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MEMO

From: Kenneth H. Thomas, Ph.D

To: OCC (2007-0012), FRB (OP-1290), FDIC (RIN 3064-AC97), and OTS (2007-0030)

Date: September 10, 2007

Re: Two Comments on CRA Interagency Q and A (Federal Register, July 11, 2007)

The following two comments are based on my on-going analysis of CRA, some of which has been published in Community Reinvestment Performance (1993) and The CRA Handbook (1998). Also, my 2002 Public Policy Brief on Optimal CRA Reform (www.levy.org) contains further background on my research and recommendations for improved CRA public policy.

1. *NEED FOR* ***OUTSIDE AUDITORS*** *TO VERIFY NO FUND DOUBLE COUNTING.*

We support the views of various community groups, including the NCRC in their 8/30/07 submitted comment in this matter, that the proposed Q&As should further address the issue of "double-counting" of CRA activities and take preventive action to ensure this does not happen. We therefore recommend that the proposed Q&A .23(a)-2 further expand upon the parenthetical note about a national or regional fund "double counting" by REQUIRING an AUDITED statement by an INDEPENDENT OUTSIDE auditor that no such double counting EVER occurred in the subject fund if ANY CRA credit is to be considered. While this would require an added expense to the fund, it would be the best way to ensure actual and potential fund investors that the subject fund had never engaged in "double counting." The current self-regulation in the form of self-serving statements that a fund does not double count is not enough in the current Sarbanes Oxley era where investors need independent outside auditors to verify such key information. We would further propose that in the event that ONE such case of double counting was found at any fund, going back to the very first allowed investment in it, that ALL subsequent investments in that fund be denied credit. Otherwise, such double counting would result in CRA grade inflation as pointed out in the cited NCRC comment.

2. NEED FOR ***NEW*** *NATIONWIDE FUNDS TO PROVIDE FORECLOSURE RELIEF*

We support the views of various community groups, including the NCRC in their 8/30/07 submitted comment, that the proposed Q&As should support foreclosure prevention activities. The proposed Q&A .23(a)-2 gives an example of an investment in a "…new nationwide fund providing foreclosure relief…" We recommend it be expanded to emphasize the need for more NEW funds and affirmatively encourage further such NEW activities. This is because the current subprime crisis is a NEW crisis, our first major financial crisis since the 1997-98 Asian currency crisis. The result has been many foreclosures, estimated at perhaps TWO MILLION or more, and this is all a NEW problem. Therefore, we need NEW nationwide funds to respond to this NEW problem that would not only provide needed foreclosure relief but also needed COMPETITION to existing nationwide funds. Good public policy not only encourages public welfare activities such as foreclosure relief but also increased COMPETITION which lowers prices and raises output.

Both of these comments follow from the 8/30/07 NCRC submitted comment on the proposed Q&As. While we don't agree with all of the material in the NCRC comment, and, in fact, disagree with some of it, we do support their views in the above two instances.

Viewpoint: CRA Due Diligence More Critical than Ever

American Banker | Friday, December 19, 2008

By Kenneth H. Thomas

One of the main lessons learned from the current crisis is that not all investments, whether collateralized debt or mortgage obligations, are what they appear, despite claims and even ratings by a third party.

A related lesson, especially in light of the recent Madoff scandal that has impacted several large financial institutions, is that banks must exercise their own due diligence not only in selecting their investments but also with the third parties with whom they deal.

Recent regulatory releases have addressed these issues relative to Community Reinvestment Act investments. They have taken on new importance with the proposed expansion of CRA to nonbank financial institutions and others receiving government bailout funds.

Assuming this initiative moves forward under the increasingly pro-consumer climate in Washington, including the pro-CRA efforts of House Financial Services Committee Chairman Barney Frank, these newly covered companies would mainly meet their proposed CRA obligations via qualified investments.

The latest interagency Q&A on CRA (http://edocket.access.gpo.gov/2007/pdf/07-3223.pdf) reaffirms credit for indirect investments through a fund whose primary purpose is community development. Community development and related funds can represent excellent opportunities to comply with CRA's Investment Test and Community Development Test.

The recent regulatory discussion of meeting CRA's geographic requirements by investing in a national or regional fund raised for the first time the issue of "double counting" of the same investment for more than one investor. Community groups have been raising the double-counting issue for some time.

The regulators specifically state that " … a financial institution has not demonstrated that the investment meets the geographic requirements of the CRA regulation if the fund 'double-counts' investments, by earmarking the same dollars or the same portions of projects or investments in a particular geography to more than one investor."

It is important to note that none of the large number of national or regional funds that exist were named by the regulators, nor are any specific funds being directly or indirectly referenced here.

This regulatory statement adds a new dimension to banks' due diligence in CRA investing. Self-serving claims by funds or their managers that they have never practiced double-counting is not enough in the current Sarbanes-Oxley and financial crisis era, where investors need outside auditors to verify key information.

Banks and their examiners should require a certified and annually updated statement by an outside auditor that the subject fund has never engaged in any such double-counting.

As part of my recommendations to the regulators on this issue, I suggested that, in the event that even one such case of double-counting is found at any fund — going back to the very first allowed investment in it — the examiners should not only deny CRA credit and publicly report their findings, but also require the fund to inform current and past investors of this problem.

Outside auditors should likewise verify other CRA-credit-related claims by funds or their managers such as community development benefits. They may, for example, be overstated by claiming credit for an entire project rather

than just the pro rata share from the fund's investment.

Also, current credit may be claimed for past investments that were sold or only temporarily held. Exaggerated community impact statements or double-counting results in CRA grade inflation, a mischievous malady that is not unlike bond rating inflation.

One way banks can help ensure they are getting the CRA or other investment promised is to perform their own due diligence when selecting a vendor. To help banks minimize risks when relying on third parties for such important products, the Federal Deposit Insurance Corp. recently issued "Guidance for Managing Third-Party Risk" (http://www.fdic.gov/news/news/financial/2008/fil08044a.html).

The FDIC recommends ongoing comprehensive due diligence in what can be termed its Know Your Vendor program. As part of the "review of all available information" about third parties to minimize reputational and other risks, the FDIC recommends, among other things, checking for the "existence of any significant complaints or litigation, or regulatory actions against the company."

Suggested online resources include the Federal Financial Institutions Examination Council (www.FFIEC.gov) and the Securities and Exchange Commission (www.sec.gov or www.AdviserInfo.sec.gov).

For example, an "Investment Adviser Search" at the latter site under the Madoff firm's name would have revealed a 2005 regulatory action resulting in a censure and fine, which may have at least raised a red flag to inquiring investors.

A final lesson we have learned from the current crisis is that due diligence on investments and their vendors is important not only to protect the value of investments, including CRA credit where appropriate, but also the bank's reputation when dealing with vendors. Recent reports about some conflicted community groups and their role in the subprime crisis suggest that banks likewise consider that source of potential reputational risk.

CRA is being unfairly blamed for many of the problems associated with the subprime crisis, and it would add insult to injury if some funds and/or their managers are inflating CRA investment credit. Bankers and especially regulators must be vigilant to make sure this does not happen.

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