so that the rationale for assigned ratings is clearly conveyed and supported. Additional recommendations involve presenting lending data relative to assessment area demographics and requiring broader coverage of CRA in OTS' quality assurance reviews.

In response to our draft report, OTS concurred with our reported findings and recommendations and has committed to undertake various management actions. Under separate subsequent correspondence, OTS also advised us of other planned management actions for two of the recommendations. Where applicable, OTS committed to initiate corrective action within a specified time frame. In other instances, management action was either already ongoing or tied to the FFIEC's planned 2002 review of the CRA regulations. Also based on OTS' response to the draft report, several revisions of a technical nature were made to the final report as applicable. For the full text of OTS's response to the draft report, see Appendix 4.

Background

The Community Reinvestment Act of 1977[1] (CRA) is intended to encourage banks and thrifts to meet the credit needs of the communities that those institutions serve. Federal banking regulators are also required to periodically evaluate these institutions' CRA performance in meeting the community's credit, investment and financial service needs, consistent with safe and sound banking practices. CRA specifically includes the credit and financial service needs of LMI neighborhoods. To enforce CRA, banking regulators are to take into account an institution's CRA performance when an institution files an application requiring regulatory approval on such matters as branches, mergers, consolidations, etc.

OTS officials believe that CRA has led many thrifts to increase their lending and to expand financial services to all segments of society. However, there have been industry concerns about regulatory burdens and the difficulties of measuring CRA performance. These concerns led to revisions to CRA in 1995. The changes were developed jointly by the federal banking regulators in consultation with the banking industry and community organizations. The resulting CRA revisions aim at emphasizing the evaluation of an institution's performance, promoting evaluation consistency, and minimizing the regulatory burden in complying with CRA.

Under the CRA regulations, thrifts are to delineate one or more geographic assessment areas where they operate and within which examiners evaluate the thrift's CRA performance. The size and

[1] 12 U.S.C. 2901.

nature of assessment areas vary. For typical thrifts, an assessment area may encompass one or more census tracts within a city or the entire city. Large thrifts or those with remote branch offices may need to designate multiple assessment areas. For example, a thrift with interstate offices would need to delineate separate assessment areas in each state and city in which it operates. Examiners are not expected to evaluate a thrift's delineation of an assessment area, but rather, to see whether a delineated assessment area arbitrarily excludes LMI area(s).

CRA Examinations

OTS conducts CRA examinations as a part of a thrift's overall compliance examination, which covers other areas such as discriminatory lending and consumer affairs. CRA examinations are conducted every 6 to 60 months, depending on the thrift's size and its prior CRA performance. Large thrifts and those with poor CRA performance are examined more frequently than small thrifts and those with adequate CRA performance.[2]

In evaluating CRA performance, examiners use information from various sources, including the thrift's records and local community groups. Information from local community, civic, or government leaders help examiners better understand the community's credit and financial service needs, as well as public perceptions of how well local thrifts are responding to those needs. OTS examiners also use information submitted by thrifts as required under the Home Mortgage Disclosure Act (HMDA). This data serves as the basis for much of OTS' lending analysis. As of the beginning of our review period, thrifts with total assets of more than $28 million were required to submit HMDA data.

One important aspect of the 1995 CRA revisions was the establishment of different evaluation requirements for large and small institutions. For example, a large institution's CRA performance is evaluated on it's lending, community investment,

[2] Generally, a small institution is defined as having total assets of less than $250 million, and a large institution having total assets of $250 million or more.

and service to the community, whereas a small institution's performance is primarily based on lending.

The three CRA components are individually assessed and then assigned one of five possible ratings: Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, and Substantial Noncompliance. From those component ratings, examiners then assign a single composite CRA rating reflecting overall performance based on uniform guidance from the FFIEC. The four possible composite CRA ratings are Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance. The results of the CRA examination along with OTS' analysis and information obtained during the examination are finalized in a PE report.

During our review period, OTS was responsible for supervising over 1,100 thrifts. These thrifts received 1,244 examinations, including multiple examinations for some thrifts. Table 1 shows the distribution of CRA ratings OTS assigned in the 1,244 examinations, as well as a comparison to the other banking regulators.

Table 1
Distribution of CRA Performance Ratings
July 1997 through June 2000

Rating	OTS		Other Regulators	
	Exam Count	Percentage	Exam Count	Percentage
Outstanding	206	17%	1,657	19%
Satisfactory	985	79%	6,832	80%
Needs to Improve	45	3%	79	1%
Substantial Noncompliance	8	1%	14	0%
Total	1,244	100%	8,582	100%

Source: FFIEC and OIG analysis of CRA database

The other regulators include the Federal Deposit Insurance Corporation, the Federal Reserve, and the Office of Comptroller of the Currency.

Findings and Recommendations

Finding 1 OTS Generally Meeting the Basic Legislative CRA Requirements

We found that the basic CRA legislative supervisory requirements are being met. CRA basically requires federal banking regulators to:

- Assess an institution's record of meeting the credit and deposit needs of its community;
- Take such record into account in the evaluation of an application for a deposit facility by the institution; and
- Prepare and make public a report of the examiners' findings, conclusions and assigned ratings.

OTS CRA examination reports were generally conducted timely, covered the required areas using regulatory criteria, appeared to consider CRA performance when acting on applications, and were readily available to the public.

OTS CRA Examinations Timely and Followed Regulatory Criteria

Using OTS' Examination Data System (EDS), we found that all required CRA examinations had largely been completed in a timely manner. The EDS showed that 1,244 examinations were conducted during our three-year review period (July 1, 1997 – June 30, 2000). Of the 1,244 examinations, 138 were repeat examinations. Only 24 (0.019%) examinations were late. Of the 24, 11 were late by one month or less; nine were late by two to six months, and the remaining four were late by more than six months. We believe that the extent of late examinations were minimal and due to understandable complexities such as thrifts with multi-state branches.

Based on a review of 41 sampled thrifts, we also found that these CRA examinations were generally completed in accordance with the regulatory criteria for assessing each component as established under 12 C.F.R. §563e. Table 2 below shows those few areas that were not always covered in the PE.

Table 2 Summary of CRA Examination Coverage	
CRA Performance Component & Underlying Criteria	**Criteria Coverage Rate (%)**
Lending Component:	
Number and amount of loans in the thrift's assessment area	100%
Geographic distribution of loans	95%
Distribution of loans by borrower characteristics	95%
Number and amount of community development loans	83%
Thrift's use of innovative or flexible lending practices	80%
Investment Component:	
Dollar amount of qualified investments	97%
Innovativeness or complexity of qualified investments	50%
Responsiveness of qualified investments to credit and community development needs	97%
Degree to which qualified investments were not routinely provided by private investors	8%
Financial Service Component:	
Distribution of branches among various income geographies	94%
Thrift's record of opening and closing branches	92%
Availability and effectiveness of alternative delivery systems	94%
Range of services provided in various income geographies	92%
Extent to which thrift provides community development services	97%
Innovativeness/responsiveness of community development service	6%

Source: OIG Analysis of Sample Thrifts

As Table 2 shows, there were three areas that examiners addressed 50 percent or less of the time. The responsible OTS official reasoned that if an area did not have an impact on the rating, then it was not necessary for the PE to specifically show that it was considered or covered in the examination. Rather than commenting on the underlying areas, the official was more concerned that the rating(s) were supported.

We appreciate the desire to avoid apparent superfluous detail. However, the breadth of potential users of PE reports may not be equally versed on CRA. Accordingly, complete and full disclosure of the regulatory criteria underlying each rating component would better ensure a full understanding of how each rating had been derived. Noting component areas that were not applicable should not be a reporting burden given the limited number of areas per component.

Unclear How CRA Performance Taken Into Account in the Application Process

The only substantive enforcement sanction to CRA is that 12 C.F.R. §563e.29 requires OTS to take into account a thrift's CRA record prior to acting on an application submitted by the thrift. These applications cover a variety of different business activities such as changing or adding new lines of business, establishing or closing branches, and mergers.

The regulation, however, does not specify how a thrift's CRA performance is to be taken into account or weighed in the application process. As a result, OTS exercises considerable subjective judgment when considering CRA performance in either approving or denying an application. OTS officials, industry representatives and community groups we met held a common belief that the CRA record could impact the ultimate decision.

Between January 1997 and December 2000, OTS processed about 4,300 applications. Of these, 24 applications were submitted by thrifts with a less than Satisfactory CRA rating. Of the 24, OTS approved 21 applications. Three were withdrawn by the thrifts, thus eliminating the need for a regulatory action. Of the 21, four were approved because they were of a type that OTS automatically approves, such as changing to a state charter. Given the lack of specific regulatory criteria, we could not assess the merits of 17 application approvals. We could not draw any conclusions or opinions as to whether current law or regulation provides sufficient sanctions when thrifts have less than satisfactory CRA ratings. Given the lack of evaluative criteria, we could not assess whether OTS appropriately considered the less than Satisfactory CRA ratings in the application process.

OTS Ensuring PE's Are Publicly Available

12 C.F.R. §563e.43 requires thrifts to make copies of their most recent CRA evaluation available to the public. Each of the thrifts we visited had a copy of their PE available to the public. Also, several community group representatives we spoke to confirmed that PE's were available to them when needed. In addition, we readily obtained copies of the PE's for the 41 thrifts in our sample from OTS' website.

Recommendations

1. Given the wide breadth of potential users of PE reports, the OTS needs to better ensure complete and full disclosure as to how examiners evaluated each component area in arriving at the component ratings.

   ### OTS Management Comment

   OTS did not agree that the reported omissions in Table 2 were needed to fully understand how the component ratings were derived. Nevertheless, OTS stated they would raise this issue with the FFIEC committee conducting the 2002 review of the CRA regulations.

   ### OIG Comments

   We believe that OTS' proposed management action is responsive to the intent of the recommendation given the broad potential applicability for more uniform reporting by all affected institutions. In response to OTS' view as to the necessity of complete disclosure, we have made several revisions from a technical perspective as applicable. However, we continue to believe that full and complete disclosure, as to how examiners derived a component rating relative to the regulatory criteria, would be less prone to improper impressions by users of PE's than the absence of such discussion. The latter would be more prone to speculation given the omission of information.

2. Given the lack of regulatory specificity, OTS should 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.

OTS Management Comment

OTS raised several legislative history issues suggesting that the original intent of CRA did not include establishing a minimum level of performance that might be used in acting on applications. Nevertheless, OTS stated they would raise this issue with the FFIEC committee conducting the 2002 review of the CRA regulations.

OIG Comments

We believe that OTS' proposed management action is responsive to the intent of the recommendation, given the potentially broad applicability affecting the other regulatory agencies enforcing CRA.

Although OTS' observations as to the original legislative intent of CRA is important to understand, the issue of whether effective sanctions exist to address poor CRA performance likely arose after the authorizing legislation. In fact, criticism of regulators for denying few applications on the basis of CRA performance was previously reported by the U.S. General Accounting Office (GAO) (*Community Reinvestment Act Challenges Remain to Successfully Implement CRA*, GAO/GGD-96-23, November 1995).

The GAO pointed out inconsistencies across regulators as to how applications were being approved relative to CRA performance. Some regulators approved applications with commitments, which explicitly tied an application's approval to tangible improvement in CRA performance. Another regulatory practice was the use of conditional approvals of applications. Similar to commitments, conditional approvals required an institution to meet certain CRA conditions before the institution could consummate the applied transaction. GAO showed that

OTS seldom denied applications and, compared to the other regulators, seldom used conditional approvals. We believe that further regulatory guidance as to how CRA performance could be considered in the application process will lessen these inconsistencies and more closely approach addressing the lingering issue of CRA sanctions.

3. In the interim, OTS should 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. Alternatively, OTS should consider covering this specific aspect of the application process through periodic internal quality reviews.

OTS Management Comment

OTS currently covers the role of CRA in the application process in their internal reviews. However, to enhance the application process and these reviews, OTS will prepare written guidance by April 2002 on how CRA performance should be considered when deciding covered applications.

OIG Comment

We believe OTS' planned management action addresses recommendation 3, if properly implemented. The additional written guidance should also better ensure consistency in the application process.

Finding 2 Unsupported or Questionable CRA Ratings

In reviewing the 41 sampled CRA examinations, we could not validate lending component ratings for eight thrifts, found apparent inconsistencies with some investment ratings, and believe that some thrifts' investment components may have been rated higher than warranted. These questionable ratings could be attributed to different causes. PE reports lacked sufficient information beyond a summarization of lending activity so that the ratings could be understood within the context of the thrifts' local lending conditions (i.e. performance context lacking). Examiners lacked sufficient criteria to evaluate investments activity; current examination practices allow broad interpretative discretion.

Performance Context Lacking

In evaluating CRA performance, examiners are not to rely solely on the level of lending alone, but also take into account information about the thrift, its competitors, community and peers. Specifically referred to in the regulations as "performance context," the examiner evaluates CRA performance in the context of the thrift's demographic characteristics within its assessment area, the thrift's known lending, investment and service opportunities, and the thrift's business products and strategies. In so doing, the examiner is to assess CRA performance in the context of the thrift's operating conditions, which the regulations recognize can vary across different thrifts.

We found that for 33 (80%) of the 41 sampled PE reports, examiners provided sufficient performance context, which provided clear support for ratings. It should be noted that in these cases the ratings were easily supported, given that the thrifts typically had high levels of lending. The rationale for the ratings was also evident from the performance context.

The other eight (20%) PE reports lacked sufficient performance context information. Consequently, we were unable to determine or validate how the examiner arrived at the CRA component ratings. Moreover, some of the statistical summary information gathered and reported without performance context surfaced some apparently inconsistent ratings across some thrifts.

For example, one of the sampled thrift's lending was rated "Low Satisfactory," indicating an adequate performance, even though its lending data was lower than its peers. The only performance context discussed in the PE was that the thrift's..."loan distribution ratios within LMI geographies are significantly lower than the aggregate HMDA loan lenders in 1998," thus raising further question as to the Low Satisfactory rating.

Table 3 below further illustrates how summary data alone does not provide sufficient support as to how a rating was derived. Instead, the lending component ratings seemed inconsistent given the lending information presented in the PE reports.

Table 3 Similar Ratings For Varying Lending Activity				
	Thrift:			
Lending Activity	**1**	**2**	**3**	**4**
Asset Size ($ in millions)	$541	$495	$848	$901
HMDA Lending ($ in millions) (% of Assets)	$348 (64%)	$151 (30%)	$205 (24%)	$169 (19%)
Comparison to Peers Based on Borrower Characteristics	Higher	Lower	Lower	Lower
Comparison to Peers Based on Geographical Area	Lower	Lower	Lower	Higher
Did PE Report Discuss Innovative Lending?	Yes	Yes	Yes	Yes
Community Development Lending ($ in thousands) (% of Asset Size)	$259 (0.0005%)	$6,200 (0.013%)	- 0 -	$933 (0.001%)
CRA Lending Rating	Low Sat.	Low Sat.	High Sat.	High Sat.

Source: OTS PE Reports

Without performance context information, the summary data alone raises apparent inconsistencies in the ratings, and inevitably their validity. For example, thrifts 1 and 2 were of similar size and both received a "Low Satisfactory" CRA rating for the lending component. Yet, other than similar peer group lending based on geographical area, the other lending component areas were ostensibly quite different. For example, the lending volume varied by as much as 34% as a percent of total assets. Thrifts 3 and 4 also raised similar questions given the lack of performance context information in the PE report.

When asked about these cases, OTS officials admitted that in some cases examiners could have done a better job of explaining their ratings. However, they felt the PE's generally provided the necessary information to justify the ratings, including all necessary data required by the regulation. Although they believed the 8 ratings in question were correct, they did not provide further explanation as to how the ratings were specifically derived in light of the accompanying lending information and absence of performance context information. Consequently, we were not able to independently validate the assigned ratings.

Inconsistent CRA Investments Ratings

As with the lending component, we were unable to validate the basis or appropriateness of the CRA Investments component ratings for 17 (41%) of 41 thrifts. There were also some apparent rating inconsistencies across several thrifts based on the actual level of investments. We also found limited instances where the investment rating appeared higher than warranted, despite the regulatory flexibility afforded thrifts with statutory investment limitations.

To evaluate the investment component, examiners use the following regulatory criteria: (a) dollar amount of qualified investments, (b) innovativeness or complexity of the investments, (c) responsiveness of investment to credit and community development needs, and (d) degree to which the investments are not routinely provided by private investors.[3] Noticeably absent from the regulations are guidance for examiners to evaluate all the information gathered for the aforementioned criteria to arrive at a specific rating. Consequently, examiners have a lot of leeway to exercise subjective judgment in arriving at the rating. But without criteria and the absence of performance context information, we could not validate how investment ratings were derived, or their appropriateness, nor could we reconcile apparent inconsistencies.

[3] 12 C.F.R. 563e §23.

Table 4 below illustrates that similar investment component ratings were given even though the level of investments varied widely.

Table 4 Similar Investments Ratings for Varying Investment Activity			
Investments Activity	**Thrift 1**	**Thrift 2**	**Thrift 3**
Asset Size ($ in millions)	$535	$526	$161
Investments ($ in thousands) (% of Assets)	$562 (0.001%)	$27 (0.0001%)	$385 (0.002%)
Investment Rating	Low Satisfactory	Low Satisfactory	Low Satisfactory

Source: CRA PE Reports

As the table shows, thrifts 1 and 2 were of similar size and both received a rating of Low Satisfactory. Yet their level of investments was significantly different, both in absolute and relative terms. Thrift 1 investments were over 20 times greater than thrift 2. Investments made by thrift 3 raise further questions as to the rating consistency. In absolute terms, thrift 3 investments were 15 times greater than thrift 2. The difference in investments is even greater in relative terms with thrift 3 assets being smaller than thrift 2 assets by over two thirds.

We could not validate the basis or appropriateness of the investment ratings, given the absence of regulatory guidance as to what level of investment qualifies for a specific rating. Nor could we reconcile these apparent rating inconsistencies, given the absence of performance context information in the PE reports. Peer comparisons were not done because, unlike the lending component, examiners are not required to compare investments based on thrifts' peers.

These rating validation difficulties were also echoed by thrifts we visited. For example, one thrift manager asked an OTS examiner what dollar amount of investment was needed to receive an “Outstanding” rating. However, the OTS examiner could not provide a specific answer. Another CRA officer, whose thrift received an "Outstanding" CRA rating, told us that the investment criterion was too vague and subjective. From reviewing other thrifts' PE reports, the officer felt that the vague and subjective criterion might have contributed to "Inflated" ratings.

OTS officials also acknowledge that the investment test is the most difficult to evaluate due to the lack of specific standards. On the other hand, officials also noted that it might be impractical to establish quantitative standards because of the different circumstances under which thrifts operate. For example, business strategies or availability of funds may limit investment levels. The officials believe that these same factors could limit the value of peer comparisons.

Thrifts Have Statutory Investment Limitations

Thrifts have limited statutory investment authority compared to banks, thus making it difficult to reasonably evaluate thrifts investments performance. The 1995 CRA revisions recognized this limitation and a modification was made to permit thrifts with limited investment authority to receive a "Low Satisfactory" rating even if they had few or no qualified investments. However in these situations, thrifts must have a strong record of lending and community development loans. The modification is not intended to be a blanket exemption from the investments test.

Of the 41 sampled thrifts, the investment component ratings for 13 were based on lending activity. Most of the 13 had minimal or no investments. However, we believe that 3 of the 13 thrifts did not warrant their investment rating, given their lending and community development record.

Table 5 below profiles the 13 thrifts with investments ratings based on lending activity.

Table 5					
Lending Profile of 13 Thrifts Receiving Investment Ratings Based on Lending Activity (Dollars in thousands)					
Inst	**Investments**	**Lending Rating**	**Community Development Lending**	**Met Strong Lending Criteria**	**Met Community Development Criteria**
1	$3,290	Outstanding	$10,300	Yes	Yes
2	$0	Outstanding	$1,600	Yes	Yes
3	**Not given**	**High Sat.**	**$7,300**	**Yes**	**Yes**
4	$367	High Sat.	$1,500	Yes	Yes
5	$40	High Sat.	$398	Yes	Yes
6	$24	Low Sat.	$1,000	Yes	Yes
7	$0	High Sat.	$2,800	Yes	Yes
8	$75	Low Sat.	$10,400	No	Yes
9	$30	Low Sat.	$6,200	No	Yes
10	$16	Low Sat.	$450	No	Yes
11	$13	Low Sat.	$259	No	Yes
12	**$3**	**Low Sat.**	**$0**	**No**	**No**
13	**$1**	**Low Sat.**	**$0**	**No**	**No**

Source: OIG Analysis of sampled PE reports

The PE report for thrift 3 noted that the investments rating was largely based on strong lending activity. However, rather than a Low Satisfactory rating, examiners assigned High Satisfactory, apparently based on strong lending and minimal investments. We were unable to determine how much, if any, actual investments had been made during the rating period. We believe there is no regulatory basis for deriving an investments rating in this manner, particularly in the absence of discernable investments.

Thrifts 12 and 13 had neither strong lending nor strong community development lending to merit the Low Satisfactory investment rating. We used 12 C.F.R. §563e as criterion for lending activities. The regulation describes Low Satisfactory as “adequate” CRA performance. By contrast, Outstanding and High Satisfactory are defined as “excellent” and “good,” respectively. The regulations require that lending be strong or particularly effective to base the investments rating on lending activity. Accordingly, we believe "strong and particularly effective lending," is more consistent with Outstanding or High Satisfactory ratings rather than a Low Satisfactory rating.

We asked OTS how Low Satisfactory lending performance met the regulation's strong lending requirement. OTS officials said they equated a Low Satisfactory rating as meaning strong and particularly effective lending. We believe that this interpretation is not consistent with regulation. We still question whether the Low Satisfactory investment ratings assigned to these 2 thrifts were warranted in light of the Low Satisfactory lending ratings and absence of any community development lending.

Recommendations

4. To better ensure that PE reports provide sufficient explanation in support of how a rating was derived, OTS needs to ensure that performance context information is appropriately incorporated into the PE report. Consideration should be given to updating the General Report Guidelines, section 125, to include both additional guidance and minimal content on performance context. This would also include requiring additional narrative on how aggregate data presented in the PE report was assessed in arriving at a rating in relation to the performance context.

OTS Management Comment

OTS concurred and stated they were testing a standard set of core tables developed by the FFIEC CRA Subcommittee. The tables are to be included in every PE for every agency. In these tables, OTS will present data on lending, investment and service tests as well as demographic information for each thrift and each metropolitan area in which it has branches. OTS believes the tables will provide guidance and minimal content regarding baseline information to be uniformly presented in all PE's.

OIG Comments

We believe OTS' planned management action will address the intent of recommendation 4 if properly implemented. We should also clarify the intent of the recommendation, given OTS' response to the draft report. We agree that inclusion of performance context should not be a stand-alone item, as OTS points out. Instead, the recommendation is intended to point out that greater OTS attention to effectively discussing performance context relative to each rated component will lessen the ambiguity as to how a rating was derived. In so doing, PE's should provide additional clarity to users, such as the thrifts we visited who raised questions as to the basis for the investments component ratings.

5. To lessen the subjectivity of the investment test, OTS should seek through the FFIEC interagency deliberations to establish more objective regulatory criteria as to how investments are to be assessed.

OTS Management Comment

OTS concurred and reiterated that regulations lack guidance for examiners to evaluate the information gathered for the investment test criteria, in order to arrive at a specific rating. OTS stated that the investment test issue will be evaluated in the 2002 review of the CRA regulation.

OIG Comments

We believe OTS' planned management action through the 2002 interagency review of CRA regulations will address the intent of recommendation 5.

6. Given the inconsistent lending and investment ratings observed from the sampled thrifts, OTS should provide for quality assurance reviews of CRA examinations to include a broader analysis comparing inter and intra-regional examinations and PE reports for consistency.

OTS Management Comment

OTS concurred and stated that during our CRA review, they had already expanded their quality assurance reviews to include PE's for fiscal year 2000. In a separate correspondence, OTS also noted that Compliance Policy will review a representative sample of CRA PE's for consistency in the implementation of any regulatory or interagency examination guidance changes arising from the 2002 CRA review process.

OIG Comments

We believe that OTS' ongoing expanded quality assurance reviews adequately address recommendation 6, and that planned management actions with respect to any subsequent FFIEC guidance from the 2002 interagency review of CRA regulations also address the intent of the recommendation.

7. OTS should also seek through the FFIEC interagency deliberations to establish objective criteria and or clarification as to what constitutes strong lending and community development lending when these activities are used in support of a Low Satisfactory investment rating for thrifts with little or no qualifying investments. In the interim, OTS needs to establish internal guidelines clarifying the process to better ensure consistent treatment by examiners.

OTS Management Comment

OTS concurred and plans to establish internal guidelines to clarify the issue for examiners by April 1, 2002. OTS also noted that issues concerning the investment test and the difficulties in measuring performance are on the agenda for the 2002 interagency CRA review.

OIG Comment

We believe OTS' planned corrective actions adequately address recommendation 7, if properly implemented.

Finding 3 Examiner Assessment of Community Credit Needs Could Be Enhanced

A telling perspective of a thrift's CRA lending performance is in the context of its community credit needs. OTS could enhance examiner assessments of community credit needs, and the reporting of it in the PE, by better ensuring examiners contact community groups, reporting the results of those contacts, and by describing thrift lending in relation to community demographics.

Identifying Community Needs Through Community Contacts

OTS examination guidelines note that community contacts are an integral part of the CRA examination planning process. The guidelines state that community contacts enable examiners to better understand public perceptions as to how well local thrifts are responding to the credit needs of the community. Such contacts include community groups, and other leaders of the community within the assessment area. The results of these community contacts are to be included in the PE report.

Of the 41 PE reports sampled, eight lacked documentation or discussion that examiners contacted community groups to assess the thrift's community credit needs. The remaining 33 PE reports mentioned that the examiner made community contacts. However, in 12 of the 33 cases, the PE simply mentioned that OTS examiners had made the contacts, but did not describe the nature or results of the community contacts.

OTS officials acknowledged that community group contacts were vital and should be made anytime they performed a CRA examination. They believed that community contacts were actually made in those eight examinations cited but not reported because examiners felt that such discussions would not add value to the report. They felt the concerns and issues faced by the community were well known within the community, and therefore, it was not necessary to discuss them in the PE's.

We did not attempt to validate the issues and concerns within these eight communities. Nevertheless, we believe that full and complete disclosure of community contacts in the PE report would better ensure that users of PE reports understand community needs, and would provide an added perspective of the thrift's lending performance. Community members would also be assured that their views were accurately portrayed, and that examiners considered their views in assessing performance.

Presenting Thrift Lending In Relation to Area Demographics

OTS guidance only requires PE's to compare thrift lending to the lending performance of peers. The guidance does not require PE's to compare thrift lending to area demographics. However, lending performance relative to peers alone may not sufficiently reflect whether a thrift's lending practices are meeting community needs.

In 38 of the 41 cases in our sample, examiners compared the thrift's lending data to its peers, as required by guidance. In 11 of 41, examiners also compared aggregate lending data to the demographic make-up of the community. In so doing, the PE reports clearly indicated whether the thrifts were meeting the credit needs of the community.

For the 30 cases without demographic comparison, the basis or appropriateness of a rating could be unclear and unconvincing. For example, one thrift's lending performance was rated outstanding with just over three percent of its loans to low-income families. This level of performance was deemed outstanding because it was comparable to the peers' percentage of lending to low-income families. Although comparable to peers, the thrift's lending to low-income families was relatively small when viewed with the 20 percent composition of families in the low-income level for its assessment area. Given this apparent gap, it is unclear whether the thrift was effectively meeting the credit needs of this income group.

OTS officials indicated that the intent of CRA was not for thrifts to completely meet the needs of the LMI families within the assessment area. Just because 20 percent of the families are low-income does not mean that 20 percent of a thrift's loans should be to LMI families. However, we believe that unless the PE report discloses demographic information for context, PE report users may erroneously conclude that the credit needs of all relevant income groups are being met, particularly when those credit needs are not discussed.

Recommendations

8. The OTS should 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.

   OTS Management Comment

   OTS concurred and stated that they have been working since 1998 on an interagency community contact database to improve the process of gathering, sharing and utilizing community contact information. OTS stated that the project will continue and that in the meantime, OTS will continue to emphasize and demonstrate the importance of community contacts with examiners at every opportunity.

   OIG Comments

   We believe that OTS' cited management action adequately addresses recommendation 8. We also believe that the expanded quality assurance reviews noted previously above could also serve as an added internal control to better ensure that the nature of community group contacts are adequately discussed in the PE's.

9. The OTS should 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. Consideration needs to be given to more effectively describing area demographics without implying a required lending distribution.

Management Comments

OTS indicated that the planned management actions to recommendation 4, in terms of making demographic data a part of the interagency core tables, would also address recommendation 9. OTS also committed to reviewing interagency instructions on what demographic information should be considered in evaluating CRA performance as a part of the 2002 interagency CRA review.

OIG Comment

We believe that both of OTS' planned management actions address the intent of recommendation 9. However, a part of OTS' response to this recommendation reflected a misunderstanding of the recommendation. We did not intend that all PE's include a comparison of lending levels to the population of LMI individuals. To the contrary, the recommendation was intended to afford OTS flexibility by recommending they assess the value of such comparisons so as to enhance the performance context of a PE. As we discussed on pages 24 and 25 of the report, there were ambiguities as to how a thrift was meeting the credit needs when viewed in the context of only a peer comparison despite the availability of LMI demographic information. And in those instances when OTS included such a discussion, the PE's more clearly explained how the thrift was meeting a community's credit needs.

Finding 4 Clear Guidance Needed for Non-traditional Thrifts

The proliferation of non-traditional thrifts has raised the question of how to properly evaluate their CRA performance, given their non-traditional organizational structure, delivery platforms, and channels. Non-traditional thrifts are generally defined as those thrifts that have their primary office in one local community but conduct their business in a broader, regional, or national area. They may not even have typical branch offices. For example, some insurance companies are granted thrift charters and conduct business through a network of agents. OTS personnel note a dramatic growth of thrifts delivering their products through non-branch systems on a national or regional basis.

The regulation (12 C.F.R. § 563e.41) provides for assessing a thrift's CRA performance in the local community where the thrift is chartered. The regulation specifically states that the thrift's assessment area will be in those areas where a thrift has deposit-taking branches. Additionally, the regulation explicitly provides that the agencies will use the assessment area delineated by the thrift in evaluating the thrift's performance. Further, the FFIEC issued Interagency Questions and Answers on October 21, 1996 providing additional guidance on when to consider loans made outside of an institution's assessment area. The guidance states that favorable consideration will be given for loans to LMI persons outside of an institution's assessment area provided the institution has adequately addressed the needs of borrowers within its assessment area.

For non-traditional thrifts, OTS does not limit its CRA evaluation to the regulatory defined assessment areas as designated by the thrift. Instead, the agency evaluates performance based on the broader areas where the thrift does business, provided that the thrift is adequately serving the needs of its designated assessment area. OTS believes that it is more realistic to measure CRA performance throughout the markets where the thrift does business, rather than just within the designated assessment area. Agency officials stated that this broader view of the service area better ensures that thrifts are meeting their CRA obligations to the communities they truly serve.

OTS used this approach to evaluate three of six non-traditional thrifts in our sample of 41. According to agency officials, the OTS was the first of the four banking regulatory agencies to deal with the issue of non-traditional institutions. Further, the OTS supervises a larger number of non-traditional institutions than the other regulators and out of necessity was proactive in developing an examination approach. OTS believes their approach follows existing regulation and guidance, is more focused, and makes active use of available options.

OTS demonstrated their approach toward non-traditional thrifts for the first time in a 1998 PE report of a nationwide lender. According to the PE report, all products and services were delivered through non-branch means. Examiners first determined the adequacy of CRA lending activity within their designated assessment area. Examiners concluded performance was adequate, given its performance context, then considered lending activity in the other areas reached by the thrift's operations. The PE report shows that, based on the thrift's good lending record to LMI areas outside their designated assessment area, OTS gave additional favorable consideration to the CRA lending component. On the other hand, an OTS official stated that OTS would not give unfavorable consideration for poor lending in LMI areas outside the designated assessment area.

We found that the OTS approach to non-traditional thrifts, as illustrated in the 1998 PE report, may not be clearly conveyed to, or consistently applied by OTS examiners. Out of six non-traditional thrifts in our sample, three evaluations involved further consideration of lending activity outside of the designated assessment area, while the other three did not. However, the PE reports did not indicate why different approaches were used. Three of the thrifts received High Satisfactory CRA ratings in the lending component, two received Low Satisfactory, and the one small institution received an overall rating of Satisfactory, as is the general standard with small thrifts.

We recognize that current regulation does not clearly address the unique operating conditions of non-traditional institutions. Nevertheless, OTS' supervisory examination procedures lack written specificity to ensure consistent application by examiners when assessing non-traditional thrifts.

<u>Recommendation</u>

10. The OTS should provide examiners with further guidance to ensure greater consistency in applying the agency's approach to non-traditional thrifts.

Management Comments

OCC concurred and pointed out that the assessment area issues raised by non-traditional institutions had already been raised by the FFIEC as a part of the 2002 CRA review. In the interim, OTS plans to issue a Compliance Alert to their examiners on the evaluation of non-traditional institutions before December 31, 2001. It is hoped that this will also supplement prior training provided over the last two years on this aspect of CRA examinations.

OIG Comment

We believe that OTS' planned management action adequately addresses recommendation 10.

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We would like to extend our appreciation to OTS for the cooperation and courtesies extended to our staff during the review. If you have any questions, please contact me at (415) 977-8810, extension 222. Major contributors to the report are listed in Appendix 4.

/S/
Benny W. Lee
Regional Inspector General for Audit

The objective of our audit was to determine whether OTS PE reports provide an accurate measure of thrift CRA performance. More specifically, we focused on factors affecting the CRA ratings of large thrifts. We also sought to determine whether OTS examiners were complying with CRA implementation regulations and OTS examination guidelines. This is the second in a series of OIG audits of regulatory agencies conducting CRA examinations. Previously, we conducted a 1998 review of OCC's implementation of new CRA performance standards for small banks.[4] Due professional care requires us to follow-up on known findings and recommendations from previous audits that could have an effect on current audit objectives, and to determine whether agency officials have taken prompt and appropriate corrective actions.

To achieve this objective, we judgmentally selected a sample of 41 thrifts and reviewed the CRA examinations conducted between July 1, 1997 and June 30, 2000. The thrifts in our sample were selected from three of the five OTS regions: Northeast, West, and Central. We chose 34 large thrifts (asset size $250 million or more), including the two largest thrifts in each region. In addition, we chose 7 small thrifts (asset size less than $250 million). The 41 thrifts are detailed in Appendix 2.

For each thrift sampled, we reviewed the most current PE. We also reviewed supporting examination work papers for 6 thrifts (2 in each region) in order to validate data contained in the PE's. Additionally, we validated selected data in the PE reports for 10 other thrifts by comparing the PE data with data retrieved from the CRA Wiz reporting system.

For questions that could not be resolved directly by reading the PE report or the supporting workpapers, we sought explanations from responsible OTS regional examination staff and managers. To understand some of the national CRA issues and the OTS examination policy, we interviewed OTS headquarters officials, as well as regional Compliance and CRA officers.

[4] *The Office of the Comptroller of the Currency Needs to Improve its Implementation of the Community Reinvestment Act Small Bank Performance Standards*, OIG-98-091, May 28, 1998.

In order to gain further understanding of the CRA program, examination issues, and individual perspectives on these issues, we spoke with representatives of five thrifts and seven community groups in the OTS regions we visited.

We conducted our audit between June 20, 2000 and June 25, 2001 in accordance with generally accepted government auditing standards.

Appendix 2
Thrifts Sampled for OIG Review

Thrift	Asset Size ($ in millions)	Date of PE Report	CRA Ratings			
			Overall	Lending	Invest	Service
1	$ 535	03/07/00	Sat	Low Sat	Low Sat	High Sat
2	25,000	10/13/99	Sat	High Sat	High Sat	High Sat
3	22,600	11/15/99	Out	Out	Out	Out
4	848	08/30/99	Sat	High Sat	Low Sat	Low Sat
5	773	01/19/99	Needs	Needs	Needs	Needs
6	2,400	04/26/99	Sat	High Sat	Low Sat	High Sat
7	479	09/20/99	Sat	High Sat	Low Sat	Low Sat
8	526	04/05/99	Sat	Low Sat	Low Sat	Low Sat
9	719	11/01/99	Sat	Low Sat	Low Sat	Low Sat
10	2,300	06/21/99	Sat	High Sat	Out	Low Sat
11	628	01/26/98	Sat	Out	Low Sat	High Sat
12	426	04/19/99	Sat	High Sat	Low Sat	Low Sat
13	398	03/13/00	Sat	Out	Low Sat	High Sat
14	63	02/07/00	Subst.	n/a	n/a	n/a
15	210	11/16/98	Needs	n/a	n/a	n/a
16	443	03/22/99	Sat	High Sat	Low Sat	High Sat
17	405	01/25/99	Sat	Low Sat	Low Sat	High Sat
18	901	01/25/99	Sat	High Sat	Low Sat	Low Sat
19	415	12/14/98	Sat	n/a	n/a	n/a
20	672	06/21/99	Sat	Low Sat	High Sat	High Sat
21	495	03/22/99	Sat	Low Sat	Low Sat	High Sat
22	32,081	07/20/98	Out	Out	Out	Out
23	70,000	07/28/98	Out	Out	Low Sat	Out
24	639	09/14/98	Sat	n/a	n/a	n/a
25	54	05/17/99	Needs	n/a	n/a	n/a
26	56	12/20/99	Sat	n/a	n/a	n/a
27	87	12/15/99	Sat	n/a	n/a	n/a
28	1,300	05/17/99	Sat	High Sat	High Sat	Out
29	541	01/25/99	Sat	Low Sat	Low Sat	Low Sat
30	142	01/10/00	Needs	n/a	n/a	n/a
31	1,580	01/10/00	Sat	Low Sat	Low Sat	High Sat
32	1,020	04/20/98	Sat	Low Sat	Low Sat	High Sat
33	161	03/20/00	Sat	Low Sat	Low Sat	Low Sat
34	353	09/21/98	Sat	High Sat	Low Sat	Low Sat
35	784	11/03/97	Sat	Low Sat	Low Sat	High Sat
36	19,900	04/06/98	Sat	High Sat	High Sat	High Sat
37	16,500	05/18/98	Out	Out	High Sat	High Sat
38	309	03/20/00	Sat	Low Sat	Low Sat	High Sat
39	473	01/04/00	Sat	Out	Low Sat	Low
40	1,000	09/29/97	Sat	Low Sat	Low Sat	Low Sat
41	1,700	12/06/99	Sat	High Sat	Low Sat	High Sat

Legend: Out - Outstanding, Sat - Satisfactory, Needs - Needs to Improve,
Subst - Substantial Noncompliance, n/a - not applicable
Source: OTS PE Reports

Office of Thrift Supervision
Department of the Treasury

Ellen Seidman
Director

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November 28, 2001

Mr. Benny W. Lee
Regional Inspector General for Audit
U.S. Department of Treasury
Inspector General
Suite 275
333 Market Street
San Francisco, CA 94105

Re: Response to Draft Audit Report on the Office of Thrift Supervision's Community Reinvestment Act (CRA) Performance Evaluations dated November 2, 2001

Dear Mr. Lee:

Thank you for the opportunity to comment on the draft report regarding OTS's implementation of the interagency CRA regulations. We have reviewed the report and offer several specific comments, which are presented in the order of the report's findings and recommendations.

We believe that the report reflects the Inspector General's appreciation of the complexities of the regulation itself and the fact that OTS is only one of four Federal financial regulatory agencies responsible for implementing the CRA regulations and must, therefore, work in cooperation with the other agencies to resolve those complexities. Many of the issues dealing with the shortcomings in the regulation and/or interagency examiner guidance will be useful as the agencies proceed with the 2002 review of the CRA regulations that we committed to conduct when the revised CRA regulations were published in 1995. Many of the issues set forth in your report have been of concern to the OTS and other Federal banking agencies for some time. We have attempted to address some of them in the context of the Interagency Questions and Answers (Qs and As) regarding the CRA, which are updated periodically. The Qs and As are published in the Federal Register as staff guidance for examiners, institutions, and other community reinvestment practitioners.

Our responses make reference, where appropriate, to the interagency guidance that has been developed to respond to some of the difficult issues the regulation presents. OTS and other Federal banking agencies have made significant strides toward a clearer, more consistent, and more performance-oriented regulation since 1995. In addition to the interagency Q and A guidance, OTS has sponsored and/or participated in many training and development initiatives both regionally and nationally to improve the overall quality and consistency of the examination process. We use CRA Wiz software for more efficient and complete analysis of an institution's CRA performance in the context of demographic data and peer comparisons. We also conduct quality assurance audits and reviews of CRA Public Evaluations at the regional level on an ongoing basis with periodic reviews at the national level. These efforts continue to ensure the highest quality examinations possible. We offer these examples in the hope that OTS's commitment to the CRA examination process will be better understood and appreciated by the users of your report.

Finding 1 – OTS Generally Meeting the Basic Legislative CRA Requirements

This finding represents a significant accomplishment and demonstrates that OTS has succeeded in effectively implementing the new CRA regulation. Given that the period covered by this finding is three years in duration and starts with the beginning of the application of the large institution test on July 1, 1997, the achievement of consistency and thoroughness reflected in the public evaluations described by this finding is outstanding. All recommendations that follow should be read in the context of this favorable finding.

- Given the wide breadth of potential users of PE reports, the OTS needs to better ensure complete and full disclosure as to how examiners evaluated each component area in arriving at the component ratings.

This recommendation addresses the fact that three of the qualitative factors listed in the large institution test (innovation/complexity and non-routine nature in investment test, and innovation/responsiveness in the service test) were not routinely remarked on in the public evaluations. None of these factors is an aspect of performance required under the regulation. Each factor is considered an enhancement of performance that an institution may bring to an examiner's attention to receive additional favorable credit. The actual users of PE reports are familiar with the regulation. In implementing the regulation, OTS and

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the other Federal banking agencies have chosen to recognize time and resource constraints by instructing examiners not to make boilerplate comments about aspects of the performance criteria that are not relevant to the institution's performance rating. When an institution has not made innovative or complex investments, not invested in activities not routinely provided by private investors or not engaged in innovative or particularly responsive community development services, no enhancement of the quantitative activity is granted. However, no discounting of that activity takes place either. It would create an improper impression of adverse impact if this lack of activity were recited in the public evaluation.

Nevertheless, we agree to forward this recommendation to the interagency committee conducting the 2002 review of the CRA regulation and its implementation.

- Given the lack of regulatory specificity, OTS should seek, through the FFIEC interagency deliberations, further regulatory guidance as to how an institution's CRA performance is to be considered and weighed in the application process.

OTS notes that the CRA statutory requirement is limited to considering CRA performance as information within each agency's independent authority and standards for approving applications for depository institutions. The regulation is restricted to the scope of authority in the Act. As Senator Proxmire described this provision in the original legislation, "The requirements in the bill apply only to applications otherwise required under existing law or regulations and do not provide any new authority to the bank regulatory agencies. The bill states that in carrying out their existing authority to approve applications..., the regulatory agencies shall give due consideration to the applicant's record in meeting community credit and its willingness to do so in the future." (Emphasis added.) Accordingly, there is no standard of minimum performance established in the CRA and, moreover, there was no intent to create one.

Nevertheless, we agree to forward this recommendation to the interagency committee conducting the 2002 review of the CRA regulation and its implementation.

- In the interim, OTS should 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. Alternatively, OTS should consider covering

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this specific aspect of the application process through periodic internal quality review.

OTS takes CRA performance into consideration appropriately in applying the criteria mandated by the Home Owners Loan Act for approval of applications. We do not believe the report supports a conclusion to the contrary. As the report notes, only a fraction of one percent of applications involve applicants with less than a Satisfactory CRA rating. For the more than 99% of applications from applicants whose past performance is satisfactory or better, the CRA rating is consistently made a part of the record. For the remaining applications, the proposed undertaking is considered to determine whether it will enhance CRA performance, or whether it is necessary for safety and soundness reasons despite any impact on CRA performance.

The application process is subject to a review of internal controls on an annual basis through the FMFIA quality assurance process for each of the five regions and the Washington office. The role of CRA in the application process is included in these internal reviews. A detailed management review is conducted on a three-year or five-year cycle based on the level of risk in each of the five regional offices and in the Washington office. The Director of Internal Review briefs the Director and Deputy Director on each review. The completed reviews are forwarded to appropriate senior management for consideration.

To enhance the application process and its internal review, by April 1, 2002, OTS will prepare written guidance addressing how CRA performance should be considered when deciding covered applications.

Finding 2 – Unsupported or Questionable CRA Ratings

The report states that the IG could not validate the examiner's evaluation under the lending and investment test components of the overall rating for a few of the public evaluations reviewed because of a lack of performance context information and, with respect to the investment test, clear regulatory standards for measuring performance. The report makes several recommendations, as follows, with respect to these observations.

- To better ensure that the PE reports provide sufficient explanation in support of how a rating was derived, OTS needs to ensure that performance context information is appropriately incorporated into the PE report. Consideration should be given to updating the General Report Guidelines, Section 125, to include both additional guidance and minimal content on performance context. This

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would also include requiring additional narrative on how aggregate data presented in the PE report was assessed in arriving at a rating in relation to the performance context.

We agree that performance context is an important element in evaluating an institution's performance. Nevertheless, for many thrift mortgage lenders operating through traditional branch systems in metropolitan areas, performance context does not vary significantly to warrant extended discussion for most satisfactory performers. Performance context covers a range of information about the institution and its community. In the typical evaluation under the interagency PE format, performance context information will be distributed throughout the public evaluation. Business strategy, product mix and other operational characteristics will appear in the "Description of Institution" section. Characteristics of the community will usually appear in the "Description of Assessment Area." Aspects of performance context that have impact on the analysis of a particular criterion in one of the tests may appear in the discussion of performance criteria. In other words, performance context is not a stand-alone item, but is instead reflected throughout the public evaluation.

Additionally, the FFIEC's Consumer Compliance Task Force and its CRA Subcommittee have been working on a set of core tables to be included in every public evaluation for every agency. These tables will present data on the lending, investment, and service tests along with basic demographic information for each institution and each metropolitan area in which it has branches. While the Task Force approved these tables several months ago, they were just shipped from our software vendor to examiners last month. The tables are being tested in the field to identify and work out any technical problems. Once the testing is successfully completed, all examiners will be including the core tables in their public evaluations. We believe that the core tables will contribute to addressing this recommendation by providing guidance and minimal content regarding baseline information to be uniformly presented in all PEs.

- To lessen the subjectivity of the investment test, OTS should seek through the FFIEC interagency deliberations to establish more objective regulatory criteria as to how investments are to be assessed.

We concur with your statement that "noticeably absent from the regulations are guidance for examiners to evaluate all the information gathered for the [investment test] criteria to arrive at a specific rating." The investment test has been the subject of much criticism. It is difficult for institutions and examiners to gauge "how much is enough." This

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regulatory omission is not accidental. The agencies recognized the need to accommodate a variety of institutions, various business strategies and different communities within one set of test criteria. Arbitrary quantitative measures for investments were rejected as unworkable by the interagency working group when the regulations were drafted.

Nonetheless, the agencies have issued question and answer guidance to address a variety of concerns regarding the investment test and the nature of investments that qualify for consideration under the test. Several Qs and As were proposed for public comment and subsequently adopted on this subject. See, 62 FR 52105 (Oct. 6, 1997) (proposal) and 64 FR 23618 (May 3, 1999) (final). These questions and answers define what the agencies meant by the term "primary purpose" when determining whether an investment is a qualified investment eligible for CRA consideration, among other things.

In addition to this guidance, OTS has explored the possibility of collecting information on the number and amount of qualified investments for thrifts during examinations so that examiners could have relative comparative data to use in evaluating an institution's investment test performance. The issue has also been discussed on an interagency basis, but the burdens associated with the collection of such information were deemed to outweigh the benefits to the examination process. The investment test is one of several issues that will be evaluated in the context of the 2002 review of the CRA regulation.

- Given the inconsistent lending and investment ratings observed from the sampled thrifts, OTS should provide for quality assurance reviews of CRA examinations to include a broader analysis for comparing inter- and intra-regional examinations and PE reports for consistency.

Quality assurance reviews were conducted internally at OTS shortly after the revised regulations were made effective as of May 31, 1996. In fact, our review of public evaluation for small institutions inspired a similar undertaking on an interagency basis. See, Interagency CRA Guidance for Examiners on Public Evaluations Using the Streamlined Assessment Method (November 1996). A second internal review of small institution public evaluations was issued the following year and an interagency review of public evaluations for large institutions was issued in May 1997. The Director of Internal Review also conducts an annual random statistical sample of compliance examination reports as noted in response to recommendation number 1. The reviews were expanded during your examination to include a review of public evaluations for fiscal year 2000.

- OTS should also seek through the FFIEC interagency deliberations to establish objective criteria and or clarification as to what constitutes strong lending and community development lending when these activities are used in support of a Low Satisfactory investment rating for thrifts with little or no qualifying investments. In the interim, OTS needs to establish internal guidelines clarifying the process to better ensure consistent treatment by examiners.

We recognize that there may be some inconsistency in how this standard is being applied. We concur with your recommendation to establish internal guidelines to clarify the issue for OTS examiners, and will issue such guidelines by April 1, 2002. Issues concerning the investment test and the difficulties in measuring performance under the test are on the agenda for the 2002 interagency review of CRA.

Finding 3 – Examiner Assessment of Community Credit Needs Could Be Enhanced

The report states that some public evaluations failed to document or discuss community contacts made in connection with the CRA examination, while several others failed to describe the contacts that were made. In addition, the report states that examiner guidance on writing public evaluations should require a comparison of an institution's lending in comparison not only to its peers, but also to the demographics of its assessment area. The report, therefore, makes the following two recommendations:

- The OTS should 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.

We agree that information from community contacts is useful in helping examiners understand the major issues in communities served by OTS-supervised thrifts. The importance of community contacts is routinely discussed in examiner CRA training. Nonetheless, the agency also has flexibility to use information from our own recent contacts as well as those made by other agencies in the course of their examinations. We have been working since 1998 on an interagency project to develop a community contact database to improve the process of gathering, sharing and utilizing community contact information. Unfortunately, technical computer security issues remain a significant hurdle for implementing this system. We continue to work on this project so that examiners will have improved access to a variety of perspectives concerning local credit needs in a manner that minimizes burden to the community representatives we contact and improves our ability to leverage limited examiner resources. In the meantime, we will continue to emphasize and demonstrate the importance of community contacts with examiners at every opportunity.

- The OTS should 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. Consideration needs to be given to more effectively describing area demographics without implying a required lending distribution.

OTS examiners routinely employ demographic information in their examinations. However, we, along with the other agencies, determined that a variety of demographic information must be considered to get an accurate picture of an institution's performance level. The report specifically recommends that all public evaluations should include comparisons of lending levels to the population of low- and moderate-income individuals. Most public evaluations do discuss lending as compared to low- and moderate-income populations, but often other information, such as housing affordability, the percentage of owner-occupied housing in the area, credit quality of the borrowers, and other factors may provide more meaningful explanations of lending performance. Our examiner guidance recommends that examiners "individual circumstances dictate the nature and extent of detail required to accomplish the objective of providing adequate support; however, significant aspects of various performance tests require some numerical data to support conclusions."

As discussed above, the recommended demographic data will be part of the interagency core tables when implemented. Moreover, we will review interagency instructions on what demographic information should be considered in evaluating an institution's CRA performance as part of the 2002 interagency review of the regulation's effectiveness.

Finding 4 – Clear Guidance Needed For Non-traditional Thrifts

As the report acknowledges, OTS supervises a number of institutions that deliver deposit and credit services using alternative delivery methods such as mail, telephones and the Internet, rather than the more traditional use of branch offices. As a result, OTS identified the limitations of the CRA regulation's definition of an institution's assessment area soon after the regulations were implemented. We have worked with the FFIEC to address assessment area issues and develop Q & A guidance that provides some flexibility for institutions that operate in a non-traditional manner by describing, among other things, the circumstances under which examiners may evaluate lending outside an institution's assessment area. OTS has made its examination approach known to the industry. Our approach has also been a topic for discussion at regional training meetings and compliance courses conducted on a national basis.

The IG report accurately describes the approach that OTS has taken to evaluating non-traditional thrifts under the regulation and the accompanying Q and A guidance. OTS follows the regulation and interagency guidance by giving favorable consideration to performance outside an assessment area when it is permitted under the regulation and when the performance itself is favorable. See, Interagency Questions and Answers Regarding CRA, __.22(b)(2) & (3), 66 FR 36620, 36633 (July 12, 2001).

Nevertheless, the report states that OTS's approach to evaluating non-traditional thrifts may not be clearly conveyed to, or consistently applied by, OTS examiners since our examination approach lacks written specificity. The report, therefore, recommends that:

- The OTS should provide examiners with further guidance to ensure greater consistency in applying the agency's approach to non-traditional thrifts.

While OTS has made its approach a regular part of training with examiners and their managers over the past two years and used actual PE case studies to illustrate the application of regulatory guidance to non-traditional institutions, we accept this recommendation. As you are aware, the assessment area issues raised by non-traditional institutions were featured as one of several issues upon which the FFIEC solicited comment in preparation for the 2002 review of the CRA regulations. See, Joint Advance Notice of Proposed Rulemaking, 66 FR 37602 (July 19, 2001). We have every expectation that the issue will be thoroughly evaluated in the interagency deliberative process.

In the interim, OTS is preparing a Compliance Alert addressing the evaluation of non-traditional institutions to be issued to our examiners before December 31, 2001. This issuance will track the material provided in our written submissions to the IG during this review and should provide the further guidance sought by this recommendation.

Conclusion

The CRA and the 1995 regulation present a number of complex policy issues that the agencies continue to work through. We expected this when the regulation was issued and understood that implementing the regulation would be a learning experience. That is why the agencies committed to conduct a regulatory review in 2002. Over time it became apparent to the agencies that the 2002 review should actually get under way in 2001. Accordingly, the banking agencies issued an ANPR soliciting comments on a number of areas that examiners, industry and community representatives had brought to our attention over the years since 1995. Several of those issues coincide with comments made by the IG's report. We will consider this report as another comment to be evaluated during the course of the 2002 review.

Sincerely,

Ellen Seidman

Ellen Seidman
Director

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Appendix 4
Major Contributors to This Report

Western Region

Joseph Eom, Auditor-in-Charge
John Mansfield, Auditor

Appendix 5
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