Re: Community Reinvestment Act Joint Advance Notice of Proposed Rulemaking
M. Barr Comment Letter October 26, 2001

248

OCC Docket No. 01-16
Board Docket No. R-1112
FDIC Re: 12 CFR 345
OTS Docket No. 2001-49

I am writing to comment on the joint advance notice of proposed rulemaking, issued on July 19, 2001, with respect to the Community Reinvestment Act.

By way of background, I served from 1995-2001 in the United States Treasury Department, first as Special Assistant to Secretary Robert E. Rubin, and then as Deputy Assistant Secretary for Community Development Policy. After leaving Treasury, I was a Visiting Fellow at the Brookings Institution, where I remain a nonresident Senior Fellow. I am currently an Assistant Professor of Law at the University of Michigan Law School, where I teach Financial Institutions law and regulation. I write in my individual capacity.

Before delving into the substance, I would argue that the agencies should be cautious about revising the CRA regulations at this time. This is so for a number of reasons.

First, despite problems with aspects of implementation of the regulation, the rules have worked exceedingly well in expanding access to credit – far more so than any involved in the 1995 revisions could have expected. Banks and thrifts subject to CRA have made more than $800 billion in home mortgage, community development, and small business loans to low- and moderate-income borrowers and communities. Banks and thrifts have increased the share of their home purchase lending going to low- and moderate-income borrowers from 31.5 to 35 percent, and the annual number of home purchase loans going to low and moderate income borrowers and areas has nearly doubled. The Federal Reserve Board's study suggests that this significant expansion of credit has come at a relatively modest cost, if any, in terms of performance and profitability of such loans.

Second, the costs to banks and thrifts, and to the agencies, of changing the rules in any fundamental way could be quite high. It has taken quite some time for banks, and for the agencies themselves, to work through complicated interpretive issues, operational and information system problems, and, perhaps most importantly, the training of bank and thrift employees, and of agency examination staff. Community-based organizations, state and local government agencies, and other for-profit and non-profit partners of banks and thrifts have organized their community development activities in response, to some degree, to the current structure of CRA regulation, and new regulations might necessitate changes in those activities, with some corresponding transition costs.

Third, given the difficult economic circumstances now facing the United States, the series of complex issues facing banks and thrifts, and the likely impact of the economic downturn on the most vulnerable of our people, now may not be the most opportune time

to re-examine basic rules governing bank and thrift performance in serving the needs of low- and moderate-income households and communities. Instead, careful attention should be paid to how to improve the administration of CRA within the basic current framework.

That being said, there is surely room for improvement in the regulations themselves, and in aspects of agency implementation of the rules even in the absence of rule changes, that could deepen and broaden the effectiveness of CRA while increasing flexibility to banks and thrifts. I briefly highlight a few such areas that the agencies may want to consider, structured to correspond to the format of the ANPR. Given the open-ended nature of the questions posed in the ANPR, this comment offers suggestions for approaches to issues, rather than specific proposals to change regulatory text.

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

The ANPR asks whether the regulations strike the right balance between qualitative and quantitative factors, and among lending, investment and service tests. In theory, the regulation itself is quite flexible on both counts.

In practice, qualitative factors are more difficult to evaluate (or "quantify"), which in examinations tends to diminish their importance. It is apparent now, as it was not in 1995, that the focus of the regulations on progress, not process, has largely worked, in the sense that lending is judged on actual performance in increasing lending to low- and moderate-income borrowers and areas. The challenge now is to preserve those gains in focusing on measurable results, with a greater integration of quality concerns into examinations. Without changing the regulations, the agencies could provide examiner guidance that in a more detailed fashion, will tend to raise the quality of the qualitative analysis over time. For example, the current interagency questions and answers note that institutions would receive favorable consideration for instituting programs that graduate borrowers from the subprime to the prime market. It may be useful to provide examiners with tools to assess the extent to which the presence or absence of such a program affects the ability of a bank or thrift to meet the credit needs of its community.

With respect to the balance among the lending, service, and investment tests, the initial matrix set out in the preamble to the 1995 rule (and not formally part of the regulation itself), is probably the right framework to continue. Lending has rightly been the focus of a statute aimed at the "credit needs" of communities, but the investment and service tests play critical roles in supporting how an institution meets the community's credit needs.

Investments play a strong role in expanding access to credit, including by enhancing the capacity of specialized local lenders such as Community Development Financial Institutions or other lenders to provide credit, and stabilizing a local community more directly, thereby enabling loans to be made in the community in a more safe and sound manner. The importance of services to the provision of credit has been less well understood in the past, but research undertaken by the Board, OCC, Treasury, and others show that services also play a critical role in expanding access to all forms of credit for low- and moderate-income borrowers. Low-income individuals with bank accounts save,

enabling them to leverage their hard work by borrowing. Low-income individuals with bank accounts have better access to, and pay less for, transaction services, short-term consumer loans, small business loans, and home mortgage loans.

A. Lending Test

The ANPR asks what weight should be given to originated loans, purchased loans, and asset-backed securities of CRA-qualifying loans. The current regulation treats loans originated and purchased the same, and asset-backed securities as investments. In principle, it would be better to measure, regardless of the structure, who bears the origination cost, the servicing cost, and the credit risk (or the costs of diminishing or shifting the credit risk to others), to quantify such factors as a percentage of the loan, and then to assign a portion of each loan to the entity corresponding to its share. In practice, this seems highly unlikely to be worth the expense and difficulty of the effort. Financial institutions should be able to provide examiners with information about their business strategy with respect to those costs, and to allocate ABS to the investment or services test according to their strategy. Examiners could use the information provided by depositories about their business strategies with respect to the allocation of these costs in making qualitative judgments about the extent to which the firm is serving credit needs.

The ANPR does not ask, but perhaps should, whether consumer loans should play a more central role in CRA examinations. Currently, such loans are only considered at the option of the bank or thrift, or in cases where consumer lending constitutes a core feature of the depository's lending activities. As evidenced by the rise of non-bank consumer lending facilities in low-income communities, there are clearly consumer credit needs of low-income individuals not being met by banks and thrifts. Greater competition in the consumer market might help drive out some the sharp practices that have been seen. The agencies might wish to consider ways of encouraging banks and thrifts to consider how their consumer lending practices could contribute to meeting credit needs under CRA.

The ANPR asks whether agencies should consider whether loans made are harmful or abusive. The agencies have begun to address this issue in the interagency questions and answers issued on July 12, 2001. Under that approach, examiners will take account of certain unlawful loan practices – including violations of the Fair Housing Act, the Equal Credit Opportunity Act, the Truth in Lending Act, the Home Ownership and Equity Protection Act, the Real Estate Settlement Procedures Act, and the Federal Trade Commission Act. In addition, examiners will take note of programs designed to transition borrowers from high cost loans to lower cost loans. Given the tremendous growth in affiliations over the last five years between federally insured depository institutions and non-bank subprime specialists, much of the effectiveness of these two approaches will depend on adequate supervision of the relationship between the bank or thrift and its affiliates: Are borrowers with good credit history "upstreamed" from subprime affiliates and offered prime products? Do borrowers with initially poor credit histories have an opportunity to demonstrate creditworthiness and move into prime products? Are individuals inappropriately steered to higher cost products or divisions?

Thus, the principles set forth in the interagency questions and answers will need to be supported by agency examination extending beyond the bank or thrift itself, while retaining the core principle under the statute that CRA pertains only to banks and thrifts.

B. Investment Test

As discussed above, appropriate investments are critical to helping to meet the credit needs of low- and moderate-income communities, consistent with safe and sound banking practices. Investments are critical both for building local financial and community infrastructure and for stabilizing and growing the broader economic base of low- and moderate-income communities. The interagency questions and answers issued on July 12, 2001, already provide appropriate flexibility for examiners to consider investments made outside of an institution's assessment area if the needs of its community are already being adequately served. With such flexibility, participation in a broad range of both direct and indirect investment options are available in today's marketplace for even reasonably small firms. Based on anecdotal evidence, largely comments from institutions in the $250 million to $1 billion asset range, agencies (and their examiners) may not be fully using existing flexibilities in the regulation, institutions may not be taking advantage of the full range of options for such participation, and greater effort may be needed to gather and disseminate information about such options. Additional examiner guidance and education about investments may be in order.

Finally, a much better understanding of the effectiveness of the investment test – as well as an institution's relative performance under the test -- could be had if the agencies were to compile annual institutional and aggregate data on the dollar amount, location, and type of investment made. The lack of such information is a serious impediment to evaluating institution performance under the investment test. Given the relatively small number of relatively large-sized qualified investments, collecting and reporting such information should not pose a serious burden on banks or thrifts.

C. Service Test

As noted above, the provision of financial services is critical to meeting the credit needs of low- and moderate-income communities. Access to an appropriate savings or transaction account, for most low-income "unbanked" individuals, would mean lower transaction costs, greater consumer protection, more access to consumer, home mortgage and other loans, and increased savings as a cushion against financial emergency.[1]

The 1995 regulations provide sufficient flexibility for analysis of an institution's performance, but agency examination procedures provide insufficient guidance as to how

[1] See, e.g., M. Barr, Access to Financial Services in the 21st Century, Capital Xchange, June 2001 (http//www.brookings.edu/es/urban/capitalxchange/article4.htm; J. Hogarth & K. O'Donnell, If You Build It Will They Come? A Simulation of Financial Product Holdings Among Low- to Moderate-Income Households, Journal of Consumer Policy 23(4):409-44 (2000); C. Dunham, The Role of Banks and Non-Banks in Serving Low- and Moderate-Income Communities," paper prepared for Federal Reserve System Conference on Changing Financial Markets & Community Development, April 5-6, 2001.

to measure an institution's activities in ways that actually matter to low-income consumers. Analysis by Professor Michael Stegman of the University of North Carolina at Chapel Hill finds that the services test has largely been ignored in practice.[2] The service test in practice has received perfunctory attention from examiners, with public evaluations containing little or no analysis of whether low-income consumers actually use bank or thrift product or services. In my judgment, examinations under the service test could be vastly improved by taking three steps:

First, examiners should evaluate the extent to which institutions offer low-cost accounts and other products designed to meet the account needs of low-income individuals. Low-cost electronic accounts with direct deposit, little or no risk of overdraft, the opportunity for the accumulation of savings, and bill payment or electronic money order, may hold special promise in this regard. Some institutions have gone further, by providing financial education and matching funds for Individual Development Accounts. Regardless of the form of the account, examiners should attempt to make a qualitative judgment about the range of product offerings of the institutions, based on the existing state of research into low-income consumer needs, and taking into account the costs to institutions of providing accounts and the requirements of sound banking practice.

Second, banks and thrifts should be evaluated based on the number of low- and moderate-income account holders at their institution, whether in a traditional, or more innovative, account. Quantitative measures of usage should provide a portrait of an institution's performance under the service test, and data collection on the numbers of accounts provided should not in and of itself be burdensome. Requiring data collection and reporting with respect to the income of account holders could require significant burdens on some banks and thrifts. Banking agencies might consider permitting institutions to use certain assumptions about their customers' incomes based on the accounts offered. For example, for reporting purposes, a holder of a specialized banking account with no checking privileges, limited ATM access, and low monthly balances might be presumed to be low income for reporting purposes. Or, traditional accounts opened at branches in low- or moderate-income areas, or, since statement information is readily kept by most institutions, traditional accounts held by individuals residing in low- or moderate-income areas, might be presumed by be held by individuals of low- or moderate-income. (A formula based on the percentage of low-income population in the census tract could also be used.) For other institutions that already collect information on income of account holders for other purposes, such as cross-marketing, reporting of income might not be more burdensome than geo-coding of accounts. Information on account usage is critical to meeting the financial services needs of low-income communities, and agencies should work closely with banks and thrifts to determine the least burdensome way to collect this essential information.

Third, conversely, the agencies should give negative consideration to activities that undermine the provision of quality services to the poor. For example, participation by banks or thrifts in arrangements with affiliates or other parties that do not provide adequate consumer protection, or raise compliance, operational, or other risks, should

[2] M. Stegman, et al., Creating a Scorecard for the CRA Service Test, Kenan Institute, 2001.

receive negative consideration as part of the performance context under the service test. Agencies should ensure that banks and thrifts are not merely "renting" their names or charters to these firms, but are engaged in appropriate monitoring and supervision of practices, and that the practices comply with applicable law. This may require targeted, risk-based examination of these parties or affiliates, as has been conducted by the OCC with respect to national bank relationships with payday lenders.

2. Small Institutions

The ANPR asks whether the dollar limitations for small institutions are still appropriate. The decision by Congress to use the $250 million in assets definition of small banks and thrifts for purposes of the CRA small bank regulatory relief provision of the Gramm-Leach-Bliley (GLB) Act augurs against raising (or lowering) that limit for purposes of streamlined CRA examinations. Moreover, under the GLB Act, bank holding companies seeking to become financial holding companies, and financial holding companies seeking to engage in newly authorized activities, must ensure that all of their bank and thrift subsidiaries, irrespective of size, have a satisfactory record under CRA. The decision by Congress not to limit these provisions to subsidiaries of a certain asset size would suggest that something quite like the current regulation's $1 billion holding company rule, disregarding asset size of the subsidiary, is also appropriate.

Although small banks successfully argued that they should be subject only to a simplified lending test under the 1995 regulation, with increased competition for commoditized mortgage loans, many smaller institutions now see their comparative advantage in retail services, more specialized lending, or in some cases even investment. This argues for developing straightforward analyses that small banks could bring forward to demonstrate how they meet the needs of their communities in those ways. Perhaps a streamlined strategic plan option could be developed that is more tailored to small institution needs.

4. Strategic Plan

The ANPR asks whether the strategic plan option is an effective alternative method of evaluation for financial institutions. The strategic plan option represents, in principle, an important alternative method of evaluation, particularly for firms with non-traditional business plans and operations. In fact, the strategic plan option is likely to become more important over time, as firms use an increasingly wide variety of means – including the internet, ATMs and POS, interstate and global branches -- to collect deposits, otherwise seek funding, make loans and investments, and provide services. Moreover, firms are increasingly meeting the credit needs of communities through a variety of affiliates that may or may not be subject to CRA. The fact that so few firms have used the strategic plan option to date argues strongly for the need to make the option easier to exercise, in part by providing assistance in development, speeding up review, and providing greater certainty and speed in examination of firms that have adopted such plans.

5. Performance Context

The ANPR asks whether the performance context is effective in appropriately shaping the quantitative and qualitative evaluation of an institution's record. In my judgment, the flexibility provided by the performance context assessment is one of the most critical aspects of the CRA regulation. It permits precisely the type of locally based decision making contemplated by Congress in enacting CRA. The performance context permits financial institutions to respond to local needs based on their own institutional organization and business plan, without being judged on the basis of national norms. Rather, examiners look to local context and the business strategy of the bank or thrift. The performance context also permits greater citizen participation in the formulation of the assessment, which may increase its accuracy, and its perceived legitimacy. The performance context also gives examiners the opportunity to evaluate the extent to which the bank or thrift relationships with affiliates or third parties enhances or diminishes the ability of the depository to meet the credit needs of its community. Based on a non-scientific review of a number of large bank examination public evaluations, however, examiners could benefit from additional training and education in more clearly linking an understanding of performance context with an assessment of performance.

6. Assessment Areas

The ANPR asks whether the regulation's current definition of assessment areas, which are tied to geographies surrounding physical deposit-gathering facilities, provide a reasonable and sufficient standard for designating the communities within which the institution's activities will be evaluated. For most institutions, the assessment area test has worked reasonably well. However, in an era in which banks collect deposits, raise funds, and make loans across states, national borders, and over the internet, "community" is going to need to be redefined. A more flexible approach is needed that lets banks better define their own low- and moderate-income target markets for providing loans, investments, and services, while strengthening protections against gerrymandering. A more tailored approach might permit institutions to emphasize different product and geographic markets in different contexts for assessment purposes, again, with strong anti-gerrymandering protections. For example, in some contexts, a bank might better serve its entire community by competing with non-bank lenders to make affordable loans to subprime borrowers in areas where it has no branches, rather than emphasizing prime loans in a tight market where it has branches. Adopting a more flexible approach to assessment areas is more complicated for the agencies to administer, and in some ways riskier for financial institutions and community organizations, than the current approach. Nonetheless, the CRA regulations will need to evolve with the marketplace if they are to be effective in the years ahead. Perhaps the prudent course if for the agencies to experiment with a more flexible approach to delineating assessment areas in the first instance in the context of institutions selecting the strategic plan option.

7. Activities of Affiliates

As financial institutions increasingly rely on a broad range of affiliations to carry on their businesses, the CRA regulations will need to take account of those business practices. It

is both possible and desirable to take account of affiliate activity while respecting the fact that CRA applies only to insured depository institutions.

First, permitting financial institutions, at their option, to include activities of affiliates in meeting the credit needs of their community, with safeguards against gerrymandering, as under the current practice, is consistent with this approach, and critical to an accurate measure of CRA performance. That is true as to direct performance – e.g., the provision of home mortgage loans by an affiliate – as well as to indirect performance – e.g., procedures to "upstream" borrowers from subprime affiliates to prime borrowing from the bank or thrift itself, as indicated by the interagency questions and answers.

Second, also consistent with the statute is the current approach of the OCC, which considers a bank or thrift's subsidiaries' assets in determining the performance context in which a bank or thrift operates. In principle, the assets and activities of all of the affiliates of a bank or thrift should be considered in assessing the performance context under which a bank or thrift meets its obligations under CRA. After all, a bank or thrift's affiliates are hardly irrelevant to the basic business decisions that banks or thrifts make with respect to their business plans, including their plans to meet the credit needs of their communities. In the wake of the congressional decision in the GLB Act to make financial holding companies' commencement of newly authorized activities, or its merger with newly authorized entities, contingent on satisfactory CRA performance by all of the affiliate banks or thrifts, a bank or thrift's affiliates have a strong interest in ensuring adequate CRA performance by all the insured depositories of the holding company. Thus, the agencies should include the assets and activities of affiliates in assessing performance context for CRA examinations of banks and thrifts.

Third, the CRA regulations already provide that evidence of illegal credit practices will affect an institution's CRA rating. The laws governing such credit practices are equally applicable to banks and thrifts as well as non-depository creditors. Illegal credit practices of an affiliate that has been included at the option of the depository institution for purposes of a CRA examination are certainly relevant to its rating, but so too are the illegal credit practices of affiliates not so included. Enforcement of these other credit laws will require risk-based examinations of bank and thrift affiliates, and the results of such compliance examinations should be taken into account in understanding the performance context of bank and thrift affiliates under CRA.

8. Data Collection and the Maintenance of Public Files

As discussed above, the collection of data is critical to understanding performance of banks and thrifts under CRA. Current data requirements should be supplemented, as noted above, by the systematic collection of data on performance of banks and thrifts under the service and investment tests as well. With respect to lending data, existing HMDA reporting could be improved by requiring information on interest rate and fees; by removing the 10 percent home mortgage rule for HMDA reporting; and by permitting banks and thrifts to collect information on the race of small business borrowers, see, e.g., Treasury Comments on Board's proposed rules under Regulation B, C, and Z. The

collection and disclosure of information about bank and thrift performance is the essential underpinning of CRA, and of expanding access to financial services for communities.

Thank you in advance for your consideration of these comments.

Sincerely

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