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Community Development Department  
135 Main Street  
San Francisco, CA 94105-1917

October 17, 2001

Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, N.W.  
Washington, D.C. 20552  
Attention Docket No. 2001-49

Robert E. Feldman  
Executive Secretary  
Attention: Comments/OES  
Federal Deposit Insurance Corporation  
550 17th Street, N.W.  
Washington, D.C. 20429

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors  
of the Federal Reserve System  
20th and C Streets, N.W.  
Washington, D.C. 20551  
Docket No. R-1112

Communications Division  
Public Information Room  
Mailstop 1-5  
Office of the Comptroller of the Currency  
250 E Street, S.W.  
Washington, D.C. 20219  
Attention: Docket No. 01-16

Re: Community Reinvestment Act Regulations

Dear Sir or Madam:

California Federal Bank ("Cal Fed") submits the following comment letter in response to the joint advance notice of proposed rulemaking on the above referenced subject as published in the Federal Register on July 19, 2001. Cal Fed is the nation's second largest federally chartered savings bank with approximately \$59 billion in assets as of September 30, 2001. We appreciate the opportunity to offer our comments and suggestions on ways in which the effectiveness of the Community Reinvestment Act ("CRA") regulations (the "Regulations") might be improved.

#### **General Comments**

In the six years since the 1995 amendments to the Regulations were published (the "1995 Amendments"), ample time has passed to properly assess the Regulations' effectiveness in meeting the objectives of the CRA. On the whole, Cal Fed believes that the Regulations have successfully met these objectives. In that regard, we commend the four bank regulatory agencies (the "Agencies") for their willingness to undertake the difficult task of substantially rewriting the original CRA regulations and to produce the Regulations as they exist today.

We acknowledge that there are those who suggest that no changes be made to the Regulations. Their views are premised on the belief that while there may be some problems with the Regulations, change could result in new and more significant problems. Cal Fed does not share this view. As can be expected with any set of rules, the Regulations have resulted in certain unintended negative consequences. If, however, the objectives of the CRA are to be sustainable in the long term, these negative consequences must be addressed.

One of our concerns has been the economic distortions in regions where competition for CRA lending has exceeded opportunity. This has resulted in unsustainable business practices and, in some situations, profit to intermediary organizations that add little or no benefit to the affected community.

Also, as a consequence of the Regulations' overly narrow definition of community development, depository institutions are not being encouraged to undertake the broadest range of activities that benefit lower income and under-served communities. This has been frustrating to those who believe that the CRA should encourage the fullest participation by institutions in meeting community needs.

Another problem with the Regulations concerns the nature of CRA examinations of large retail-oriented depository institutions. The 1995 Amendments endeavored to bring greater consistency and performance-based measurement into the CRA examination process. These were worthy goals. However, in many situations, we believe that the desire for consistency conflicts with the need to be responsive to the diverse needs of local communities. All communities do not have the same needs, and all institutions do not have identical areas of CRA expertise. Accordingly, for the Regulations to be effective, they should incorporate appropriate flexibility to permit institutions to meet the varied needs of the communities they serve. Because in the CRA one size does not fit all, we suggest the re-adoption of certain of the principles of the prior regulations that encouraged research about local community need and development of activities to address those needs.

Cal Fed, including its predecessor, First Nationwide Bank, has had a very long history of commitment and outstanding performance related to the letter and spirit of the CRA. We have prepared this letter to share with policymaking staff insights into the practical consequences of the Regulations and to offer suggested approaches to address these concerns. In doing so, we seek to preserve the basic approach of the Regulations, while proposing certain changes that will address existing problems and make improvements where needed.

Our detailed comments are presented in the balance of this letter and are based on the following objectives:

- CRA business practices that are sustainable and viable over the long term.

- Flexibility that allows institutions to tailor their CRA programs to meet the needs of their diverse local communities.
- A more inclusive definition of community development that encourages participation in a broader range of activities benefiting lower income and under-served communities.
- Elimination of unnecessary or unjustified paperwork burden.
- Incentives for institutions that achieve an "Outstanding" CRA rating.

### Detailed Comments

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

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

Cal Fed believes that the Regulations do not strike the best balance between quantitative and qualitative measures. Lending distribution (volume) is given substantially more weight than efforts to address unmet need. The former almost always and the latter rarely determines an institution's CRA rating.

The use of benchmarks that have questionable validity such as "all lender averages" and demographic distributions of populations create intense competition among institutions to obtain more volume in the CRA categories. This results in decisions to engage in uneconomic lending behavior that, but for CRA pressures, would not occur. Examples of activities that we have observed include: (1) subsidizing loans (e.g., offering grants to pay closing costs, rate buy-down, and/or to provide down-payment assistance for mortgage lending); (2) payment of increased incentives to mortgage brokers for CRA loans; (3) interest rate and fee reductions on various types of CRA loans; (4) increased employee compensation for CRA loans; and (5) payments of premiums to purchase CRA loans.

The overemphasis on quantitative measures has affected the investment test as well. Examples here include: (1) very-low yields on low-income housing tax credits (which have led some non-regulated investors to exit the market); (2) newly formed investments that are highly risky and/or simply create profit opportunities for intermediaries with no or little benefit passed on to the community; and (3) equity investments that are effectively grants with virtually no hope of a yield or return of principal.

Cal Fed believes that if these economic distortions are to be minimized, the Regulations must be modified to reduce their overemphasis on quantitative measures. Further, and as discussed later in this letter, it has been our experience that the Performance Context, which in theory might address this issue, has not been an effective tool because some of the Agencies are interested in using identical benchmarks for all institutions.

In this regard, it is critical that CRA examiners have the ability to recognize when a market is adequately or over-served (excess competition leading to uneconomic decisions) and take that fact into account when evaluating an institution's performance. This is not to say, however, that an area that is adequately or over-served does not have residents or businesses that would like to, but cannot access credit. Unfortunately, in many of those cases it is not the absence of available credit, but an inability to meet minimum qualifying requirements that limits the inflow of capital. Effective interventions in those cases must come from organizations other than financial institutions that are better equipped to deliver them.

Another negative outcome of the overemphasis on quantitative measures is that more complex (but deserving) transactions are overlooked by institutions when they are too small in size. This is particularly problematic in the area of community development where many very important, high impact projects require small loans and/or investments. By moving the focus away from quantitative performance, this problem can be alleviated.

*Possible Changes.* Cal Fed believes the methodology presently used to evaluate limited purpose and wholesale banks under the Regulations could offer the kind of flexibility that is needed in the large retail bank examination. By having categories with multiple options, an institution could choose which one or more would provide a needed service to its local communities and which its institution has the expertise and infrastructure to undertake successfully.

One option might be to combine the lending and investment tests into a single category. The institution could then choose to focus exclusively or with greater emphasis on one and not participate or do so to a lesser extent on the other. Furthermore, an institution could be allowed to weight the various types of lending (mortgage, small business, consumer, etc.) depending on community needs and institutional capacity.

Another option would be to replace the investment test with a community development ("CD") test that would be comprised of CD lending (relocated from the lending test), CD investments, and CD services (relocated from the service test). Similarly to the application of the CD test for wholesale and limited purpose institutions, a large retail-oriented bank could choose to be active in one or more of the three.

Finally, one could allow an institution to choose among the current Regulations and either of the two options described above.

If the Agencies believe they must continue to evaluate institutions through comparisons to benchmarks, then those benchmarks should be better developed. Utilizing population distribution to evaluate consumer lending is of limited validity because it fails to take into account loan demand or credit worthiness. Comparison among lenders such as loan distribution in the four CRA categories doesn't take into account the infrastructure of each institution. Features of an institution that legitimately affect its mortgage loan distribution include, for example: (a) the portion of their lending that is done through a wholesale channel, (b) whether they provide sub-prime credit, and (c) if they have the ability to originate FHA.

Again, the need for flexibility arises from the fundamental fact that all markets do not have the same unmet needs, and all institutions do not possess the same strengths in various product lines. For example, one institution may have an opportunity to make great strides in introducing retail deposit services into an area that has long been under-served but may not be strong in mortgage or consumer lending in the CRA categories. Under the Regulations, such an institution would work to compete in the lending arena and forego allocating resources to the area of need. The Regulations should be changed to permit and encourage this institution to focus on the new deposit services rather than competing with other institutions for the same loans.

Because of the standalone investment test and difficulty finding a sufficient level of qualified opportunities, institutions and nonprofit organizations have spent time and resources converting loans into investments. This is costly with no compensating benefit to the transaction or the community served and can increase the level of repayment risk to the institutions. Combining investments and lending as described above will eliminate this problem.

#### **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?*

The lending test is generally effective. As noted above, because it goes too far in benchmarking and quantitative analysis, it has led to unhealthy economic distortions. As a consequence, although an institution may appear to be meeting credit needs, it may be doing so at an unreasonable and unsustainable cost.

One area of the lending test that needs revision is the treatment of consumer lending. The Regulations' Q&A does not clearly delineate when consumer lending treatment is no longer optional. This uncertainty has led to inconsistent application among the Agencies. An institution may have a small percentage of its loans in the consumer area and still be required to include it in a CRA examination. This subject should be clarified so that inclusion of consumer

lending becomes obligatory when a substantial, calculable portion of loans made during the review period are consumer loans.

Cal Fed agrees that the Agencies should be reviewing lending practices for harmful or abusive terms. Because such an analysis is synergistic with the fair lending examination procedures, we recommend that it be reviewed in that context and not within the CRA examination. Such an approach would effectively address the concern that abusive practices should be reflected in the CRA evaluation. Under current practice, inadequate fair lending performance can negatively impact a CRA rating.

### **B. Investment Test**

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

Cal Fed believes that the investment test has been ineffective and often problematic. Although the CRA addresses credit and not investments, there are often cases when investments are needed so that credit can be obtained. The connection may be tenuous, but there is great community need for investments. While the inclusion of a standalone investment test in the 1995 Amendments was innovative and well intended, it has not worked well and its unintended consequences have been severe.

In our view, institutions have made uneconomic investments with greater risk than would be prudent but for CRA investment test concerns. For example:

- Low-income housing tax credit funds have been successfully marketed with expected yields lower than debt.
  - CRA-qualified mortgage-backed-securities ("MBS") typically sell at premiums and can present unwise levels of interest-rate risk because they tend to be backed by fixed-rate loans.
  - High-risk SBIC's have been formed to attract insured depository investors needing CRA credit.
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- Equity investments have been made and then written-off because they are effectively grants.
  - Funds have been created that provide no or minimal added value to lower-income communities, but rather create profit opportunities to fund managers.

An institution can provide some level of subsidy in the CRA area when it truly benefits communities, but the current levels have become too great, thereby jeopardizing the sustainability of CRA.

Like the lending test, the investment test is primarily quantitative, in that the volume of investment determines the ratings regardless of community need and whether that need is already being addressed by other institutions. Moreover, there is no consideration given for whether the investments fit with the institution's operation or whether the investments make sense with respect to risk and potential return.

Under the Regulations, little credit is given for investments made prior to the review period that are still on the bank's books. Furthermore, no credit is given for investments that have been written-off even though the recipients of the investments still show them on their books (e.g., equity in a community development financial institution). Institutions that undertake investments with terms longer than the time to the next review period should be recognized for the importance of such activity. Given the limited supply of quality investments, it is unrealistic for the Agencies to expect continued high levels of new investments. Therefore, we recommend that long-term investments be given greater recognition during the examination.

Cal Fed believes that institutions should be encouraged to make appropriate CRA-qualified investments. Accordingly, we recommend that it be retained, but combined with other activities such that an institution would not feel pressured into making imprudent decisions. Rather, institutions would only make CRA investments when they have a true community benefit, are in line with the bank's business strategy and have an acceptable risk/reward relationship.

### 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 has largely been effective. However, in keeping with the changes that the business of banking has experienced over the 24 years since the CRA statute was first adopted, we believe that the service test should be updated. Many banking products are not delivered through brick-and-mortar branches. Alternative delivery channels (for example, telephone and the Internet) as well as wholesale lending channels are increasingly important. In those cases when a bank does not have an adequate geographic footprint, the examiners should give weight to these alternative delivery channels.

A perverse outcome of the service test affects institutions with only one or few branches in an assessment area. Such an institution may be criticized for not serving a wider diversity of the population in that assessment area. Such criticism or the risk of criticism could cause an

institution to exit a market, leaving affected communities with even fewer services. The examination methodology needs to consider this risk.

**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?*

Cal Fed believes the definition of "community development" needs to be broadened. Our suggestions follow.

- Expand Multifamily Carve-Out to Other Types of Lending. The Regulations currently include a carve-out for affordable multifamily lending that allows it to be counted twice - once on HMDA and again as a CD loan. Although we do not know the reason for this decision, we suppose it was intended to encourage bank participation in this much-needed activity and to recognize the complexities and creativity involved in such lending. There are other equally important areas of lending that need the same recognition and encouragement, and therefore should be folded into this special provision. Examples include single-family loans that involve mortgage credit certificates and/or soft, subordinate debt from local governments, nonprofit agencies and GSE's (e.g., the Federal Home Loan Bank Affordable Housing Program). These are also critical programs and require that participating banks allocate additional resources to accommodate revised underwriting, loan documentation and servicing, and communication with nonprofit sponsors if payments become delinquent. Similarly, small business loans to nonprofit organizations involved in CD activities could also be encouraged by receiving this same special treatment.
- High Cost Areas. In areas where middle-income households are under-served because of the wide gap between income and home prices, serving them should be given very positive treatment and weighted heavily.
- CD Services. The requirement that activities be tied to financial services should be eliminated. Also, the requirement that a majority of those served must be low- or moderate-income ("LMI") should be replaced with a requirement that the activity serve LMI people. We believe bank employees should be encouraged to volunteer in their communities in ways that assist lower-income people and neighborhoods. Although the two restrictions mentioned make good sense on paper, they have led to great frustration. For example, some employees enjoy volunteering for Habitat for Humanity to build a home for a low-income household, or to renovate a school in a poor community. We should encourage them to do so by being able to recognize them for participating in the bank's CRA effort. Under the Regulations such activities do not qualify. Another employee may wish to serve on the board of directors of a housing counseling agency.

But, if that employee serves on the personnel committee instead of the finance committee, the examiners may determine that the work does not constitute a CD service. Similarly, an employee may enjoy teaching small business owners about developing a business plan and accessing credit, or about how the SBA loan programs work. Unless that employee can state that a majority of the attendees were LMI, he/she will not have a CRA-qualified activity. In such a context, ascertaining the percent of attendees who are LMI is a laborious process and some participants may find the associated questioning offensive.

- Letters of Credit ("LC's"). The rule should specifically state that LC's count equally to loans. This has received uneven treatment from various Agencies. LC's involve identical processing as loans, and constitute full legal obligations. Banks should be encouraged to provide this much needed form of credit.

*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 no, how should the regulations be revised?*

Except as noted above, we believe that these provisions are generally effective.

**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?*

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

Cal Fed has no comments on these issues.

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

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

*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?*

Cal Fed has no comments in this area.

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

As noted above and for the reasons described, Cal Fed believes this should be one of several options from which a large retail financial institution could choose.

#### **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?*

In theory, a strategic plan makes very good sense. It would enable an institution to customize its examination in line with its business strategy and the needs of its communities. However, the process as currently required is arduous and the related risks are too great. It would be very beneficial if the Regulations could integrate the principles of the strategic plan into the body of the rule so that its benefits could be better realized.

Our suggestions above, to provide flexibility and choice to each institution, would effectively accomplish the goals of the strategic plan.

#### **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?*

The concept of a performance context is valid and commendable. Unfortunately, its application has been inconsistent among the Agencies. Some Agencies have focused on uniformity in the sense of using the same benchmarks to conduct a quantitative evaluation of each institution. Therefore, they have been unwilling to take into consideration market circumstances and the business strategy of the institution and modify the quantitative methodology accordingly. If CRA examiners were required to assess and give weight to the performance context and freed from the pressure of applying identical methodologies to all institutions, the performance context might be more effective.

Cal Fed believes that the Agencies should create and share with their regulated institutions the component of the performance context that assesses the environment external to

the bank. That component should look at how well markets are being served and take into account the types of products that are offered and legitimate barriers to obtaining banking services (e.g., poor credit history and income deficiency in relationship to credit need). The institution would have the opportunity to review the agency-generated market assessment and provide comments. The institution would then have the option to provide the component of the performance context that discusses its operation and the resultant barriers and opportunities for CRA activities. The examiners would be expected to fully take into consideration the performance context.

**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?*

Cal Fed believes the current assessment area approach is reasonable and sufficient. However, we also believe that the examination should take into account how large a presence the institution has in a particular assessment area. The expectations for level of activity should be commensurate with the level of deposits gathered.

**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?*

Cal Fed believes the affiliate provisions are effective and conform to the provisions of the CRA. The CRA specifically references insured depository institutions with no mention of affiliates. Therefore, requiring inclusion of affiliates would conflict with the statute. Because many institutions provide credit through affiliates (e.g., a mortgage subsidiary), it is important that they be given the option to include them.

**8. Data Collection and Maintenance of Public Files**

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

Cal Fed believes there should be no changes made to the data collection. The burden for insured depository institutions is already substantial. Our systems are in place and functioning well. The benefits of any proposed changes would need to be clearly identified and weighted against the costs.

File requirements should be modified. The requirement to have files in each branch with the current contents is a tremendous waste of paper (our CRA Performance Evaluations alone are approximately 450 pages) and bank resources in the areas of staff training, copying and distribution to each branch, and periodic auditing. It is our experience after many years that these files are not reviewed by the public. Each year we receive no more than five requests for the HMDA/CRA data and those requests are made directly to the central CRA department. Between CRA examinations (typically a two- or three-year period) we receive no more than 15 requests for our latest CRA Performance Evaluation; these requests are also typically made directly to the CRA department.

Cal Fed recommends that an institution be permitted to keep one central file so long as each branch is required to respond to inquiries by referring them to the central CRA department.

## **9. Other Issues**

### **A. Should There Be an Incentive to Obtain and Maintain an Outstanding Rating?**

Cal Fed believes the Regulations should include incentives/rewards to institutions in this regard. Possible options include: (1) a streamlined examination process built on sampling and (2) a streamlined application review related to mergers and acquisitions. The first option would reward the institution by reducing the resources needed to manage the examination process. The second option would address a current inequity in the Regulations. When an institution submits an application for approval related to an acquisition/merger, members of the public may question an institution's CRA record, even when it has an outstanding rating, and cause the Agencies to hold hearings. That means an institution effectively must go through two examinations - one during the agency examination and another during public hearings.

The public should be encouraged to submit comments to the Agencies in between or during the examination process rather than wait until the time when an institution is seeking regulatory approval and under pressure to transact a major activity. Furthermore, by requiring hearings for an outstanding rated institution, the Agencies are effectively supporting the accusation that their examinations are deficient. Based on our experiences with numerous CRA examinations, we strongly disagree with that accusation. We believe the Agencies should codify into the Regulations their belief in the validity of the examination process by stating that outstanding-rated institutions do not need to be re-examined through a public hearing process.

**B. Should Purchased Loans and Originations Receive Equal Credit?**

Yes, they should be weighted equally. Purchased loans are critical to providing liquidity in the market so that origination can continue. Institutions should be encouraged to purchase CRA loans by giving it equal weighting in the CRA evaluation. There have been concerns expressed about banks "churning" portfolios for CRA credit and sellers of CRA loans charging premiums and keeping the profits rather than passing them to the borrowers in the form of reduced pricing. Cal Fed shares these concerns. However, we do not believe that eliminating or reducing the weighting of an important activity such as purchasing loans is the solution. Rather, the Agencies should address the root cause of these problems by reducing the quantitative pressure on institutions to meet or exceed benchmarks.

Some have stated that because banks purchase loans rather than make the effort to originate loans, reducing or eliminating the weighting of purchased loans is warranted. Cal Fed disagrees with this assessment. It is our observation that many institutions that are allocating substantial resources to originating CRA loans also feel pressured to purchase loans to reach certain volumes. Again, attacking the cause, reducing quantitative pressure, is the most effective remedy.

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In closing, we would again express our appreciation for the opportunity to comment on ways in which the Regulations might more effectively promote the goals of the CRA. If you have any questions, or would like to further discuss any of the matters presented in this letter, please feel free to contact the undersigned.

Sincerely,



Dorothy Broadman  
Senior Vice President  
Manager, Community Development Department