

279

April 6, 2004

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Attention: No. 2004-04

Dear Sirs/Mesdames:

E*TRADE Bank, Arlington, Virginia (the "Bank") appreciates the opportunity to provide its comments on certain aspects of the February 6, 2004 Joint Notice of Proposed Rulemaking ("Notice") relating to proposed amendments to the interagency regulations implementing the Community Reinvestment Act of 1977, as amended ("CRA").

The Bank has no objection to, and is not submitting any comments regarding, the revisions proposed by the Office of Thrift Supervision ("OTS") and the other Federal banking agencies to their CRA regulations, to be set forth in 12 C.F.R. Part 563e. However, the Bank does wish to comment upon two issues also raised in the Notice that the Federal banking agencies plan to address through subsequent interpretations and guidance. These comments concern: (1) the agencies' proposal to distinguish loan purchases from loan originations in a public performance evaluation's display of loan data, either on an aggregate basis or by assessment area; and (2) the weight to be given under the investment test component of the large retail institution CRA test ("large bank test") to investments from past periods, commitments for future investments and grants.

Distinction between Loan Originations and Loan Purchases

In the 2001 Advanced Notice of Proposed Rulemaking referenced in the Notice,¹ the Federal banking agencies solicited comment as to whether loan purchases should be given less weight than loan originations under the lending test component of the large bank test. In response to comments received from both financial institutions and community groups, the agencies indicated in the Notice that they would not change the existing CRA regulations' equal weighting of loan purchases and originations. At the same time, the agencies twice propose in the Notice to distinguish between the two types of lending activities in institutions' public CRA performance evaluations.² The rationale articulated by the agencies for breaking out purchased and originated loans was to improve "transparency" in CRA evaluations.

In the Bank's view, the proposal to report an institution's purchased and originated loans separately in its public performance evaluation is entirely inconsistent with the agencies' pronouncement in the Notice that loan purchases and originations would continue to be weighted equally for purposes of the large bank lending test. If in fact the two types of lending activities are entitled to equal weighting, then there is no need to distinguish between purchases and originations in institutions' public

¹ 66 Fed. Reg. 37602 (July 19, 2001).

² The proposal is first made in the "Loan Purchases and loan Originations" section of the Notice (at 69 Fed. Reg. 5732). Later, in the "Enhancement of Public Performance Evaluations" section of the Notice (at 69 Fed. Reg. 5741), the Federal banking agencies stated that they intend to disclose in an institution's public CRA performance evaluation "[t]he number, type, and amount of purchased loans". With respect to affiliate loans included in an institution's evaluation, the agencies proposed the disclosure of "the number, type, and amount of loans that were originated or purchased by an affiliate", as well as the affiliate's identity. Based on the above affiliate lending description, it did not appear that a distinction between originated and purchased loans would be made for affiliate loans in the public performance evaluations.

performance evaluations. According to the agencies themselves, such a distinction is irrelevant for evaluation purposes. It does not provide any insight to the public as to how an institution was evaluated for its CRA performance or how its CRA rating was determined. Thus, there is no additional transparency benefit to be gained by disclosing such information and making any distinction between an institution's purchased and originated CRA-qualifying loans.

At the same time, breaking out an institution's purchased and originated loans in its public performance evaluation could have serious unintended negative consequences. Making such a distinction in the data could easily create the false impression by the public that there *is* a difference as to how purchased loans and originated loans are evaluated by the agencies. Such disclosures could also incorrectly suggest to the public that an institution having a greater proportion of purchased CRA-qualifying loans is not performing as well as one that has a higher percentage of originated loans, even if the overall levels of CRA lending activity of both institutions are the same.

By suggesting a qualitative difference where none exists, disclosing loan purchases and originations separately could make certain institutions open to criticism by community groups, even though not warranted, that they had relied excessively on purchased CRA-qualifying loans, notwithstanding the agencies' official pronouncement that each type of lending activity is entitled to equal weight. Concerns about this type of perception, in turn, could discourage institutions from purchasing CRA-qualifying loans, thereby potentially reducing liquidity in the secondary market for such loans and the

availability of such loans to low-to-moderate-income (“LTMI”) borrowers at current interest rates.

In summary, the agencies’ should refrain from adopting a disclosure regime that distinguishes between purchased and originated loans because such information is not germane to the proper evaluation of an institution’s CRA performance, it would run counter to the agencies’ determination that purchased loans and originated loans are entitled to the same weight, and it could serve to discourage institutions from purchasing CRA-qualifying loans to the detriment of LTMI borrowers.

Interagency Investment Test Guidance

In its discussion of the investment test component of the large bank test, the agencies indicated that they anticipated issuing guidance that would clarify that (1) “the investment test is not intended to be a source of pressure on institutions to make imprudent equity investments” and (2) “the criteria of ‘innovative’ and ‘complex’ are not ends in themselves, but means to the end of encouraging an institution to respond to community credit needs”. The Bank believes that such guidance would be extremely helpful to institutions and is strongly in favor of its issuance. Specifically with regard to the second point noted above, the Bank concurs with the views previously expressed by other institutions that, from a CRA perspective, the impact of a particular lending or investment activity relative to the community’s credit needs is much more important than whether the loan or investment is either “innovative” or “complex”. The Bank also notes

that when the agencies' take into account qualitative factors such as the innovativeness and/or complexity of an activity, both of which are inherently subjective by their very nature, it is much more difficult for an institution to assure itself that its performance will be deemed satisfactory or better by its Federal regulator. In the Bank's view, as a general matter, the more objective the performance assessment criteria are under the large bank test, the more likely it is that institutions will be better able to fulfill their responsibilities under the CRA.

The Bank also wishes to comment upon the extent to which past investments, future commitments, and grants should be taken into account in assessing an institution's performance under the investment test, an issue that the agencies also plan on addressing in upcoming CRA guidance.

Past Investments

In the case of a community development or other CRA-qualifying investment made by an institution during a prior CRA assessment period that is still carried on an institution's books, that investment carries with it an ongoing opportunity cost. Not only is the institution precluded from using those funds for other purposes in the period in which the CRA investment was made, but the institution is also unable to deploy those funds by purchasing any other loans or investments to the extent that the CRA-qualifying investment is still reflected as an asset of the institution and has not been monetized through its sale to another institution or some other third party. Moreover, in the Bank's

view, it makes little sense for an agency to regard more favorably under the investment test an institution that sells off and purchases an equivalent amount of CRA investments in a given year as compared to an institution that adopts a “buy and hold” CRA investment strategy and consequently has little portfolio turnover year-over-year.

In addition, an investment for which an institution receives CRA credit produces benefits for a community and addresses the community’s credit needs not only in the original year of the investment but in subsequent years as well. For example, an institution’s investment in low-income multi-family housing will continue to provide a benefits to LTMI individuals in an institution’s community for many years, not just during the first year after the investment was made. Since CRA investments made during prior assessment periods are in many instances just as “valuable” to the community as CRA investments made during the current period, there is no reason for making a distinction between prior- and current-period investments under the investment test component of the large bank test.

Because a better measure of an institution’s performance under the investment test is the total amount of CRA-qualifying investments on its books rather than the number or amount of new CRA investments in a particular assessment period, the Bank submits that past and current investments should be accorded equal weight in assessing an institution’s investment test performance.

Future Commitments

In the case of future commitments to make CRA-qualifying investments, such as when an institution becomes a limited partner in a private equity fund that proposes to make community development investments, there is no actual outlay of funds. Thus, the Bank does not believe that future commitments should be entitled to the same weighting for investment test purposes as compared to the weighting accorded to investments that are already on the institution's books. However, a number of factors argue in favor of institutions receiving at least some form of CRA investment test credit for commitments to make future CRA-qualifying investments.

First, as in the case of continuing CRA investments although not to the same extent, commitments to make such investments entail some opportunity cost for an institution as well. Given that, in many cases, the timing of capital calls and other advances is not within the control of the institution and is not always foreseeable, an institution that has committed to making a future investment must maintain sufficient liquidity to be able to fund its commitment on relatively short notice. Also, institutions that have made investment commitments will generally still be required to make the investment even if, in the interim, the economics of the transaction change and the terms of the investment are not as attractive as originally anticipated.

At the same time, community development projects and other entities in which CRA investments are made oftentimes derive significant benefits from commitments received from institutions. Knowing that binding investment commitments are in place, a community organization is better able to undertake long-term development initiatives that will require additional funding in future years. Moreover, such commitments in hand will make it easier for community groups to obtain additional investments from other sources. The existence of future commitments from institutions enhances the likelihood that a project will receive sufficient funding in order to be completed, and this increased prospect of success will in turn make other investors more likely to invest in the project, either because they believe that the project represents an attractive investment opportunity or they want their investments to have a maximum impact on community development.

In short, therefore, the Bank believes that institutions should receive substantial CRA credit for their commitments to make qualifying investments, although not to the same extent as if they had actually made such investments.

Grants

The Bank believes that grants should be weighted at least equally with other CRA-qualifying investments. In many respects, grants represent the most attractive form of funding for community organizations because there is no expectation, as in the case of an investment, that the grantor will either receive back its invested funds at some future

point or earn a reasonable return on its investment. This gives the recipient of the grant the most flexibility in deciding how the funds can be best utilized to further its community development objectives. Similarly, there is also no need for the institution making the grant to first demonstrate that it would be making a prudent investment.

Grants represent a highly desirable source of funding for community groups as they can be utilized for worthwhile development projects that for whatever reason are not likely to generate any return on equity. Institutions should therefore continue to be encouraged to make grants and other charitable contributions by according them equal weighting with other CRA-qualifying investments under the investment test.

Conclusion

In summary, E*TRADE Bank believes that the CRA's objectives of institutions meeting the credit needs of their communities will be best served (1) by a reporting regime that does not distinguish between CRA-qualifying loan purchases and originations (or otherwise suggest or imply that loan purchases are somehow less desirable than loan originations) and (2) by the agencies weighting equally with current period CRA investments an institution's past CRA investments and current period grants and giving partial credit for future CRA-qualifying investment commitments under the investment test component of the large bank test.

Sincerely,

John A. Buchman

John A. Buchman
General Counsel
E*TRADE Bank