Center for Community Change

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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

Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Docket No. R-1112
Ms. Jennifer J. Johnson
Secretary, Board of Governors of
the Federal Reserve System
20th St. & Constitution Ave., NW
Washington, DC 20552

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20551
Attention Docket No. 2001-49

Dear Sirs/Mesdames:

The Center for Community Change appreciates this opportunity to provide comments on the Advanced Notice of Proposed Rulemaking regarding the Community Reinvestment Act (ANPR). The ANPR raises a series of important questions about the current rules. Our response to these questions and other issues we believe are important are discussed below.

The Center for Community Change (CCC or the Center) is a national, not-for-profit organization, with offices in Washington, D.C., San Francisco and Los Angeles, that specializes in providing technical assistance and training to community-based organizations seeking to improve the conditions of low-income and predominately minority communities. CCC's history with CRA is a long one. Our staff was there at the birthing process for CRA, providing input and guidance in the drafting of the statute, and for companion laws, such as the Home Mortgage Disclosure Act (HMDA). Since then, we have been a leading source of advice and assistance on CRA to local groups in urban and rural areas.

CRA has been a critically important law for older urban and underserved rural communities. The law recognized the importance of private sector lending and investment to the health and well-being of these communities. CRA also has helped to curb redlining, the once-common practice whereby lenders shunned low and moderate-income and minority communities and which contributed so much to the deterioration of these areas. By all indications, CRA is making a difference. The U.S. Treasury Department's CRA study found that institutions covered by the Act had a higher level of lending in low and moderate-income communities than institutions that were not examined under the statute.

The 1995 changes to the CRA rules received broad support from community groups and lenders alike. The increased emphasis of these revised rules on performance was applauded by all

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stakeholders and has helped to spur new lending activity to underserved areas. This progress must continue and should be the primary consideration for the review of the rule currently underway.

Accordingly, key points addressed by our comments are as follows:

- On the whole, the current regulatory framework appears to be working. The three-pronged large bank exam, with its emphasis on lending performance and quantitative measures should be maintained. CRA is first and foremost a lending law and the rules should reflect this emphasis. Thus, the rules should not be revised to provide more weight to the two other tests (investment and service).

- More needs to be done through the CRA exam to discourage the rapid rise in predatory and high-cost lending, and to encourage lenders to make as many prime loans as possible and provide mainstream banking services to underserved areas. The CRA rules should also encourage lenders to expand options for borrowers who may qualify for a prime loan, were that option available.

- The CRA rules must be modernized to reflect changes in the way financial services are now being provided to consumers. Rules governing assessment areas must take into account not just the physical locations of Internet and other non-traditional banks, which may be limited. They should also encompass markets served by these institutions through electronic means or alternative delivery systems.

- CRA ratings must do a better job of taking into account the performance of large lenders in small and less populated rural market areas. Too much emphasis is currently placed on large urban centers, providing too little incentive for large multi-state banks to make every effort to ensure that these areas are being adequately served.

- More attention should be given to the CRA process. Outside contacts with interested parties as part of CRA exams should be increased, especially for small bank exams. More and better information should be provided through CRA Performance Evaluations to enable the public to better compare the records of their local lenders.

- The current $250 million asset threshold for banks qualifying for the streamlined exam should be maintained. Most lenders already qualify for this truncated procedure; permitting additional banks would particularly provide non-metropolitan areas with much less information about how their local institutions are performing.

Our more detailed comments follow.

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

Do the regulations strike the appropriate balance between the quantitative and qualitative measures, and among lending, investments and services? If so, why? If not, how should the regulations be revised?

The revised CRA rules adopted in 1995 emphasized performance over process. The new rule also sought to provide clearer and more objective standards and thus, provide for more consistency for CRA exams. For large banks, the new rules replaced the 12 old CRA assessment factors, which were criticized by lenders and community groups alike for being much too process driven. Quantitative measures were used as a means for accomplishing these objectives (i.e., the application of statistical measures, such as the number and amount of loans made, the distribution of loans, etc.). The emphasis on performance has improved CRA exams and help to foster increased CRA activity. It is essential, therefore, that the focus on outcomes be maintained.

Some have suggested that the current large bank exam places too much weight on quantitative measures and outcomes and not enough on qualitative factors, by which they seem to be referring to anomalies in certain limited markets. They complain that applying quantitative measures may encourage lenders to engage in non-economic behavior (i.e., making unprofitable loans) in order to obtain good CRA ratings. However, there is no independent evidence to confirm that this has been the case. On the contrary, research conducted by the Federal Reserve Board and others has found that CRA related activity has been reasonably profitable for those lenders actively engaged in these efforts.

This is not to suggest that lenders never compete with each other by lowering their prices for particular products. In fact, they do it all the time. Sometimes they compete for short periods by offering below market "loss leaders" (e.g., free checking, teaser rate loans, reduced fees, etc.). Such activity can be termed non-economic, at least over the long haul, but they do it to increase their market share and build their customer base. There is no evidence we are aware of to suggest that lenders in general do this any more frequently for low and moderate-income households or neighborhoods than they do for other consumers. They probably do less of this activity for this demographic group. This is not to say that an individual lender, or a group of lenders in a specific market, might not seek to overcome a long-term disinvestment pattern and seek to win back a market segment by making products available below cost for a limited duration. You would expect the market to operate this way. In and of itself, this should not necessitate a wholesale shift away from the use of quantitative measures for CRA purposes.

Non-economic behavior perhaps can also arise in a CRA context when lenders are seeking to fulfill their responsibilities by offering the same or substantially similar products (i.e., single family mortgage loans) for a specific assessment area. This could lead to a situation, from time to time, where the supply of certain loans exceeded the demand for this type for credit. For example, in a large urban area in which a majority of the housing stock was rental apartments, lenders might compete for the relatively small single family mortgage market and an oversupply of these loans could create certain uneconomic effects (i.e., lenders willingness to pay a premium for CRA related single family loans). Of course, lenders could find ways to receive credit in

such markets by addressing other credit needs likely to exist (need for multifamily financing, small business lending, etc.).

However, should such situations arise, we believe this can be addressed through refinements to the existing performance based approach. For example, such information could be contained in the Performance Context, which then would permit examiners perhaps to place greater emphasis on more qualitative factors for a particular assessment areas than they normally would. Again, such limited situations can be addressed through exceptions to the existing rules.

While we support a continued emphasis on performance and quantitative measures, we also believe that more can be done to sharpen the way in which qualitative factors are used in CRA exams. However, qualitative factors should not be used to raise what would otherwise be a failing grade or even a low-satisfactory grade for any of the three tests (i.e., qualitative factors should be used only to raise a grade from high-satisfactory to an outstanding level).

One of the ongoing challenges for the CRA exam is how to provide adequate consideration for activities that while perhaps small in volume, are critical to the health of certain local communities. Some have voiced concerns that lenders tend to take the simplest path to obtaining a satisfactory CRA grade, preferring to concentrate on generating volume for plain vanilla loans, rather than rolling up their sleeves, and tackling important community needs, but which may entail higher transaction costs or greater degrees of complexity.

The current rules already attempt to address the "degree of difficulty" problem. They provide for examiners taking into account a range of qualitative measures, such as the use of "innovative and flexible lending practices." The community development component of the three tests for large banks also is intended to reward lenders for their efforts in tackling these types of opportunities. For example, the lending test gives consideration to the "complexity and innovativeness" associated with the community development loans. The application of qualitative factors is also more extensively addressed through the Interagency Questions and Answers Regarding Community Reinvestments.

Further, the current rules afford a multifamily loan with a special double weight for grading purposes, in an effort to reflect the greater degree of difficulty often associated with this type of lending. Thus, a multifamily loan is counted for the general lending test and then counted again for calculating the community development lending activity engaged in by the institution.

We believe these qualitative measures should help to balance the more quantitative aspects of the CRA assessment process. To the extent that they are not, we suggest that examiners receive additional training and guidance to help them weigh these factors appropriately. However, here again, addressing this concern need not necessitate de-emphasizing performance and the application of quantitative measures for determining a CRA grade.

A. Lending Test

Does the lending test effectively assess an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

Large retail banks and thrifts (assets in excess of $250 million) are evaluated on the basis of three tests: lending, investments, and service. The lending test was designed to be the cornerstone of the 1995 assessment process. Reflecting CRA's history, lending receives twice the weight of the investment and service tests. The lending test looks at performance characteristics, such as loans made, the ratio of lending inside and outside of an assessment area, the geographic distribution of lending by geography, the distribution of lending by borrower characteristic, loans to economically disadvantaged and small businesses, community development lending, and the use of innovative and flexible products.

The strong emphasis on lending in the CRA exam is appropriate and we believe it should be maintained. The lack of credit availability still is a major concern for many low and moderate income and minority families and underserved geographic areas.

At the same time, changes in the structure of the financial services industry and the way in which services are provided to consumers would seem to necessitate that the lending and two other tests place more attention on the quality of activity that is occurring, and not simply the volume. In particular, over the past five years there has been a rapid rise in predatory lending and fringe banking activities in markets still underserved by more mainstream financial institutions. Consequently, the CRA rules should be modified to reflect those activities that are constructive for low and moderate-income households and geographies and those that are not.

Predatory lending occurs primarily in the largely unregulated subprime mortgage market, which has grown substantially over the past half dozen years. The HUD/Treasury Department report released last year found that while the subprime market can provide an important function, it can also be a fertile ground for predatory lending (see *Curbing Predatory Mortgage Lending:* A Joint Report, HUD/Treasury, 2000).

The HUD/Treasury report recommended that lenders should be denied CRA credit for the origination or purchase of loans with predatory terms. The report also recommended that the Federal Reserve Board use new authority provided to the agency under the Gramm Leach Bliley Act to examine not just depository lenders, but affiliates of these institutions to ensure that they do not aid and abet predatory lending practices.

We agree strongly with both of these recommendations and urge that the CRA rules be revised to expressly reflect this fact. Currently, the rules are silent on disallowing CRA credit for these loans. Lenders engaged in making predatory loans or aiding or abetting this type of abusive credit activity should be barred from receiving a CRA grade higher than less than satisfactory.

Second, the CRA rules should provide positive credit for lenders that provide opportunities to move borrowers from the subprime to the prime market. Thus, CRA credit should be given to lenders who, either directly or through their affiliates, offer to promote borrowers who make on-

time payments from subprime to prime loans. Further, the rules should take into account successful efforts by lenders to institute systematic efforts to "refer up" prime worthy borrowers who may unknowingly seek a loan from a high cost affiliate when they could qualify for a cheaper loan. Both of these recommendations are in accord with the HUD/Treasury report.

But the CRA rules need to go further than discouraging illegal predatory practices. They need to take a more qualitative approach to determining whether loan activity is of value to households being served and constructive to communities in which this activity is occurring. Accordingly, examiners should be instructed to consider the impact that a particular type of credit, such as high-cost loans are having on low and moderate income borrowers and the neighborhoods in which they are being made. Such an analysis is critical, since evidence suggests that the lack of competition from prime lenders in low-income and minority neighborhoods has increased the chances that borrowers in these areas are paying more for credit than they should, regardless of whether or not these loans are classified as predatory.

Last year, HUD found that the overall number of high-cost or subprime loans reported under HMDA increased ten-fold from 1993-1999. The Department's research also revealed that subprime loans were five times more likely in predominately African American neighborhoods (than in white neighborhoods) and three times more likely in low-income neighborhoods (than in upper income neighborhoods). The rapid growth of these loans in minority and low income geographies is a major change in the lending dynamics of these areas since the current CRA rules were adopted.

Perhaps some of this disparity may be explained by differences in credit behavior, but the absence of mainstream lenders has no doubt also contributed to the concentration of high-cost lending in low-income and minority neighborhoods (see Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development, Woodstock Institute, Chicago, 1999). HUD also found that upper-income black borrowers rely more heavily on the subprime market than low-income white borrowers, suggesting that a portion of subprime lending is occurring with borrowers whose credit would qualify them for lower cost conventional prime loans. There is also evidence to suggest that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they present (see Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, *Subrpime Lending: An Investigation of Economic Efficiency*, Freddie Mac, 2000). Also analyses by Fannie Mae and Freddie Mac suggest that some portion of subprime lending is occurring with borrowers whose credit would qualify them for loans sold to the GSEs.

Federal regulators have noted the link between the growth in subprime lending and the absence of mainstream lenders. Ellen Seidman, Director of the Office of Thrift Supervision, has stated: "Many of those served by the subprime market are creditworthy borrowers who are simply stuck with subprime loans or subprime lenders because they live in neighborhoods who have too few credit or banking opportunities." Further, Comptroller of the Currency, John Hawke, voiced similar sentiments last year, when he stated that, "We must target not just the predators themselves, but conditions that allow them to flourish. That means encouraging responsible competition in the same markets in which the predators operate." An increased presence by

prime lenders could possibly reduce the high interest rates and fees currently being paid by many low and moderate-income borrowers.

Whether it is abusive practices, the lack of mainstream lender competition, or both, the high foreclosure rates for subprime loans provide concrete evidence that many subprime borrowers are entering into mortgage loans that they simply cannot afford. HUD and other recent studies have documented the wave of foreclosures now coming out of the subprime market. HUD found that subprime loans accounted for 45 percent of all foreclosure petitions in Baltimore, compared with only 21 percent of all loan originations. A study by Abt Associates found that while the overall volume of foreclosures in Atlanta declined by 7 percent between 1993 and 1996, the volume of foreclosure action initiated by subprime lenders grew by 232 percent. Another study by the National Training and Information Center found that the subprime share of all mortgage foreclosures in the Chicago area has skyrocketed, up from 1.3 percent in 1993 to 35.7 percent in 1998. This research reveals that subprime foreclosures are disproportionately concentrated in low-income and predominately African American markets. Thus, the concentration of foreclosures can have devastating effects on neighborhoods and quickly undo progress made to increase homeownership opportunities and revitalize local areas.

The research also demonstrates that subprime lenders are quicker to foreclose. In Chicago, Atlanta, and Baltimore, the research shows that subprime lenders foreclosed more quickly than FHA and prime lenders. In Baltimore, for example, the mean lag between loan origination and the date that the foreclosure petition was filed was only 1.8 years for subprime, compared with over 3 years for FHA and prime loans. This suggests that many subprime borrowers are entering into loans that they simply cannot afford and subprime lenders are all too eager to make without consideration of the borrowers' ability to pay.

Unfortunately, the current rules do not have a mechanism for taking destructive lending activity into account, since all loans are treated equally for the purposes of determining a lender's CRA rating. Given the history with high-cost lending, examiners should be required to review as part of a CRA exam whether subprime activity engaged in by the lender is actually serving a legitimate purpose (i.e. providing loans to credit impaired borrowers). Examiners should be required to consider such factors as whether the lender is: routinely providing high-cost loans to credit worthy individuals who could qualify for cheaper loans, selectively marketing high-cost loans to low and moderate –income and minority neighborhoods (since so much of this activity is concentrated in these areas), or otherwise engaging in two-tiered banking practices (with modest income borrowers being routinely afforded inferior products). Moreover, the collective impact that these high cost loans are having in particular neighborhoods (i.e. high concentrations of foreclosures) also should be considered.

Distinguishing between prime and subprime would entail the separate reporting for each type of loan. However, this approach need not be onerous or particularly burdensome to lenders, if the HMDA reporting requirements are altered to require this distinction. (The Federal Reserve Board is currently considering whether to require lenders to report on their subprime mortgage activity).

On another front, we believe that loan originations should be calculated separately from puchased loans. While purchased loans serve an important function, and may help to increase

liquidity, they do not involve the same degree of investment in infrastructure (i.e., personnel, physical facilities, etc.) that originations require. Thus, the lending exam should reflect this distinction.

B. Investment Test

Does the investment test effectively assess an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

The 1995 rules wisely incorporated investment activity into the evaluation for large banks. The inclusion of this component reflected recognition of the importance that non-debt financial support plays for community development. We recommend that the investment test should be maintained as a separate test. The elimination of this test would lessen the incentive for lenders to provide equity investments, deposits to CDFIs and others, non-member shares in community development credit unions, or grants that meet one or more of the definitions of community development activities.

Some critics of the investment test say that a separate evaluation for this activity may inadvertently dictate a lender's decision about what form of financing to use (i.e., debt vs. equity). However, we have not seen evidence to suggest that this is a widespread problem, if it is one at all. In any event, we believe the existing rules (or perhaps through the Interagency Questions and Answers) are adequately flexible for enabling an investment to be counted for lending exam purposes. However, this approach should only be used for lenders that already have a satisfactory or higher rating and not to beef-up what would otherwise be a substandard record.

In addition, we are aware that some would prefer to see the community development activities removed from the lending and service tests, and combined with investments as part of a separate community development test. However, we believe such an approach would be a mistake. Establishing a separate community development test is likely to dilute the importance of the lending test. Combining all community development activities under a separate test is also likely to marginalize even further this activity from the mainstream operations of lenders. Thus, we believe the investment test must remain a separate component of the large bank exam.

Much of the complaint with the existing investment test could be addressed by sharpening the application of qualitative factors. The present test does not adequately differentiate between different types of investments. Thus, grants, Low Income Housing Tax Credits, equity investments in economic development projects, socially responsive investments, and deposits in eligible institutions are treated the same for CRA purposes, even though each of these activities involve different risks and expected rates of return. The lack of differentiation serves as a disincentive for lenders to provide investments that are in the shortest supply. Similarly, the investment test should encourage investments that are particularly responsive to a community's needs (as reflected in the Performance Context for an assessment area).

C. Service Test

Does the service test effectively assess an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

The Service Test is intended to evaluate an institution's record of helping to meet the credit needs of its community(ies) by analyzing the availability and effectiveness of its system for delivering retail banking services. The current components of the evaluation include an analysis of the distribution of the bank's branches, its record of opening and closing branches (particularly those located in low and moderate income neighborhoods or serving low and moderate income people), the availability and effectiveness of alternate systems for delivering banking services, and the range of services the bank provides and the degree to which they are tailored to meet the needs of particular communities.

A second element of the Service Test is the extent and innovativeness of the bank's community development services, which must benefit the institution's assessment area(s) but may also benefit a larger statewide or regional area that includes the assessment area(s). In this evaluation, examiners are to look at the extent to which the institution provides community development services and their innovativeness and responsiveness.

The Service Test was instituted in 1995 in recognition of the fact that access to deposit services was essential for low and moderate income people to gain access to credit. Obtaining a bank loan is impossible without first acquiring a bank account. On an even more fundamental level, access to safe, secure and affordable deposit services is critical for the creditworthiness of low and moderate- income individuals. It provides both physical and financial security for handling money, allows people to pay their bills in an efficient and timely manner, offers an opportunity to save money and earn interest on savings, and helps to build a credit history.

In addition, the availability of affordable banking services has an impact on the economic conditions in low and moderate-income communities. In the absence of such services from banks, people may spend substantial sums of money purchasing services from fringe banking institutions. A recent study by the Fannie Mae Foundation estimates that consumers spend $5.45 billion a year on fringe banking services, including check cashing, payday loans, pawnshops, rent-to-own, and auto title loans. (See James H. Carr and Jenny Schuetz, "Financial Services in Distressed Communities: Framing the Issue, Finding Solutions," Fannie Mae Foundation, June, 2001.)

The structure of the Service Test recognizes the critical link between deposit services and access to credit, reflecting the history of CRA as a law designed to enhance access to credit. To maintain this link, it limits its consideration to services that are directly related to accessing credit. The essential nature of CRA is also reflected in the weight given to the Service Test, 25% of the bank's overall rating. The Center believes that the basic outline of the service test and the weight it receives are both appropriate and should be maintained.

However, the Service Test has not been effective as a means to evaluate banks' systems for delivering retail banking services for two reasons:

1. The test lacks qualitative analysis.

2. The test lacks quantitative rigor.

With respect to the first, any effective examination of the deposit services an institution provides must begin with some analysis of the types of services needed in a particular community. Much research has been done, by the banking regulatory agencies and others, about the retail banking services needs, practices and patterns of low and moderate income individuals. We know that people need access to affordable ways to pay their bills and carry out other financial transactions. In immigrant communities, for example, there may also be a demand for wire transfer services. We also know much about the barriers that deter low and moderate income people from using retail banking services. These include lack of convenience (in terms of branch location, hours of access, and the mix of products and services offered), high opening and minimum balance requirements for checking accounts, high bounced check fees, and excessive cost for certain products (such as money orders), among others. Because of these barriers, many low and moderate income people turn to other types of financial service providers – check cashers, payday lenders and the like – to fulfill their needs.

While the agencies, collectively, have substantial knowledge of the deposit service needs of low and moderate- income consumers and communities, this knowledge has not found its way into the CRA exam process. Examiners should begin with an assessment of the deposit service needs of low and moderate income communities, and be given better guidance on how to compare the bank's product offerings (including account features and pricing) against those needs. It is not enough to note, for example, that an institution offers a low cost checking account. Examiners must make some assessment about how well the features and terms of the account respond to local needs, and how effectively the institution markets that account to low and moderate income communities.

With respect to the second shortcoming of the service test, we have found very little quantitative analysis in CRA evaluations of the types of deposit or community development services provided by lending institutions. Examiners may note that an institution offers low cost checking accounts, for example, but do not look to see how many of these accounts have been opened. This type of quantitative analysis should be conducted for all of the products and services for which a bank claims credit under the Service Test. Just as examiners look at quantitative measures under the Lending Test, similar analysis is needed in the service area to evaluate the effectiveness of a bank's activities. The Service Test, as currently structured, would be greatly enhanced if examiners had the tools they need and the proper guidance for analyzing lender performance in delivering banking services.

D. Community development activities of large retail institutions

Are the definitions of "community development" and related terms appropriate? If so, why? If not, how should the regulations be changed?

Inclusion of community development activities as a separate factor within each of the tests was an innovative result from the 1995 rule writing process. It acknowledged the emergence of the community development sector and also the critical role these activities play for revitalizing distressed communities. However, the way "community development" is defined in the current rules needs some further refinement.

The clear intent of the rule is to encourage lenders to provide financial and other support for community activities in low and moderate-income areas. This is reflected in the fact that eligible affordable housing and community service activities must serve this income group in order to count for CRA purposes. However, a glaring omission from this approach exists in the definition for "activities that promote economic development by financing businesses or farms," which permits consideration of virtually any loan, investment, or service, regardless of location. Here the rule omits any reference to these activities having to serve low and moderate-income communities in order to qualify. Thus, lenders can get CRA credit for almost any conceivable financing they do, so long as it meets the business size requirements set out in the rules.

Thus, we recommend that the rules be revised to make them consistent with the other components of the definition (i.e., housing and community services). Accordingly, only those business activities located in low and moderate-income geographies should be counted for qualifying community development purposes.

Are the provisions relating to community development activities by institutions that are subject to the lending, investment, and service tests effective in assessing those institutions' performance in helping to meet the credit needs of their entire communities? If so, why? If not, how should the regulations be revised?

Community development was defined separately under the CRA rules to reflect the recognition that there are some loans, investments, and services that are important to the infrastructure and well being of communities, but which might not generate sufficient volume to compete with more mainstream activities of lenders (loans to consumer and businesses, purse income generating investments, along with deposit and other banking services). To encourage lenders to support these activities, the current the large bank test gives special weight to these activities. This is an approach that we think should be maintained (but, as noted previously, we do not support combining them into a separate community development test).

The mainstream activities of lenders remain critical to local community well being. The CRA statute was and is intended to encourage institutions to make affirmative efforts to help serve important needs. There is still a need for CRA to consider this "bread and butter" lending. Community development activities are important, to be sure, and their inclusion as a separate factor for the lending and service tests helps to encourage lenders to support less volume oriented activities than they otherwise might.

However, the establishment of a separate, consolidated community development test (incorporating elements from the three tests) may help to address some technical issues concerning how to count different types of activities, but it is unlikely to result in a net gain for community development. The only way this is likely to happen would be at the expense of the lending test, which would be unfortunate. Reducing the weight assigned to lending is critical to maintaining the increased CRA activity that has occurred since the 1995 rules were adopted.

The ANPR also asks whether large banks should be permitted to receive CRA credit for community development activities undertaken anywhere in the country, regardless of whether it is outside of the lender's assessment areas or the states or regions in which these areas are located. We are concerned that, however well-meaning the intent, such an approach would dilute the attention of large lenders from their local assessment areas. For one thing, encouraging lenders to maintain strong ties to their local communities has always been at the heart of CRA. Also, from our review of the CRA exam reports, adequate standards have yet to emerge to determine whether a lender first adequately provided for the needs of its local assessment area(s), and should be allowed to claim credit for activities elsewhere.

Accordingly, the focus should continue to be first on local assessment areas, and only second on the larger states and regions in which these assessment areas are located.

2. Small institutions: The Streamlined Small Institution Evaluation

Do the provisions relating to asset size and holding company affiliation provide a reasonable and sufficient standard for defining "small institutions" that are eligible for the streamlined small institution evaluation test? If so, why? If not, how should the regulations be revised?

Small banks are defined as those with assets under $250 million. The definition does not include lenders with assets under $250 million that are part of bank holding companies with combined assets over $1 billion. Nearly 80% of all depository institutions meet this definition. The small bank exam was introduced into the 1995 rules to simply things for those truly smaller institutions with minimal staff to handle compliance considerations. We believe the current threshold is an appropriate one and should not be changed.

To increase the current threshold, as some may suggest, would mean that local communities would be provided much less detailed analysis of a larger number of lenders. This is particularly important for rural America, where these small institution play such a pivotal role. For these areas, increasing the number of lender eligible for the streamlined exam is likely to decrease access to credit and other banking services for lower income residents, small and minority-owned businesses and farms, and community development efforts.

We are mindful that as with any threshold requirement, there will be some lenders just below and just above the line. Consequently, those transitioning from a small bank exam to the large bank test may argue that they are being disadvantaged. Apparently, some have suggested that the rules

be changed to provide for a "mid-size" exam, or an increase in the asset size allowable for the streamlined treatment. However, there does not appear to be a need for these changes.

The current regulation already builds in a transition period for institutions whose assets skirt up just above the threshold. Specifically, the large bank rules apply only to those lenders whose assets exceed $250 million for two prior calendar years. This wiggle-room allows for banks to grow more than $250 million in assets and still be considered a small bank. Indeed, there are examples of lenders with assets of $700 million, and even $850 million that are still examined under the streamlined rules.

Because of this built-in flexibility in the current regulation, lenders do not suffer adversely on their first CRA exam as a large bank, at least as reflected in the ratings they received. For example, we reviewed the exams of banks at the margins that were examined by the FDIC from January 1, 2001 until October 1, 2001. As of March 31, 2001 FDIC supervised 1694 institutions with assets between $250 million and $1 billion - the next closest regulator, the OCC, supervised 955 (more than 700 fewer banks in this size range)[1]. Seventy-one of these lenders were examined under the large bank exam this year; all were previously eligible for at least one streamlined examination. We found that the ratings of 55 banks either stayed the same or improved after making this transition. Only 17 of these lenders' ratings appeared to have declined.

Another argument against increasing the current $250 million asset threshold is that it would conflict with the way small banks are defined for examination purposes in the 1999 Financial Services Modernization Act in "Subtitle B Community Reinvestment, Section 809. Small Bank Regulatory Relief," which is also set at $250 million. Thus, increasing the existing threshold would be in conflict with the most recent legislative definition of a small institution. Based on the prior cited evidence and the legal conflict shown above, we urge that the threshold for the streamlined exam remain at its current level.

Are the small institution performance standards effective in evaluating such institutions' CRA performance? If so, why? If not, how should the regulations be revised?

The focus of the small bank exam should be sharpened, so that examiners take a more critical look at each bank's activities and the extent to which it is using its resources to serve the needs of the under-served areas and residents within its assessment area(s). More detailed information on small bank performance should be made available to the public through the CRA Performance Evaluation.

[1] FDIC Statistics on Banking, March 31, 2001

3. Limited Purpose and Wholesale Institutions: The Community Development Test

Are the definitions of "wholesale institution" and "limited purpose institution" appropriate? If so, why? If not, how should the regulations be revised?

The definitions of "wholesale institution" and "limited purpose institution" are not sufficiently precise. Currently, a limited purpose institution offers only a narrow product line, such as credit cards to a regional or national market. A wholesale bank is not in the business of making retail loans or services to customers. However, the regulators seem to have too much discretion in awarding these designations, which has led to some undesirable results. In some cases, institutions receiving these special designations seem to be determined through a self-selection process.

One example occurred last winter, when MetLife, one of the largest insurance companies in the country, applied to the Office of the Comptroller of the Currency to purchase Grand Bank, a one-branch bank in New Jersey. At the same time, Metlife requested wholesale designation under CRA for the bank. The OCC was poised to grant this designation, although all of the media coverage concerning the acquisition documented MetLife's business strategy of operating the bank as a retail institution. The OCC seemed willing to grant this wholesale designation, until community organizations filed complaints and raised questions about its appropriateness. Eventually, MetLife was asked to withdraw its application and the request for the designation was dropped.

As this example demonstrates, clearer standards should be provided for determining whether institutions qualify for either wholesale or limited purpose designation.

Does the community development test provide a reasonable and sufficient standard for assessing wholesale and limited purpose institutions? If so, why? If not, how should the regulations be revised?

The community development test appears to be an appropriate measure of performance for an institution that can truly be considered a wholesale or limited purpose bank or thrift. However, a key issue remains as to how community development lending, investments, and services should be counted outside of what is usually the institution's limited assessment area. From our review of CRA exams, we could not discern the existence of adequate standards to guide examiners on how to determine whether or not an institution has adequately addressed the needs of its assessment area, prior to beginning to count the community development activity outside of the assessment area.

The percentage of adequate activity within the assessment area seemed to vary by institution. For example, both Morgan Guaranty Trust Company and Chase Manhattan Bank and Trust Co., N.A. received 'outstanding' ratings on their most recent examinations. However, while Morgan made 88% of its community development loans within its assessment area, Chase apparently made only 21%. Despite these dramatically different records, both received outstanding ratings and both were allowed to count activity outside of their assessment areas for CRA ratings purposes.

Clearly better standards are needed.

Would the community development test provide a reasonable and sufficient standard for assessing the CRA record of the other insured depository institutions, including retail institutions? If so, why and which ones and how should the regulations be revised? If not, why not?

We do not favor the establishment of a separate community development test for large retail institutions for the reasons discussed in section, "B. Investment Test".

4. Strategic Plan

Does the strategic plan option provide an effective alternative method of evaluation for financial institutions? If so, why? If not, how should the regulations be revised?

The strategic plan option has not developed as an effective alternative method of evaluation for financial institutions. By all accounts, it is rarely used or even considered by lenders. Only 14 out of 9,821 FDIC insured institutions have chosen this option. Since so few institutions have utilized this option is it hard to say whether or not it has achieved its purpose, which we gather is to provide a lender with greater certainty about the rating it will receive if it achieves certain stated goals, which have been approved by its regulator.

It would appear that the greater clarity and more discernable standards found in CRA exams, have largely reduced lender interest in this alternative approach. We encourage the regulators to provide the industry and consumers an analysis of how well the strategic plan option has achieved its objectives for the few lenders who have made use of this option.

5. Performance Context

Are the provisions on performance context effective in appropriately shaping the quantitative and qualitative evaluation of an institution's record of helping to meet the credit needs of its entire community? If so, why? If not, how should the regulations be revised?

An important innovation in the 1995 regulations was the establishment of the performance context. This was designed to set the framework within which an institution's performance was assessed, whether that institution was subject to the large bank test, the small bank test, the community development test, or a strategic plan. As part of the performance context, examiners are to look at demographic data pertaining to the bank's assessment area(s), information about lending, investment and service opportunities in those assessment area(s), the institution's product offerings and business strategy, institutional capacity and constraints, the bank's past performance and performance of similarly situated lenders, the bank's public file, and any other information the agencies deem relevant.

The performance context is especially important for two reasons. First is the tremendous variation among institutions, in terms of size, location, product offerings, business strategy, and the like. These differences have to be taken into account for any kind of rating system to yield meaningful results. A small bank in a rural community faces a different set of needs and opportunities than a small bank in an urban area. The rural small bank also has different resources and constraints than the branch of a megabank located in the same community. At the same time, communities vary tremendously, and these locational variations are just as important for meaningful evaluations as are the institutional variations. Context is fundamental, and that is what the Performance Context was designed to address.

As the result of the Performance Context provisions of the regulation, examiners are now providing the public with much more detailed data about the conditions of the local communities in which the institutions they examine operate. Information about the condition of the local economy, major employers and employment trends, housing market conditions and trends, and the like, which can now be found in CRA performance evaluations, is very helpful. We encourage all the agencies to continue to provide this information.

However, the Performance Context is not being used to its fullest potential to provide the necessary backdrop for evaluating the CRA performance of individual lenders. For example, examiners do not consistently incorporate information about the lending, service and investment opportunities in each of the bank's assessment areas. Without this information, it is difficult for the public to assess how well the institution is taking advantage of the opportunities available, and the extent to which it may be acting above and beyond -- or, for that matter, lagging behind -- the average institution in a particular market. Nor do examiners regularly provide information about how a lender's performance compares to that of its peers. Without this kind of comparison, each bank's evaluation appears in a vacuum. Providing such a comparison would help the public to place the institution and its CRA record in a larger context and would make the overall evaluation more meaningful.

The Performance Context could also be used to address issues that are of concern to the agencies but difficult to address directly in the CRA exam. An example of this is subprime lending. Few insured depositories are heavily engaged in subprime lending, but quite a number have affiliates who are. This raises a number of issues of great concern to community groups, including whether the bank is as aggressive as its subprime affiliate in seeking out qualified applicants in low and moderate income communities and communities of color, whether there is a refer-up program in place, and whether the bank and its affiliates offer loan products that allow borrowers to move up from the subprime to the prime market. These issues are addressed in more detail in our discussion of the Lending Test. The Performance Context provides the examiners with an opportunity to discuss how the bank and its affiliates fit into a larger picture, which would enable the public to understand the role of the bank more clearly.

We urge the agencies to build upon the progress that has been made with some elements of the Performance Context and provide examiners with the guidance and support they need to address the full range of performance context items spelled out in the CRA regulations, so that this

portion of the examination can truly provide a context for understanding each bank's record in each of its assessment areas.

6. Assessment Areas

Do the provisions on 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 during an examination? If so, why? If not, how should the regulations be revised?

The method for defining assessment areas must be revised to encompass the way increasing numbers of banks operate in today's environment. Yet, the assessment area concept should not be eliminated, as some have suggested. Care must be given so that the regulators do not throw the baby out with the bath water. The tremendous consolidation in the financial services world has created fewer but larger banks, covering huge geographic areas. These institutions tend to focus their attention on the largest cities within their territories, devoting less attention and resources to smaller communities and rural areas. The assessment area approach may ensure that this is not always the case, by maintaining the connection of banks to their local communities, which has been a key concept for CRA all along.

The CRA rules should be revised to require lenders to incorporate into their assessment areas not only where they have a physical presence, but also those areas in which they obtain a substantial amount of deposits or make substantial numbers of loans. Thus, a mega-bank that collects deposits via internet banking would be required to include as an assessment area those parts of the country where it obtained substantial deposits or had a substantial market share for lending. The same would be true for internet-only banks, and for insurance companies, or auto manufacturers and other types of commercial firms that own a local bank for the purposes of selling financial services to a broader area than the one in which the physical institution happens to be situated. For example, the business plan of many thrifts owned by insurance companies or security firms includes use of their sales force, rather than branches to interact with clients.

In looking at the few CRA performance evaluations that have been completed for internet-only institutions and insurance or security owned thrifts -- many of the PEs show a preponderance of lending outside the assessment area. Examples include:

- 98.5% of Travelers Bank & Trust, FSB's loans were made outside its assessment area (OTS, February, 2001, Community Reinvestment Act Performance Evaluation)
- 83.64% of First Internet Bank of Indiana's loans were made outside its assessment area (FDIC, December, 2000, Community Reinvestment Act Performance Evaluation)
- 57% of Security First's loans were made outside its assessment area (OTS, September, 1999, Community Reinvestment Performance Evaluation.

In all of these cases the institution still received outstanding or satisfactory CRA exam ratings. Thus, it appears that examiners are provided with too much discretion in interpreting how to assess CRA performance. The rules need to provide additional guidance for determining how to

judge activity by non-traditional institutions outside of their limited assessment areas, as discussed above.

7. Activities of Affiliates

Are the provisions on affiliate activities, which permit consideration of an institution's affiliates' activities at the option of the institution, effective in evaluating the performance of the institution in helping to meet the credit needs of its entire community, and consistent with the CRA statute? If so, why? If not, how should the regulations be revised?

Financial services modernization has changed the ways in which lending and financial services are provided to the public. Today, particularly among the nation's largest banks, more and more of the lending and the provision of other banking services occurs not simply through depository institutions, but through specialized non-bank affiliate companies (e.g., prime conventional mortgage companies, subprime consumer finance entities, and the like). As part of this trend, depository institutions are finding themselves connected with affiliates routinely engaging in predatory loan practices or fringe banking arms charging extremely high and unreasonable fees to consumers.

Unfortunately, the CRA rules are antiquated in this area. They provide the lender (i.e., depository institution) with an option to include the activities of any of its affiliates in determining its overall CRA performance. Consequently, lenders are free to pick and choose among their different affiliates, selectively the activities only of those, which they believe, reflect positively on their own record. This approach permits lenders "to game" the evaluation in an effort to portray themselves in the most favorable CRA light.

The CRA rules should be updated to reflect the current realities in the financial services marketplace. The regulators have long maintained that they do not have sufficient authority to enable them to systematically consider activities of affiliates. Assuming this view is legally correct (a view we do not share), the rules still can be revised to encompass more affiliate activity than is currently the case. One way to accomplish this would be for the rules to specify that once a depository elects to have *any* affiliate's activities considered as part of its own record, the records of *all other* affiliates of the institution would be considered as well. This would preserve the lender's option to include or exclude the record of affiliates. At the same time, it would prevent lenders from "gaming" the system by selectively including the record of certain affiliates while excluding others.

8. Data Collection and Maintenance of Public Files

Are the data collection and reporting and public file requirements effective and efficient approaches of assessing an institution's CRA performance while minimizing burden? If so, why? If not, how should the regulations be revised?

CRA performance evaluations (PE) for lenders are available to the public. Perhaps not for the regulators, but certainly for the average citizen, these reports are an important means for learning about how well a lender is serving local community needs. Along with the composite rating, the PEs' contain a narrative report supporting the evaluation the lender has received on its CRA examination. The PE also contains certain loan and other data institutions are required to collect and maintain for CRA purposes, including the following: small business and farm loans originated and purchased, aggregate number of community development loans originated or purchased, affiliate lending if to be considered, consortium or third-party lending if to be considered. Home Mortgage Disclosure Act data is used by CRA examiners, but is not technically part of the CRA disclosure requirements.

Providing well formated, meaningful statistical data and other information is essential to making the CRA process work for communities. Unfortunately, the loan data reported for CRA purposes often does not achieve what should be its primary objective – providing sufficiently detailed information to enable readers to compare for themselves the performance of banks operating within their local areas.

Accordingly, we suggest several revisions to current CRA loan disclosure requirements:

- Report small business data in a format more comparable to the format used for reporting mortgage loans under the Home Mortgage Disclosure Act (i.e., applications, approvals and denials, withdrawn, incomplete). Further, the Federal Reserve Board should finalize the proposal that it has pending that would enable banks to report on the race and gender of the small business owner obtaining a loan.

- Report community development loan data on a census tact basis (currently, it is only reported in the aggregate). Also, the purpose of the community development loan should be reported by category (i.e., housing, economic development, community services, etc.).

- CRA exams should analyze prime and subprime loans separately (such a revision to HMDA that would require lenders to report on their subprime mortgage loan activity is currently pending with the Federal Reserve Board).

- Report qualified investments under the investment test by category and amount.

Further, it would be helpful to the public to provide more quantifiable measures of activities that are counted under the service test (e.g., number of basic banking accounts by geographic levels, the extent to which electronic and other alternative banking services are provided, etc.).

Other Comments

Outside Contacts

We recommend that the agencies maintain, and even expand, the practice of contacting local experts in conjunction with CRA exams to gain local insight into both the credit needs in particular communities and the extent to which the institution being examined is meeting those needs. Community organizations of all types – advocacy groups, neighborhood organizations, community development organizations, coalitions, civil rights groups, and other – have a wealth of information that can help examiners better understand the dynamics of particular markets. Similarly, various government agencies – planning offices, housing and community development offices, housing finance agencies, etc. – have valuable insights to offer examiners about the needs they have identified, the programs they offer that can help banks address those needs, the plans underway that might affect low income areas, and their experiences with local lenders. These outside contacts are critical in shaping the performance context sections of CRA exams, as well as for making fully informed judgments about each bank's performance. They should be used widely and should be a routine part of every exam.

Rural Issues

Although the ANPR did not raise specific questions about how well the current CRA regulations address the needs of rural communities, the Center believes that this topic deserves a separate discussion. Many rural communities find themselves in a precarious position with respect to access to credit. Small institutions tend to play a critical role in rural areas. The fact that they receive a disproportionate share of the less than satisfactory CRA ratings suggests that, despite their claims to the contrary, small institutions do not always serve their local communities effectively. However, these institutions are subject to a truncated CRA evaluation and, since enactment of the Gramm-Leach-Bliley financial modernization legislation, are examined relatively infrequently. All of this suggests that conscious steps must be taken if CRA is to be an effective tool for encouraging these institutions to help meet the credit needs of their local communities. On the other hand, if large banks have a presence in rural communities, the role that they play in those areas may have little impact – positive or negative – on their overall CRA rating. This aspect of CRA exams also needs strengthening. Further, the data available on lending activity in rural communities is less than ideal. All of these issues should be addressed as the agencies undertake the current review of the CRA regulations.

To address these problems, first, the Center urges the agencies to take a tougher stance when evaluating small institutions with low loan to deposit ratios. Community groups in rural areas report that, even in states where the average loan to deposit ratios for banks range from 80-100%, examiners judge 40-50% loan to deposit ratios to be "reasonable," without providing any explanation of their findings. Past evidence suggests that some small banks act more like mutual funds than banks. They collect local deposits and invest them in various securities for the benefit of a small number of shareholders or large depositors, rather than making loans in their local communities. Unless there are specific extenuating circumstances, such institutions should not

be viewed as adequately serving local credit needs. They should receive a less than satisfactory CRA rating.

In addition, we recommend that community contacts be made a regular part of CRA exams for small institutions, a practice that does not appear to be followed consistently now. Outside contacts are invaluable in helping examiners understand the needs and opportunities in rural areas (as they are elsewhere), and also how well a particular institution is doing in addressing those. It is important for examiners to tell the community contacts which bank they are examining, a matter of public record, if they are to get feedback on a particular institution.

Second, we recommend that the agencies also take a tougher stance with respect to their evaluation of the performance in rural areas of large banks. Too often, this aspect of large bank performance gets only cursory review. The Performance Context is abbreviated and lacks detail, there do not appear to be community contacts conducted, and examiner expectations seem to be lower than they are – for the same bank – in urban areas. Rather than evaluating the extent to which a large bank is bringing its resources, expertise and products to bear on the problems of rural markets, the examiners seem to expect large institutions to be doing less in these areas. Further, even when an examiner notes that a large bank is not performing at the same high standard in its rural assessment areas as it is in the urban areas, this lower level of performance seems to have no impact on the bank's overall CRA rating. It seems as though there is an unwritten rule that rural areas carry less weight, perhaps because they generate fewer deposits. There is no policy to support this position. In fact, an early interagency CRA policy statement established the policy that the level of a bank's performance in low and moderate income communities should be measured, not against the deposits generated from those communities, but rather against the lending opportunities that exist there. The statement noted that lower income areas, by definition, generate less deposits, but that a lower level of deposits was not indicative of the potential loans a bank might make. The same should be true for rural communities when compared with their urban counterparts, and the agencies should take steps to make sure that their examiners are aware of this fact.

Finally, with respect to data, we suggest two specific steps to improve the quality of CRA evaluations in rural communities. Both pertain to large banks:

1. Provide greater detail about banks' CRA-qualified investments, both with respect to geographic location and type of investment. A single number and aggregate dollar amount simply do not give the public the level of detail needed to understand and evaluate how well a particular institution is serving the investment needs of each of its local communities. Since banks must start with the individual investment information in order to arrive at the aggregate figure, requiring greater detail should not pose any additional burden (and, in fact, would eliminate one step in reporting). This would also be of benefit in analyzing banks' performance under the Investment Test in urban areas.

2. Improve the quality and accessibility of the non-metropolitan mortgage lending data reported under CRA. Currently, it is very difficult for the public to gain access to these data. There is no central depository for them, they are not available through the FFIEC website, and it is difficult to retrieve them off of the HMDA CD ROMs. Unlike the data for metropolitan

areas, no Census data are provided for rural census tracts or BNAs, and this increases the difficulty of analyzing this information. These data appear to be treated as an afterthought rather than the important resource they could be for analyzing banks' performance in rural areas as well as overall patterns in rural housing markets. We urge the agencies to take steps to rectify these problems.

Another step that would be of great benefit in analyzing performance in rural areas would be for the Federal Reserve Board to amend the Home Mortgage Disclosure Act regulations to, among other things, code manufactured home loans separately from other mortgages. Manufactured homes are a significant part of the rural market, yet they play a very different role than other forms of housing. Similarly, the loans are often underwritten very differently than other mortgage loans, and there are reports of widespread abuses in the manufactured home lending process. The ability to distinguish these loans, and the lenders that make them, would aid greatly in the CRA evaluation process.

Again, thank you for the opportunity to provide these comments. We look forward to a continuing opportunity to work with you toward developing improvements in the CRA rules.

Sincerely,

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