



General Government Division

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January 26, 1994

The Honorable Henry B. Gonzalez  
Chairman, Committee on Banking,  
Finance and Urban Affairs  
House of Representatives

The Honorable Joseph P. Kennedy II  
Chairman, Subcommittee on  
Consumer Credit and Insurance  
Committee on Banking, Finance  
and Urban Affairs  
House of Representatives

This letter responds to your request for our analysis of the proposed Community Reinvestment Act (CRA) regulations, which the bank and thrift regulators recently released for public comment. We began a review of CRA and the related fair lending laws last May at your request. Our review is still under way and includes visiting about 40 banks and thrifts across the country to assess CRA from the perspectives of the industry, regulators, and community groups.

The bank and thrift regulatory agencies deserve credit for their concerted efforts to obtain input from all affected parties prior to formulating their CRA proposal and for attempting to address some of the major criticisms of the current regulations within the short time afforded them by the President. The major change in the proposed regulations is the focus on assessing institutions' performance in lending, investing, and servicing their communities, particularly the low- and moderate-income segments, rather than the current focus of assessing institutions' efforts in helping to meet community needs. The proposed regulations also provide a streamlined assessment option for small institutions and an option for institutions to be assessed based on a preapproved CRA strategic plan.

It is not clear, however, whether the proposed regulations' shift to performance-based assessment standards will achieve the desired goals of improving performance and promoting consistency while minimizing compliance burdens. Moreover, such a significant

regulatory shift will necessitate numerous operational changes. To date, the agencies have not had sufficient time to work through many key issues and their ramifications. We believe that the agencies should take the time necessary to complete the planning and analysis needed to ensure effective implementation of the proposed regulations.

The remainder of this letter briefly discusses what we believe to be the major strengths and weaknesses of the agencies' proposed revision to the CRA regulations. Because of the seriousness and complexity of the areas where we have concerns, we have discussed them in greater detail in enclosure I. In addition, enclosure II lists a number of key operational issues that the agencies must address before implementing this or any similar proposal.

STRENGTHS OF THE AGENCIES'  
PROPOSED REGULATIONS

While many of those we have talked to agree that problems exist with the current CRA regulations, there is less agreement within the banking industry, regulatory community, and among community groups about how CRA could best be improved. The proposed regulations respond to many of the diverse and sometimes conflicting views, such as between those who want more and those who want less direction on what institutions should do to comply with CRA. Some of the strengths of the proposal include:

- (1) A Focus on Performance. The proposal shifts the emphasis of CRA examinations from an institution's efforts to its actual performance in lending, investing, and servicing its community. The proposal also provides flexibility to recognize differences in communities and institutional strategies.
- (2) An Alternative Standard for Nonretail Institutions. The proposed investment test provides a more meaningful set of standards for nonretail institutions, such as wholesale or credit card banks, that are not involved in community lending activities. The proposal also clarifies how investment activities by retail institutions will be considered and may provide an incentive for institutions to engage in these activities to improve their CRA performance ratings.
- (3) Greater Public Disclosure. The public will have access to more information about some institutions' lending activities beyond the current Home Mortgage Disclosure Act (HMDA) data. Also, under the provision for advance notice of

examinations, the public will be able to provide input to examiners about any institution's CRA performance.

- (4) Relief from Burdensome Documentation. In most cases, the proposal clarifies information requirements and reduces the need for some types of documentation, such as marketing efforts and ascertaining community needs, that are currently collected by banking institutions.
- (5) CRA Plan Option. The plan option encourages institutions to formally incorporate CRA into their strategic business plans and acquire upfront community input. Under the proposal, an institution submits its plan for regulatory approval, thereby providing the institution with greater certainty about the acceptability of its CRA approach. The preapproved plan will also allow institutions to better assess their own performance at any time.
- (6) Enforcement Policy. The proposal clarifies under what circumstances enforcement actions will be taken.

#### AREAS OF CONCERN

Although we have noted a number of strengths of the proposed revisions to the CRA regulations, we also have some reservations about several aspects of the proposal. Some of our concerns are related to elements of the proposal itself and its potential impacts, while others are related to practical aspects of its implementation. Based on our work, we are concerned that some of the weaknesses in the current system, such as data quality problems and rating inconsistencies, may continue under the proposed regulations. We have briefly noted our primary concerns below. A more detailed discussion of these concerns can be found in enclosure I.

- (1) Uncertain Impact on Performance. Despite the proposal's clear intent to encourage more lending in low- and moderate-income areas, it remains uncertain how this proposal will ultimately affect the lending, investment, and service decisions of depository institutions. Some officials are concerned that it may create disincentives for institutions not already located in low- and moderate-income areas to move into these areas. In addition, some concerns have been raised that certain aspects of the proposal could encourage some institutions to engage in lending activity that is inconsistent with safety and soundness, such as relaxing underwriting standards to achieve higher market shares or loan-to-deposit ratios. More information is needed about the possible consequences of the proposed regulations to

determine if adjustments are needed to correct for them. Also, guidance for bankers and examiners is needed to emphasize adherence to safety and soundness standards while striving to satisfy CRA requirements.

- (2) Workability of the Market Share Test. The market share test may not be a meaningful standard to assess performance in certain situations. For example, the market share test will not be meaningful when a depository institution is the only reporting institution in a market or when nonreporting institutions comprise a significant share of the market. Analysis is needed to determine the extent of the anomalies related to this test, as well as guidance for examiners and institutions detailing how such situations should be assessed.

Another important problem with the market share test is that the market share calculations depend on the activities of other reporting financial institutions in the market. Bank and thrift officials will not have information about other institutions, so they cannot realistically compute their market shares or assess their own performance until after the fact.

- (3) Examiner Discretion and Consistency. Because of the significant amount of examiner discretion inherent in the agencies' proposal and because of the ambiguity regarding when and how such discretion will be used, the proposed regulations may not achieve the desired goal of greater consistency in the exam process. Guidance and comprehensive training programs will be important for examiners detailing how and under what circumstances discretion will be used.
- (4) Documentation Burden. The proposal seeks to reduce some of the documentation burden associated with the current regulations, particularly for small institutions. The proposal provides a streamlined assessment method for small institutions. However, the proposed regulations do not specify how examiners will assess small institutions without some form of record keeping and whether the burden of preparing information for the exam will fall on institutions or the examiners. Small institutions need guidance on how they will be assessed and who will be responsible for compiling the data necessary for the assessment.
- (5) Data Quality and Collection. The proposed performance-based assessment standards increase examiner reliance on reported data. However, because the agencies do not plan to verify the new data, it is questionable whether examiners will have

access to accurate and complete data upon which to base their decisions. Additionally, some large institutions are concerned about the cost of the proposed requirements to collect additional data on the geographic distribution of their small business, consumer, and home mortgage lending activities. Bankers and examiners will need guidance on quality assurance and control procedures to ensure that reported data are accurate.

- (6) Examiner Workload. The proposal attempts to address some of the banking industry's complaints about documentation burden by shifting the burden to the examiners. For example, examiners will have to review considerable data to calculate market shares and assess the difficulty of community lending or investment arrangements. It is not clear that the examiners are prepared to handle the increased workload from a time or expertise standpoint. The regulators may need to reassess their resource needs based on the length of time exams are taking and the number of examiners available, with relevant expertise and experience, needed to conduct the revised CRA examinations.
- (7) Operational Preparations. One of the most significant challenges faced by the agencies is completing the numerous logistical preparations required to implement such fundamental changes to their examination process. Some of the most critical operational areas that need to be addressed before this proposal can be effectively implemented include
- examination guidance, procedures, and training;
  - guidance for institutions and community groups;
  - criteria and procedures for approving CRA plans; and
  - procedures for data collection, analysis, and dissemination.

The time frames for implementing the proposal need to be assessed to determine if revisions are necessary.

The proposed new CRA regulations represent a commendable effort on the part of the bank regulatory agencies. While we believe that the regulators accomplished a great deal in developing a comprehensive proposal within such a short time frame, we have elaborated upon our concerns regarding the proposal and the agencies' ability to implement it within the designated time frame in enclosure I. Also, to ensure effective implementation of the CRA proposal, we believe the regulators will need to accomplish the tasks highlighted in enclosure II. Finally, the public comment period will undoubtedly raise additional issues that will need to be considered. We believe consideration should

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be given to the time and attention needed to address concerns raised rather than jeopardizing this worthwhile reform effort by placing undue priority on adhering to what may be rather optimistic implementation time frames.

Thank you for the opportunity to provide our views on this important subject. We are also sending copies of this letter and enclosures to the four bank and thrift regulatory agencies for their consideration along with other public comments. We look forward to completing our CRA study for you and appreciate the opportunity it affords to assist you in identifying additional ways to improve CRA performance while reducing related regulatory burden.



James L. Bothwell  
Director, Financial Institutions  
and Markets Issues

Enclosures

AREAS OF CONCERN

We recognize that the agencies performed a difficult task in developing this proposal in such a short time frame. However, such dramatic changes in procedures may require careful analysis of the potential impacts and necessary preparations to ensure effective implementation. We believe particular attention should be focused on some of the following key issues:

- impact on performance,
- workability of the market share test,
- examiner discretion and consistency,
- documentation burden,
- data quality and collection,
- examiner workload, and
- operational preparations.

IMPACT ON PERFORMANCE

A key objective of the regulators' CRA reform effort is to improve banks' and thrifts' performance in lending, investing, and providing services in their communities. While the proposal intends to create incentives for institutions to improve their performance in providing loans and services across their community, it is not clear how this proposal will ultimately affect institutions' lending, investment, and service decisions. One possible result is that institutions not currently located in low- and moderate-income areas may not reach out to these areas because they must then show roughly comparable performance between the low- and moderate-income areas and the remainder of their service area. More information is needed about the possible consequences of the proposed regulations so that any necessary adjustments can be made. Implementation should also be carefully monitored to make further adjustments as the need arises.

Another area of concern is that the proposal may encourage, either directly or indirectly, some institutions to engage in lending activity that is inconsistent with safety and soundness. For example, an institution that needs to raise its market share in a low- and moderate-income area may resort to riskier pricing of its products. Additionally, the use of a specific loan-to-deposit (LTD) ratio may inadvertently encourage unsafe or unsound banking practices. Recall that a characteristic common to many of the small institutions that failed in the 1980s and early 1990s was a high loan-to-deposit ratio. Very small institutions

typically have low loan-to-deposit ratios because they are often located in small towns with undiversified economies. While the prospect of greater competition in low- and moderate-income areas is a benefit of this proposal, consideration of safety and soundness standards is also important to emphasize in guidance for bankers and examiners.

#### WORKABILITY OF THE MARKET SHARE TEST

The market share test may not be a meaningful standard for examiners to use to assess performance in certain situations.<sup>1</sup> For example, the market share test will not be meaningful when financial institutions (1) do not have low- or moderate-income areas in their service area, (2) are the only reporting institution in the market or are located in markets where the nonreporters comprise a significant share of the market, and (3) have service areas that only partially overlap with other financial institutions' areas.

These situations raise questions about the meaningfulness of the market share test and could potentially pose problems in several markets. For example, there are likely to be rural areas where only one institution or branch would be required to report summary lending activity under this proposal, and in these cases the market share test will be meaningless. Another problem area may arise if, for example, two financial institutions have a common low- and moderate-income area and each institution's market share in the rest of their service areas exceeds 50 percent. Consequently, one or both will have a less than satisfactory preliminary lending rating because both institutions will not be able to have comparable market shares in the low- and moderate-income area. More information is needed to determine how often and in what types of markets such anomalies may occur so that guidelines can be developed for examiners and institutions detailing how such situations should be assessed.

Another concern we have with the market share test is that financial institutions cannot realistically compute their market

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<sup>1</sup>The market share test is one part of the lending test that measures the extent to which an institution makes housing, small business, and certain consumer loans. Under the market share test, examiners will compute an institution's share of the market for each type of loan in the institution's low- and moderate-income areas and compare that share to the institution's share in the remainder of its market. In order to receive a satisfactory rating, the shares must be at least "roughly comparable."



shares until after the fact. Markets are constantly changing so that the number of competing institutions within an institution's market and each institution's market share will likely change from year to year. Since market share calculations depend on the activities of other institutions in the market, it may not be possible for financial institutions to develop meaningful plans, assess their performance relative to others throughout the year, and make necessary adjustments.

#### EXAMINER DISCRETION AND CONSISTENCY

One of the major challenges for the regulators in developing this proposal has been balancing the call for quantitative, performance-based measures with the need for some discretion and flexibility in the assessment system. When CRA was initially considered, Congress recognized the danger of mandating credit distribution and the need to recognize differences in financial institutions' operations, economic conditions, and communities' needs across the country. Indeed, extensive examiner discretion and rating inconsistencies have frequently been major criticisms of the current system. Because of the significant ambiguity regarding when and how discretion will be used, it is not clear that the proposed regulations will promote consistency in the exam or rating processes--one of the major goals of CRA reform. While this is clearly a difficult task, it is not clear in the proposal how these factors will be balanced and how discretion will be used by examiners.

There are numerous areas in the proposed regulations where examiners will be required to use their discretion to determine an institution's performance. For example, examiners may adjust the lending score for innovative underwriting or meeting special needs. However, it is not explained how examiners will make these judgments, particularly if they are not familiar with the community. Some are concerned that the proposal deemphasizes examiners' assessment of community needs and that as a consequence, examiners may not have sufficient information to assess institutions' performance in helping to meet community needs. They are also concerned about how examiners will factor in comments submitted from the community on institutions' performance or their CRA plans. Another area of discretion involves the rating of multiple-branch institutions where only a sample of the institution's service areas will be evaluated and rated. Details are not provided on how they will determine the sample and weigh differences in performance among service areas.

The danger exists that discretion could be used to such an extent by examiners that the performance-based data collection will

become less meaningful and the intended predictability will not be improved. In order to achieve the necessary balance of quantitative measures and discretion, specific guidance is needed on how and under what circumstances examiner discretion will be used. In addition, comprehensive training programs for all examiners will be important to emphasize the guidelines for using discretion. Several examiners have told us that they have not received adequate CRA training. Given the complexity of the proposed examination procedures, training will be key to effective implementation.

#### DOCUMENTATION BURDEN

Another of the regulators' goals for CRA reform was to minimize the documentation burden on financial institutions, particularly small institutions.<sup>2</sup> However, the proposed regulations do not specify how examiners will assess small institutions without some form of record keeping, how much of the burden of preparing information for the examination will fall on the institution, and how much of the burden will fall on the examiner. For example, the small institution assessment method requires an institution to make the majority of its loans in its service area and have a good mix of loans to consumers across economic levels. The proposed regulations state that the burden of the examinations will be shifted from the institutions to the examiner; however, it is not clear how examiners will make assessments about institutions' loan portfolios if data are not collected and readily available. Small institutions will need guidance on how they will be assessed and who will be responsible for compiling the data necessary for the assessment.

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<sup>2</sup>The proposal allows independent banks or thrifts with assets under \$250 million, or banks or thrifts that are members of holding companies with assets less than \$250 million, to be assessed under a streamlined assessment method. Under this alternative method a small institution must (1) have a reasonable loan-to-deposit ratio, where 60 percent is assumed to be reasonable; (2) make the majority of its loans in its service area; (3) have a good loan mix; (4) have no legitimate complaints from the community; (5) have not engaged in discrimination; and (6) have a reasonable geographic distribution of its loans if it reports HMDA data.

DATA QUALITY AND COLLECTION

The proposal's shift to performance-based assessment standards increases the examiners' reliance on quantified data to make their judgments. Hence, the need for accurate and complete data will become even more important. Yet, in our current review of CRA and the fair-lending laws, many examiners, regulators, and community group representatives have criticized the accuracy of the HMDA data. Some agency officials have estimated that as much as 30 to 40 percent of the reported HMDA data is inaccurate. Some institutions have told us that HMDA data errors are due to several reasons, such as confusion in reporting mixed commercial and home loans or lack of information on purchased loans. Better guidance may be needed to avoid compounding such confusion with the new data requirements.

The proposal requires large institutions to report additional data on the geographic distribution of their residential, small business, and consumer loan applications, denials, originations, and purchases. According to Federal Reserve Board data, about 3,400 institutions, including 980 banks that are non-HMDA reporters, would be required to report lending data under this proposal.

Some institutions have questioned the costs and benefits of collecting the additional data, particularly for the non-HMDA reporters that were not originally required to report HMDA data because such data were judged to be less useful in rural areas. Some rural institutions have told us that geocoding their lending data is not meaningful because they cannot distinguish various income groups within census tracts. In addition, some institutions have told us that they must use vendors to geocode their loans by census tract, and they are concerned about the increase in costs for the additional reporting requirements.

Agency officials told us that they are not planning to verify the accuracy of the additional data that are required under the proposal. Some examiners have told us that additional data would be useful only if it were reliable. We agree that if these data are not verified, then its accuracy and usefulness are questionable. In fact, inaccurate data used by various affected parties may lead them to inappropriate conclusions about an institution's CRA performance. Procedures are needed to ensure that the data collected are accurate.

EXAMINER WORKLOAD

In addition to monitoring how examiners exercise their discretion, it will also be important to monitor how the revised examination procedures affect the examiners' workload. Although examiners may not have to review as much documentation, they will have to analyze more data. In addition, as we have previously stated, examiners need to verify the accuracy of data collected in order for these data to be meaningful. It should be recognized that data verification will require additional time. Some examiners have told us that they currently do not analyze HMDA data because they do not have enough time. The regulators may need to reconsider their resource needs based on the length of time it takes and number of examiners needed to conduct the revised CRA examinations.

OPERATIONAL PREPARATIONS

We believe that one of the most significant challenges faced by the agencies is completing the numerous logistical preparations required to implement such fundamental changes to their examination process. Under the proposed regulations, some institutions will be required to begin collecting additional data as of July 1, 1994, and report that data by January 31, 1995.<sup>3</sup> The agencies plan to institute the new CRA examination procedures between April 1 and July 1, 1995.

We believe these time frames may be too optimistic based on the time the agencies have needed to incorporate HMDA data analysis into the examination process and revise their fair lending examination procedures. In 1989, Congress required additional HMDA data collection and disclosure of these data to the public. Even though HMDA data have been available for 3 years, some examiners are not using HMDA data during examinations due to several factors, including the lack of ready access to HMDA data, lack of time, significant data quality problems, and lack of training in analyzing HMDA data. Federal Reserve Board staff estimated that the proposed new data collection requirements could double their current HMDA data processing workload. The

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<sup>3</sup>Banks and thrifts with at least \$250 million in assets and members of holding companies with that level of assets will be required to report data on the geographic distribution of their home purchase, consumer, and small business loan applications, denials, originations, and purchases. Banks and thrifts that do not fall into this category can elect a streamlined method of assessment where they would not be required to report these data.

agencies need to determine how the additional data will be collected, processed, analyzed, and disseminated to examiners.

Additionally, the regulators announced in June 1993 that they were developing uniform fair lending examination procedures and training. The regulators estimated that the new procedures would be finalized in September 1993 but have had to revise their timetable. They now estimate that the procedures will be finalized by the summer of 1994. The fair lending examination procedures may be even more important to the new CRA regulations because findings of discrimination affect the overall CRA rating. The proposed revisions to the CRA examination procedures are even more extensive than the fair lending changes and will require critical development and training before implementation.

Other workload considerations include the review process for preapproving CRA plans and disseminating public information. The regulators will need to develop a methodology for approving CRA plans that details the criteria to be used to assess the plans. They will also need to develop procedures detailing how performance will be measured and how examiners will determine if the plan's goals are met.

Another area where the regulators will need to focus is the dissemination of publicly available information. Several community groups have told us that this information is very important to their local community development efforts. However, they have criticized the public CRA examination reports on individual institution performance because they do not provide detailed performance information. Also, they have commented that the publicly available HMDA data are not provided in a useful format. They have suggested that the agencies develop uniform standardized formats for the public CRA examination reports and more user-friendly formats for all of the reported lending data that will be available to the public.

LIST OF TASKS NEEDED TO IMPLEMENT  
THE PROPOSED CRA REGULATIONS

Following is a list of tasks that we believe are prerequisite to addressing our concerns as well as to effectively implementing the agencies' proposal to reform CRA. The list is intended to highlight the nature, magnitude, and time requirements of critical planning and preparatory activities.

- More information about the potential consequences of the proposal's shift to performance-based standards is needed to determine if adjustments are necessary. Also, safety and soundness standards should be emphasized in the guidance for examiners and institution officials.
- Analysis of potential market anomalies is needed to assess the meaningfulness of the market share test.
- Guidelines for both examiners and institution officials will need to detail how examiners will assess CRA compliance in situations where the market share test is not meaningful.
- Examination procedures and guidance will need to detail how and under what circumstances discretion will be used by examiners.
- A comprehensive training program, possibly on an interagency basis, is needed for all compliance examiners in order to promote greater consistency and competency in CRA examinations.
- Small institutions will need guidance about how they will be assessed under the proposed streamlined method and who will be responsible for compiling the data necessary for the assessment.
- Procedures are needed for verifying the accuracy of lending data reported under the proposed regulations.
- The agencies will need to plan and prepare for collecting, processing, analyzing, and disseminating lending data to examiners.
- The procedures and criteria to be used for approving institutions' CRA plans and for assessing performance under the plan option needs to be developed and disseminated.

ENCLOSURE II

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- The public CRA examination reports should be standardized, and a more user-friendly format developed for the publicly available lending data.

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