CRA: Revisiting Some Fundamentals

Remarks
by
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Thank you for inviting me to speak here today.

I have been asked to discuss the Community Reinvestment Act and the issues that arise in applying the CRA regulations to the new group of institutions recently chartered by OTS. In addition to the issues raised by new applicants, I would like share my thoughts on the CRA regulations generally, based on our examination experience since the regulations were revised.

As you know, OTS, together with the other banking regulatory agencies, published revised CRA regulations in 1995 after an extensive process that involved two public comment periods and several hearings. Although the regulations went into effect for small institutions in January 1996, large institutions were not subject to regulations until July 1997. In fact, there are many large institutions that have yet to be examined under the revised regulations.

Our examination experience over the last 22 months has indicated that the revised regulations are, for the most part, flexible, performance-based, and fair. In fact, most institutions we have examined under the new rules describe their examination experience as more focused and with fewer surprises. They also say they have a better understanding of what is expected of them.

But there are several "big picture" issues and some substantive implementation concerns that warrant our attention. The most widely-publicized of these issues relates to the limitations of our regulatory notion of an institution's assessment area. This issue has been getting a lot of attention recently because of the charters OTS has granted to "Internet" thrifts and to entities such as Travelers and State Farm.

There are also several other issues that are less visible, but certainly important to the effectiveness of CRA. These issues also deserve careful consideration by everyone concerned about the long-term effectiveness of this statute and the health of all our communities. Some of these issues are covered by the annual questions and answers published by the joint agency staffs, but others compel us to begin thinking about the structure of the regulation itself. They are simply too important to ignore.

As you may recall, when the agencies published the revised CRA regulations in 1995, we committed to undertake a full review of them in 2002. This commitment was made because we knew that, try as we might, we wouldn't fully get it right the first time. Even though we went through two proposals and the benefit of thoughts of several thousand commenters, nothing is as instructive as actual experience to identify the shortcomings and unintended consequences of any regulation.

So now, what to do about the assessment area?

The assessment area is the geographic area within which the agencies evaluate an institution's CRA performance. For most institutions, the regulation's requirement to delineate assessment areas that correspond to commonly recognized metropolitan areas or political subdivisions that surround their branches or deposit-taking ATMs is adequate. This construct, which has been around since the beginning of CRA, is based on a 1977 understanding of how institutions take deposits and make loans. It was reasonable then to assume that branches were the primary means by which institutions gathered deposits and so should define the area in which they should lend.

But with each day, more and more institutions are using alternative product delivery systems rather than the traditional brick-and-mortar branch structure. It is not unusual today for an institution to use mail, telephone, loan production offices, agent relationships, affinity relationships, and the internet to market and deliver banking services. The reach of these systems transcends the regulation's focus on assessment areas in evaluating CRA performance. And, even with its intended flexibility, the revised rule challenges an examiner's ability to measure the CRA performance of these institutions.

The problems with the assessment area definition are as varied as are the business strategies of financial institutions. Some institutions chose to be very visible in the area where their main office is located. These institutions often wish to focus their attention on the low- and moderate-income areas within that community, much the same way that wholesale and limited purpose institutions are allowed to do under the community development test. Other institutions have little or no presence within the area where they are headquartered. Internet banking where, in its purest form, all deposit and loan related activity would take place in cyberspace, vividly illustrates a business strategy that does not look to any one local area for its identity. Rather, these institutions literally view the entire nation and sometimes the world, as their "community."

And, of course, there are an increasing number of traditional retail institutions that are expanding the geographic reach of their deposit and credit markets by introducing alternative service delivery systems as increasingly important adjuncts to their underlying branch networks, or as separate, independent business strategies.

The first and most important point to make about these institutions is that with limited exceptions, all banks and thrifts have a CRA obligation; the issue we're wrestling with is how to evaluate their performance of that obligation. One obvious question that presents itself is whether it is time to expand the traditional notion of community. If we evaluate these institutions solely on the basis of assessment areas delineated around branches, there is little incentive to meet the needs of low- and moderate-income borrowers in areas where institutions lend but have no branches. We need to guard against implicitly fostering a perverse, unintended outcome of actually lessening the CRA obligations of those who operate more and more in nontraditional ways. It makes no sense to create a system of CRA evaluations that distinguishes, not on the basis of the credit products offered by an institution, but on the method by which those products are delivered.

So where do we go from here? The agencies have developed several alternatives to consider; undoubtedly there are others, which we'd like to learn about.

One possibility is to expand the scope of the community development test. The new regulations define two categories of institutions that can avail themselves of the community development test: wholesale and limited purpose. Wholesale institutions are those that are not in the business of extending home mortgage, small business, small farm, or consumer loans to retail customers. Limited purpose institutions are those that offer only a narrow product line (such as credit card or motor vehicle loans) to a regional or broader market. These institutions, such as CEBA credit card banks, were difficult to evaluate under the old regulations and as wholesale or limited purpose institutions, they are now evaluated on the basis of their community development lending, qualified investments and community development services in their assessment area and the broader statewide or regional area that includes the assessment area. Moreover, where the institution adequately meets the needs of its assessment area in this way, examiners also consider its community development activities <u>outside</u> of its assessment area or broader statewide or regional areas that include the assessment area. This feature of the community development test is particularly helpful to institutions with a national deposit or lending reach.

However, because they offer a full array of credit products to the retail public, many of the nontraditional institutions that are presenting assessment area issues under the regulation do not qualify for treatment as either wholesale or limited purpose institutions. One possible avenue for addressing the assessment area problems of these institutions might, therefore, be to broaden the eligibility for the community development test to encompass a larger variety of nontraditional institutions.

On the other hand, the CRA regulation, at its core, is based on the notion that a financial institution that provides retail services should help meet the credit needs of its entire community by providing loans in that community. There are many non-branch based institutions lending on a regional or nationwide basis to all borrowers, including those with low or moderate incomes. Should these institutions be able to demonstrate their commitment to CRA with their lending performance in all income segments in all lending areas without regard to where they may have an office?

For example, the agencies could expand upon the regulatory definition of assessment area by allowing institutions to delineate areas not only where they have their main office, branches and deposit taking ATMs, but also where they either gather a substantial amount of their deposits or make a substantial portion of their loans. If the agencies were to take this approach, they would have to find a way to prevent institutions from delineating only those areas where their CRA performance looks good. However, I am sure that precautions against this kind of “cherry picking” can be designed.

Another possible approach is suggested by the statutory assessment area provided for institutions that are established primarily to serve military personnel or their dependents. As Congress recognized several years ago, the notion of a geographic assessment area is irrelevant to evaluating the CRA performance of an institution whose customers are spread across the world. Their solution: create an customer-based assessment area. This solution is one that, by analogy, may be applicable to other non-branch based institutions. It is certainly an alternative worth exploring, particularly as more institutions are being chartered as a means of servicing pre-existing customers of a credit union or an affiliated financial services provider, such as a brokerage or insurance company.

Sometimes I think there are as many different options for solving this problem as there are business strategies of financial institutions. Which brings me to the strategic plan option. The regulations give all institutions the option of operating under an approved strategic plan.

The strategic plan option requires that an institution consult with community representatives on an informal basis in developing a plan for helping to meet the credit needs of its community. Once the plan is developed, the institution must formally notify the community that it is available for review for a period of at least thirty days. Plans must then be submitted for approval to the institution’s primary regulator. The regulations require that strategic plans have annual, measurable goals. They may cover a period of up to five years.

Why would an institution pursue the strategic plan option? It provides more certainty in the evaluation process for an institution willing to spend the time to develop a plan in consultation with its community. For institutions with unusual business strategies, the strategic plan provides flexibility, because it allows institutions to tailor the criteria used in their evaluation to their business strategies. The plan option allows institutions to emphasize investments over lending or to combine lending, investment and service goals in any way that is justified by the institution’s business plan and the needs of its community.

The strategic plan recently approved by OTS for Household, FSB offers a good example of the flexibility institutions have in tailoring their CRA obligation to their particular business strategies. In that case, Household established goals for community development activities within the Chicago metropolitan area, where its home office is located, as well as lending goals related to its consumer loans with the AFL - CIO.   Household's business arrangement with the AFL - CIO illustrates how the customer-based relationship can substitute for a branch-based assessment area. Household's plan demonstrates that serving consumers with a particular affinity—in this case AFL-CIO membership -- can effectively address an institution's obligation to help meet the credit needs of the low- and moderate-income segments of a nationwide market.

Unfortunately, there have been very few strategic plans approved since the new regulations became effective.   It seems that the option is perceived as more work than it is worth.

We often hear that institutions are concerned about giving away confidential information in their business plans or that community groups will ask for more than institutions feel they can commit to in a plan. We don't believe that these concerns should drive institutions away from exercising the strategic plan option. The regulations specifically allow institutions to provide confidential information to the agencies separately from the strategic plan. All that we ask is that the goals contained in the plan are measurable and specific enough for the public and the agency to judge its merits.

None of the institutions that submitted plans to the agencies indicated that working with community groups to develop the plan was particularly difficult. And, quite frankly, our review of public comments submitted in the formal comment phase leads us to believe that the concern over public participation is overstated. Moreover, nothing in the regulations or in any interagency guidance we have issued on the strategic plan suggests that the agencies would require an institution to meet the demands of any particular commenter.   On the contrary, we are looking for reasoned comments from the public on credit needs in the community and appropriate responses on the part of institutions to those comments.

Even so, for most traditional lenders the strategic plan may be more work than is necessary. But for institutions that are using non-branch delivery systems to do business, this option may be well worth the trouble and time to do a plan. The rewards are these: your CRA obligation can be met using the expertise that you have within your institution, with goals that reflect your institution's overall business, and you can rest well knowing exactly what needs to be done to accomplish that satisfactory or outstanding CRA rating at the next examination.

Let me reiterate: no matter what the right answer is to the assessment area question, one thing is certain: institutions have an obligation to the low and moderate-income segments of the communities they are chartered to serve.   That obligation is not going away.   Our goal over the next several months is to be sure that financial institutions have the flexibility to meaningfully meet their CRA obligation within the context of their business and the communities they truly serve.

Now I would like to focus on a few issues related to the lending, investment and service tests, both in terms of the criteria we use to evaluate these tests and in terms of their interplay in assigning an overall CRA rating to an institution.

The lending test for large, retail institutions considers both originations and purchases of loans. There are some problems inherent in considering purchased loans. The incentive to buy and sell loans over and over again among institutions covered by CRA does not lead to more dollars in the communities where credit is needed. The consideration of loans purchased during the examination period often provides institutions with a last minute quick fix for poor origination performance during the time between exams.

Is this the kind of performance that we should encourage? Or where this type of activity is evident, should purchased loans receive less weight in an examiner's overall evaluation of an institution's lending?

The reason that the regulations consider purchased loans in the lending test is because sometimes there are good reasons for purchasing loans. Purchased loans are an important source of liquidity, especially where one or more institutions that are not very good at making some of the more difficult loans needed in the community team up with others that have such expertise. But I believe that the agencies must find ways to discourage the churning of loans from one institution to another for the sake of hitting the numbers they believe are necessary to achieve a good lending test rating.

The regulations place emphasis on lending in evaluating CRA performance. In simple terms, the lending test is weighted at 50 percent of an institution's overall grade; the investment and service tests count for 25 percent each. The formula was established to ensure the primacy of lending when evaluating CRA performance. The agencies built several controls into the formula to assure that an institution could not receive an overall rating of "satisfactory" without having satisfactory performance on the lending test.

The regulation's emphasis on lending, combined with its equal consideration of loans that are purchased as well as originated during the examination period, may have encouraged some institutions to count loans and buy market share rather than to creatively meet the credit needs of their communities. Some insured depository institutions are, in essence, funding the mortgage operations of entities (such as mortgage bankers) that are not covered by CRA, often at a premium. While some might argue that this new market in "CRA loans" will benefit low- and moderate-income communities and individuals by providing more money for loans to these areas and individuals, it is useful to think about the long-run implications for institutions serving low-income communities in this way, as well as whether it is a good idea to encourage depository institutions to fund the operations of "unregulated" competitors rather than serve the needs of their communities directly.

As a corollary to this issue, I am also concerned about how the CRA regulations affect institutions that are "large" for examination purposes, but, in a relative sense are dwarfed by their competition. Smaller, community-based institutions face stiff competition from larger entities with a national marketing reach. Some are having a difficult time keeping their loan rates in line or in processing loan applications as efficiently as their competitors. These competitive difficulties challenge these institutions to find creative ways to support their neighborhoods – whether through different loan products better matched to community credit needs, or through deposit or other services.   Currently, our examiners consider these contextual factors as part of a CRA evaluation. Even so, the CRA regulation should encourage and reward this creativity better than it does now.

Aside from lending, the CRA regulations direct institutions to use investments and services to help meet the credit needs of their communities. Institutions may not be taking full advantage of the investment and service opportunities available to them. One part of the problem may be that the CRA regulations are very specific about the types of activities that are considered under the investment and service tests and it is taking some time for institutions to familiarize themselves with those requirements; another part of the problem may rest with how those activities are evaluated under the rating system. Should the CRA regulations inspire more creative use of investment and service opportunities, particularly in institutions that are employing less traditional product delivery methods?

For instance, institutions that heavily use the Internet to deliver products, may be serving very few low- or moderate-income individuals or communities. Nonetheless, those institutions have expertise and resources that could benefit the low- and moderate-income segments of their communities.   Establishing computer resource centers in public libraries, providing training on the use of computers in financial management, or assisting small businesses with their computer needs are just a few ideas of how a nontraditional bank or thrift could help meet the financial needs of their community within the bounds of their business plan and expertise. Similarly, institutions that plan to use their relationship to other financial services providers, such as insurance companies, for product delivery could be thinking about the investment and service opportunities that might be available through such affiliates.

I'm not saying this is the end of the issue or that we should ignore lending. What I am saying is that service and investment are important too and we need to take them more fully into account.

Another issue that arises under the investment test regularly has to do with the agencies' distinction between quantitative and qualitative evaluation criteria. All too often we hear that institutions fear sticking with programs or community partnerships that work because they have been done already and, therefore, are no longer "innovative." Let me just say that this is not what was intended by adding qualitative criteria to the investment test. Rather, the agencies were trying to encourage even the small dollar investments in communities that are so badly needed by recognizing the work that the institution put toward the investment.

Yet we still hear the tales of frustrated bankers who are in their communities doing the hard work, who believe that the agencies are more likely to reward large dollar investments in targeted mortgage-backed securities. I want you to know that's not OTS' policy but we clearly need to do more to clarify the investment test for institutions and our own examiners.

The agencies also need to be clearer about our expectations under all three tests: lending, investment and service. There are several activities that thrifts engage in that cross the lines between lending, investing and providing services. The Federal Home Loan Bank System's programs promoting community development provide examples of the many ways participating institutions get lending, investment or service consideration. Thrift institutions can be involved in these programs in a variety of ways – from making loans to assisting community organizations in their efforts to win grants under the AHP – and there is a great deal of confusion about how these activities are considered for CRA purposes.

For example, the technical assistance to prospective borrowers in preparing the application for AHP funds and ensuring that the borrower meets the eligibility criteria as well as disbursing funds for the FHLB and monitoring the continued qualified use of the funds are considered community development services and are now clearly recognized as such in our guidance to thrifts and other financial institutions.

On the other hand, the FHLB's Community Investment Program, or CIP, functions as a specialized source of Bank advances for member institutions to finance qualifying community development projects. As distinguished from the AHP grant program, this use of an FHLB program results in lending test credit.

As an example, let's consider the activities of First American Savings Bank in Roanoke, Virginia, a $ 355 million institution. It has provided on-going, critical support to Virginia Mountain Housing, a non-profit housing organization established to provide safe, decent and affordable housing for the very low-income residents of rural Virginia. In 1996, First American sponsored a successful AHP application to the Federal Home Loan Bank of Atlanta on behalf of Virginia Mountain Housing. The grant funds were combined with funds from the Virginia Department of Housing and Community Developments Indoor Plumbing Program and the Virginia Water Project to rehabilitate homes of very low-income individuals before indoor plumbing could be installed in their homes. First American has also provided a number of related community development loans – from a bridge loan for the indoor plumbing project to a loan to acquire a commercial building that Virginia Mountain Housing uses to house and counsel troubled youth. And First American's employees have offered their financial expertise to many community development organizations dedicated to affordable housing, economic development, and social services.

First Virginia received community development lending credit for the loans and service credit for their work with the AHP program and their direct work in the community. Other bank projects received investment credit.

These are the things that make a real difference in the quality of people's lives. These are the kinds of activities that the regulation was meant to encourage.

In conclusion, I invite you share your observations about the issues that I have raised with me or with your primary regulator. There is no reason to wait until 2002 to hear from the industry and representatives of the community. We need to start to focus on these issues now so that we have a set of well-developed proposals in time for our regulatory review.

I thank you for your attention and look forward to further discussion of these issues in the future.

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