COMMUNITY
REINVESTMENT
FUND

October 18, 2001

269

Internet
www.crfusa.com

Headquarters
2400 Foshay Tower
821 Marquette Avenue
Minneapolis, MN 55402
Phone ~ 612-338-3050
Toll Free ~ 800-475-3050
Fax ~ 612-338-3236
Email ~ info@crfusa.com

California Office
550 Bercut Drive Suite G
Sacramento, CA 95814
Phone ~ 916-498-3764
Fax ~ 916-448-3811
Email ~ ned@crfusa.com

Southwest Office
P.O. Box 552
Clifton, CO 81520
Phone ~ 970-434-5318
Fax ~ 970-434-5317
Email ~ claudette@crfusa.com

Docket No. 01-16

Communications Division
Public Information Room - Mailstop 1-5
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Docket No. R-1112

Ms. Jennifer Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Attention: Comments/OES

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Docket No. 2001-49

Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

SUBJECT: REVIEW OF COMMUNITY REINVESTMENT ACT REGULATIONS

Dear Ladies and Gentlemen:

On behalf of the Board of Trustees of Community Reinvestment Inc. ("CRF"), we would like to take this opportunity to comment on the Community Reinvestment Act ("CRA") Regulations as requested in the Joint Advance Notice of Proposed Rulemaking ("Joint Notice") published on July 19, 2001 in the *Federal Register*.

ccoa1i

BACKGROUND

A national nonprofit organization, headquartered in Minneapolis, Minnesota, CRF provides new loan capital for community-based development organizations by operating a secondary market for their loans. We purchase performing economic development and affordable housing loans from nonprofits, city, state and local governments, and quasi-public agencies, pool these obligations and transform them into securities. These securities are then *privately placed* with banks, insurance companies, pension funds and other qualified institutional investors.

CRF pioneered the application of *securitization* techniques to economic development loans more than 12 years ago, and since that time, has become a leader in the structuring and issuance of community development securities. To date, we have purchased $219 million of development loans from 89 organizations in 22 states and the District of Columbia. CRF has issued 13 Series of its Community Reinvestment Revenue Notes, secured by credits purchased from development lenders. These notes and other financing structures have attracted $179 million from private investors. Additionally, CRF's affiliate/subsidiary, Community Reinvestment Services provides specialized loan servicing for nearly $200 million in development loans and CRF has provided training for more than 500 development professionals across the country.

CRF has been a strong proponent of the Community Reinvestment Act and actively participated in the policy discussions surrounding the revised regulations that became effective on July 1, 1995. We commented at length, on both the Proposed Joint Rule published in the *Federal Register* on October 7, 1994 and on the Federal Financial Institutions Examination Council's Interagency Questions and Answers regarding Community Reinvestment published on October 6, 1997 also in the *Federal Register*.[1] We believed then, as we believe now, that the revised regulations have encouraged depository institutions to be more flexible and innovative in determining how best to meet the credit needs of their communities without impairing their financial performance. Moreover, the implementation of the revised regulations has succeeded in emphasizing an institution's performance rather than the process it conducts to meet it Community Reinvestment Act requirements. Nevertheless, the Joint Notice does raise a number of structural and implementation issues about which we are concerned and therefore, wish to offer our own comments and views.

[1] See Community Reinvestment Fund's letter to the Federal Financial Supervisory Agencies dated November 8, 1994 and to the Federal Financial Institutions Examination Council dated December 4, 1997.

ISSUES FOR COMMENT

1. ***Large Retail Institutions***

The Joint Notice raises a key question as to whether the current CRA regulations "*strike the appropriate balance between quantitative and qualitative measures, and among lending, investments, and services?*"

In general, we believe that the CRA regulations do strike the appropriate balance between quantitative and qualitative measures, as well as among lending, investments and services. However, the category of *large retail institutions* encompasses a wide variety of depository institutions engaged in a broad array of lending, investing and service activities. With the repeal of prohibitions on interstate banking and increasing consolidation of banks and other financial institutions, the profile of the so-called typical "*large retail institution*" may be vastly different than it was even a few years ago. Thus, if depository institutions are shifting their activities away from retail lending and instead are increasing their investment activity or the provision of services then the supervisory agencies should consider adjusting the CRA evaluation process to more clearly reflect or correspond to the activities being conducted by a given financial institution. In other words, if an institution does not significantly engage in retail lending, then the lending test should not be more heavily weighted than the investment or service tests. Rather than discounting the lending test, the CRA evaluation should be adjusted to take into account the other activities an institution is conducting. Modifications or adjustments to the CRA evaluation process should also consider any changes in how or where an institution gathers deposits. We believe that this more flexible or customized CRA evaluation process will enable examiners to better determine whether or to what degree an institution is meeting the credit needs of the communities it serves.

A. ***Lending Test***

The Joint Notice raises two issues related to the lending test, as it applies to *large retail institutions*, which are of particular concern to CRF as a secondary market entity and a securitizer of economic development and affordable housing loans.

First, the Notice raises the question of whether loan originations and loan purchase should continue to be given equal weight or consideration under the CRA regulations. As an organization committed to providing liquidity for a wide variety of development lenders, CRF is strongly opposed to any changes in the CRA regulations that would discourage these lenders from selling their loans as a means of recapitalizing their lending operations. Moreover, in order for the secondary market for development loans to expand and become more

economically efficient, the volume of loans bought and sold must increase. Any disincentives to such loan sales will only result in the market remaining small and illiquid. This, in turn, will force depository institutions to be portfolio lenders, unable to expand their development lending activities because they are unable to recapitalize their operations through the sale of existing loans. In addition, discouraging loan sales limits the capital available for community development financing activities by not permitting these assets to be sold and securitized – a process which enables a whole new class of investors to finance/invest in community development activities.

Not only are loan sales an important source of liquidity, but for many institutions that lack the capability to originate loans, it is their only means of acquiring such assets. Thus, one potential danger of giving greater consideration to loan originations, as opposed to loan purchases, would be to place institutions without an origination capability at a distinct disadvantage in terms of their CRA evaluation.

Despite our strong belief that loan purchases should be accorded the same treatment as loan originations under the regulations, we recognize that there have been abuses by institutions seeking to influence their CRA ratings. Specifically, these institutions have purchased and sold the same loan(s) repeatedly in order to enhance their rating. We *strongly* disapprove of such activities and respectfully suggest/recommend that the supervisory agencies should develop a means of determining when an institution is engaged in "churning" its loan portfolio in order to meet its CRA requirements. In other words, regulators need to develop a way of distinguishing the difference between a loan purchase that is carried out merely to obtain CRA credit and a loan purchase that provides additional capital for community development by increasing liquidity among development lenders.

If the goal of the CRA regulations is to encourage depository institutions to increase the amount of capital available for community and economic development, then discouraging loan purchases and stifling secondary market activity, by giving greater weight to loan originations would appear to directly undermine that goal.

Second, we also wish to briefly comment on the issue of how the agencies treat secondary market activity. In particular, the regulations currently capture purchased loans under the lending test and purchased asset-backed securities under the investment test. As an issuer of securities backed by economic development and affordable housing loans we firmly believe that this dichotomy provides important flexibility for depository institutions under the regulations, since they must meet both lending and investment test requirements. As will be discussed below, the supply or availability of *qualified investments* and asset-backed securities that meet the investment test

requirements may vary from region to region. This reflects the fact that secondary markets for community development loans are still in the early stages of development. In order to encourage the growth and development of these markets and the securities created from loans traded in these markets, we strongly support maintaining the flexible approach taken by the current regulations.

B. ***Investment Test***

CRF is particularly interested in investment test and how it is applied to *large retail institutions*. The Joint Notice raises three issues that we believe are relevant to our activities, as well as having broader implications for the development of *qualified investments*.

First, we would first like to share our views on the question of "*whether it is appropriate to evaluate institutions' investment activities*" and if so, how should these activities be evaluated in light of the other tests, and in particular, in light of the lending test. The supervisory agencies touch on this issue tangentially in section 1 on *large retail institutions*, when they ask, "*whether the regulations strike the right balance between lending, investments and services.*"

As a secondary market entity and an issuer of Community Reinvestment Revenue Notes, CRF believes that investment activities are "invaluable in helping to meet the credit needs in low- and moderate-income communities." Our mission as an organization is to develop and refine the process by which economic development and affordable housing loans are purchased, pooled and packaged into marketable securities that can be sold to institutional investors. We therefore, believe that the investment test is an important component of the CRA regulations. We also appreciate and support the importance of the lending test as the "*primary vehicle for meeting a community's credit needs.*" But we recognize the changing nature of how capital is being delivered in mainstream communities and need to adapt those new financial mechanisms or techniques to the needs of low- and moderate-income communities.

To reconcile the need to maintain the primacy of the lending test while incorporating new vehicles for delivering capital to communities, we propose that *large retail institutions* that have achieved a satisfactory rating be given full credit under the CRA regulations for *qualified investments* regardless of whether those investments are outside of its designated assessment area. The rational for this approach is that depository institutions making such investments, even those outside of their assessment area, are engaging in a *market building activity* and thus should receive recognition or credit for those activities that help to increase liquidity by building a more efficient and

sophisticated capital delivery infrastructure to serve low- and moderate-income communities.

A second, and related issue has to do with concerns about the availability or the limited supply of *qualified investments.* Initially, this was a serious concern for many depository institutions trying to meet the requirements of the investment test. However, there has been a dramatic increase in the number of targeted CRA investments backed by affordable housing loans and issued by government-sponsored enterprises (GSEs). While we welcome the efforts of the GSEs to develop a broader secondary market for affordable single-family mortgages, the growth of highly customized securities designed to meet the CRA needs of depository institutions raises the question of what is driving the capital allocation process. In other words, are the CRA requirements of banks and thrifts dictating where capital for affordable housing is being deployed or is capital being allocated to communities where it traditionally has not been available and for housing activities that meet the needs of low- and moderate-income residents?

It is also interesting to note that although investments backed by affordable housing mortgages has grown significantly, *qualified investments* supporting economic development activities, such as financing small businesses, have not expanded to the same degree.

In our experience, one of the key constraints on the availability or supply of asset-backed *qualified investments* is the very nature of the vehicle itself. An investment that is collateralized by loans incorporates the aspects that have made structured finance or *securitization* an enormously successful means of raising capital. Specifically, an asset-backed security incorporates the risk mitigating principle of diversification by pooling a large number of loans from different geographic locations and with differing terms and characteristics. While diversification enhances the attractiveness of the security to an investor, but its very composition, it reduces the benefits from a CRA perspective, the regulations require the investment to target or focus on specific geographic assessment areas. Unless a security can be created using loans that identically match the assessment areas of a particular depository institution, then the bank or thrift will only receive credit for those loans made in its assessment area or a "broader statewide or regional area that includes their assessment area." Thus, there is a difficulty in reconciling safety and soundness concerns with the need to meet CRA requirements as they are currently drafted.

We have also received comments from banks seeking to invest in our notes that if an examiner sees the same investment in the investment portfolio of two institutions, only one institution can be given credit for this investment. Again, the structural nature of investments, e.g. the fact that often there are many investors, makes it difficult for a depository institution to receive consideration

under the CRA regulations. In the last two issues of Community Reinvestment Notes, we have tried to address this issue of how to allocate credit by providing letters indicating where specific loans are located, and how these locations fall within a bank investor's assessment area. After working in this marketplace for more than a decade, we have discovered that these issues create serious obstacles to expanding the supply of asset-backed securities that meet the definition of *qualified investments* because they prevent CRF, and others like us, from building long-term relationships with investors. Instead, what we often find is that a depository institution will make a single investment in one of our issues but is discouraged from becoming a repeat investor. This hampers the issuance process and limits our ability to distribute our securities.

Finally, the third issue raised in this section, relates to concerns that the innovative and complex elements of the investment test lead to a constant demand to change programs, even where existing programs are successful, just to maximize CRA consideration. We found this concern to be particularly disturbing because we know how long it takes to develop an innovative market and to create complex securities backed by community development loans. Having been focused on these activities for more than a decade, we can still say that our activities and our securities are *still* innovative. Developing a secondary market or an alternative liquidity source for economic development and affordable housing loans is a lengthy process that could take many more years before market practices and players are institutionalized. Similarly, securitizing these loans is still in its infancy as evidenced by the absence of public ratings for these transactions (in part, reflecting the small volume of these securities) and very narrow investor base. Thus, it we would contend that the terms "innovative" and "complex" should be applied to investments and activities that are still in their formative stages and not yet highly liquid, despite the fact that organizations, like CRF, have been engaged in developing these activities or investments over a number of years. Without sustained efforts to build secondary markets and refine investment securities, community development finance will not be able to benefit from the tremendous technological changes taking place in mainstream financial markets.

Before leaving the investment test section, we respectfully suggest that this test may warrant further study by bank and thrift regulatory agencies. Moreover, given the relatively specialized nature of *qualified investments* and the limited number of organizations issuing these securities, the supervisory authorities might wish to call upon private groups or individuals with expertise in this area – perhaps through a task force or other forum devoted to reporting on these issues.

D. ***Community Development Activities of Large Retail Institutions***

The Notice indicates that some individuals and organizations have voiced concerns about the definition of "community development" and whether it is broad enough to cover the full range of activities that should receive favorable consideration in a CRA evaluation. CRF believes that the definition of community development is, with perhaps one exception, comprehensive enough to cover all the activities that should be considered for CRA purposes. The one exception we feel may have been inadvertently overlooked involves loans made to medium sized or large firms that provide jobs to low- and moderate-income individuals. While all small business loans are generally counted toward an institution's CRA requirements, loans to larger companies fall outside of consideration. We think that the regulations should grant equal weight to loans that have an economic or community development component, such as providing employment for low- and moderate-income residents or stabilizing or revitalizing distressed areas.

We would also concur with those who believe that *large retail institutions* should receive full consideration for community development activities anywhere they are conducted, as long as the institutions have adequately addressed the needs of their assessment areas. This approach coincides with not only the treatment for wholesale and limited purpose institutions, but also the proposal we put forth above in section B. Investment Test, that *large retail institutions* should receive full credit for investment activities, regardless of where they take place as long as the institution has a "low satisfactory/satisfactory" rating under the lending test. As we explained above, we believe that full credit should be granted in order to encourage institutions to engage in path breaking or market building activities that they might otherwise not chose to conduct.

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

The CRA performance of *small institutions*[2] is evaluated under a streamlined test that focuses exclusively on the lending activities of banks and thrifts. Agencies consider an institution's loan-to-deposit ratio, the percentage of loan in its assessment areas, its record of lending to borrowers of different income levels and businesses and farms of different sizes, the geographic distribution of its loans and its record of taking action in response to written complaints about its performance in helping to meet the credit needs in its assessment area(s).

[2] A *small institution* is defined as an institution having total assets of less than $250 million that is independent or is affiliated with a holding company with total bank and thrift assets of less than $1 billion as of the two preceding year ends.

CRF appreciates the importance of the lending activities of small banks and believes the factors used to evaluate an institution's performance under the CRA regulations are clearly appropriate and useful. However, as an organization dedicated to recapitalizing development lenders through the securitization of their loans, we believe that there should be some sort of recognition and incentive for *small institutions* interested in investing in community development securities or activities. While we agree the lending factors identified in the streamlined test should remain the principle criteria when assessing the institution's performance, we firmly believe that the goals of the Community Reinvestment Act will be best served by encouraging innovative approaches for making capital available in distressed communities and providing as much flexibility as possible for small institutions seeking to meet their CRA requirements. For example, there may be instances in which a small institution would find it very beneficial to consider investing in some type of community development security. However, without the ability to receive any sort of credit, even "extra credit, for this investment, a small bank or thrift may not be able to justify making such an investment.

We also believe that the benefits associated with structured finance and other sophisticated financial techniques should not be the exclusive domain of large retail institutions. Our objective is to foster understanding of and investments in our Community Reinvestment Revenue Notes among depository institutions of all sizes. Without some degree of recognition or credit for these investments, we believe that *small institutions* will not be motivated to even consider making investments in securities that support community development activities or organizations in underserved communities. We therefore, respectfully suggest that the agencies explore various ways to modify the streamlined test applied to *small* institutions in order to take these investments into account.

6. ***Assessment Areas***

The question posed in this section of the Notice relates to whether or not the provisions that define an institution's assessment area, which are tied to geographies surrounding physical deposit-gathering facilities, provide a reasonable and sufficient standard for designating the communities within which the institution's activities will be evaluated during a CRA examination. We commend the supervisory agencies for their willingness to raise this controversial issue and to recognize the dynamic changes taking place in the banking and financial services industries. As a secondary market entity and a securitizer of economic development and affordable housing loans, CRF has long been aware of about the increasingly tenuous relationship between where and how an institution gathers its deposits and where it conducts the bulk of its

lending activities. The advent of the Internet bank provides the clearest example of the type of institution that both gathers deposits and makes loans on a national level. In our own business, we expected wholesale and limited purpose banks, which provide specialized products and services on a nationwide basis, to be very interested in our Community Reinvestment Notes because they include loans originated in many geographical areas. What we discovered is that these institutions are in fact the *least* interested in our securities because their assessment areas are determined by the location of their main offices (often in places like Delaware and South Dakota), not by the location of their lending or financing activities. In our view, the tremendous technological changes taking place in the banking industry, coupled with the repeal of interstate banking prohibitions and the Glass Steagall Act have vastly altered the way depository institutions operate today and will operate in the future. We believe the supervisory agencies need to recognize that some of these institutions serve a national marketplace, not simply a local geographic area and thus should be granted a national assessment area for the purposed of their CRA evaluation. We understand that this approach raises a whole new set of questions, such as how an institution could possibly meet the credit needs of its community, if that community is composed of the entire country. Nevertheless, given the radical changes taking place in banking today, we believe that if CRA is to remain an effective tool for channeling capital to underserved communities, then its regulations must take into account the current state of the industry.

7. ***Activities of Affiliates***

Finally, we would like to offer one point of clarification with regard to the activities of affiliates. The Notice observes that the current regulation allows institutions to decide whether or not they wish to have the activities of its affiliates considered as part of their CRA evaluation. According to the agencies, some have suggested that this approach allows institutions to target different customers of different income levels through affiliate or associated lending organizations. Specifically, the Notice refers to the practice of providing products and services targeted to middle- and upper-income customers either through affiliates or by "*lending through consortia.*" We were surprised by the use of the term "*consortia*" here. In our experience, lending consortia have been effective vehicles for a group of institutions to pool their community development resources and expertise in a specialized organization dedicated to meeting the credit needs of low- and moderate-income communities. Rather than being a means of avoiding institutions' CRA responsibilities, loan or lending consortia have been the key components of their shareholding institutions CRA strategies. CRF has purchased loans from several such loan consortia and they have proven to be an excellent source of credit for many distressed communities. We respectfully suggest that the supervisory agencies may wish to clarify their use of this phrase or term and to

recognize the important contribution these lending consortia are making to communities across the country.

In closing, we commend all of the Federal financial supervisory agencies for their efforts to reform and improve the Community Reinvestment Act regulations. We also thank the agencies for this opportunity to share with them our views concerning potential revisions to these regulations. We would be pleased to provide further assistance and information to this interagency effort on any of the issues discussed in this comment letter.

Sincerely,

Frank Altman
President