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DEVELOPMENTS IN FEDERAL CRA REGULATION: A HOUSE DIVIDED?

A Proposed New CRA Regulation Would Put Federal Banking Regulators at Odds with the OTS.

By Warren W. Traiger and Joseph Calluori*

After more than 25 years of a uniform approach to Community Reinvestment Act ("CRA") regulation, the federal bank and thrift supervisory agencies are breaking ranks. The Office of Thrift Supervision ("OTS") has unilaterally increased, from $250 million to $1 billion, the asset size threshold that allows "small banks" to qualify for a less rigorous CRA examination. The OTS has also granted larger banks the option of completely eliminating investment and service activities from consideration in their CRA evaluations, which would allow such banks to have only lending activities determine their final CRA rating.

In contrast, the Federal Reserve Board ("Board"), Office of the Comptroller of the Currency ("OCC"), and Federal Deposit Insurance Corporation ("FDIC") have refused to deem all institutions with less than $1 billion in assets "small banks," choosing instead to address the regulatory burdens faced by banks with assets of more than $250 million but less than $1 billion by creating a new measure of CRA compliance. Unlike the OTS, the other regulators will also continue to treat investment and service activities as substantial and significant factors in computing a large bank's final CRA score.

The OTS's decision to go it alone is unfortunate, because at the very least it creates the appearance that the OTS is less diligent than the other agencies in enforcing the CRA. It also fuels suspicions that the communities served by OTS-regulated banks are being shortchanged by lax enforcement of the CRA.

Background

The Community Reinvestment Act of 1977 gave the federal banking agencies 390 days to promulgate regulations "to carry out the purposes" of the Act.[1] The Board, the OCC, the FDIC, and the Federal Home Loan Bank

*WARREN W. TRAIGER and JOSEPH CALLUORI are attorneys with the New York City law firm of Traiger & Hinckley LLP. Messrs. Traiger and Calluori advise banks and other financial institutions on federal and state fair lending and Community Reinvestment Act compliance. Their email addresses are, respectively, wtraiger@traigerlaw.com and calljoe@traigerlaw.com.

1. 12 U.S.C. §2905. Pub. L. 95-128, title VIII. §806. October 12, 1977.

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WARREN W. TRAIGER is a Counsel Attorney at BuckleySandler LLP, in the New York, NY office.

Board, the OTS's predecessor agency (collectively, the "Agencies") took a unified approach to the process, together publishing a list of 26 questions to be addressed at a series of public hearings held throughout the country. The hearings and subsequent comment period ultimately led to the promulgation of substantially identical regulations.[2]

The Agencies continued their shared approach to CRA regulation throughout the 1980s and 1990s. They issued a joint policy statement in 1989,[3] largely in response to congressional dissatisfaction with CRA enforcement. After Congress amended the CRA to provide for public disclosure of a bank's CRA performance,[4] the Agencies issued new uniform examination guidelines[5] through the Federal Financial Institutions Examination Council, the "formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the [Agencies]."[6]

2. "The Agencies' final regulations, which are presented together for convenience, are identical in their substantive provisions." 43 Fed. Reg. 47,144 (1978).
3. 54 Fed. Reg. 13,742 (1989).
4. § 1212 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73.
5. 55 Fed. Reg. 18,162 (1990).
6. *See* www.ffiec.gov.

Unanimity also prevailed as the Agencies sought to implement President Clinton's 1993 directive to have CRA examinations refocus on more objective assessment standards. The Agencies held seven public hearings and proposed two sets of regulations[7] before promulgating a joint final rule.[8]

The final rule established CRA evaluation criteria consisting of distinct lending, investment, and service tests for retail institutions with $250 million or more in assets ("large banks") and a streamlined lending-only test for smaller banks that were not part of a holding company with banking assets of at least $1 billion ("small banks"). The Agencies also agreed to conduct a full review of the rule in 2002, five years after full implementation, to determine whether the rule was effective in achieving its goals, including emphasizing performance rather than process, promoting consistency in evaluations, and eliminating unnecessary burdens.[9]

This review commenced in July 2001 with published notice of advance rulemaking.[10] Based on the comments received in response to that notice, in February 2004, the

7. 58 Fed. Reg. 67, 466 (1993); 59 Fed. Reg. 51,232 (1994).
8. 60 Fed. Reg. 22,156 (1995)
9. 60 Fed. Reg. 22,156, 22,177 (1995).
10. 66 Fed. Reg. 37,602 (2001).

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Agencies jointly proposed allowing more banks to qualify for a streamlined examination by increasing the small bank asset size threshold from $250 million to $500 million.[11] The February 2004 proposal also clarified that a bank's CRA evaluation would be adversely impacted by abusive or illegal credit practices involving loans considered in the CRA evaluation, whether made by the bank or an affiliate of the bank.

The End of Uniformity

The first split among the Agencies occurred in July 2004, when the FRB and OCC withdrew their support for the February 2004 proposal. The OCC explained:

> The OCC is very sensitive to the impact and potential burden on small banks from the CRA and other regulations, and recognizes the strong interest among community banks in raising the small bank asset threshold to address their concerns about regulatory burden. The OCC also recognizes and is very sensitive to the fact that many community organizations and others believe strongly that an increase in the small bank asset threshold would have a very significant, and detrimental, impact on CRA activities nationwide, including in rural communities. Resolution of these deeply divided views involves a balancing of political and economic considerations that can best be addressed in a legislative forum.[12]

Concurrent with the OCC's and the Board's withdrawal, the OTS announced it would unilaterally increase the small bank threshold from $250 million to $1 billion and eliminate from its regulations a provision that made small banks in a holding company with consolidated banking assets of $1 billion or more ineligible for streamlined examinations.[13] These amendments were formally adopted by the OTS, effective October 1, 2004.

The following month, the FDIC went its own way, announcing a new proposal that contradicted but, according to the FDIC, did not supercede the February 2004 proposal.[14] The new proposal followed the OTS's lead in increasing the small bank threshold to $1 billion, regardless of holding company affiliation. It also proposed adding a new community development criterion to the small bank examination for institutions with assets between $250 million and $1 billion and expanded the definition of community development to encompass a broader range of activities in rural areas.[15]

In November 2004, the OTS proposed further unilateral changes, the most significant of which would revise the ratings matrix for banks with $1 billion or more in assets. Under the existing matrix, 50 percent of a large bank's score depends on its lending activities; 25 percent on service activities; and 25 percent on investment activities. Asserting that it was appropriate to evaluate such institutions with a greater emphasis on lending than at present, the OTS proposed that large banks be allowed to decide for themselves whether to increase the extent to which their CRA score is premised upon lending, and to give lesser or no weight to investment and service activities. This change was subsequently adopted by the OTS, effective April 1, 2005.[16]

The FDIC Reunites with the Board and OCC

On March 11, 2005, the Board, OCC, and FDIC jointly issued a proposal to amend the CRA regulations.[17] In what may be viewed as a thinly veiled criticism of the OTS, the Board, OCC, and FDIC affirmed the commitment of the "federal banking agencies" to reducing unnecessary regulatory burdens and improving the effectiveness of the CRA, while at the same time emphasizing these objectives should be achieved without compromising the need for uniform standards applicable for all banks subject to the CRA:

> The federal banking agencies continue to believe that it is both worthwhile and possible to improve the CRA rules in ways that reduce unnecessary burden

11. 69 Fed. Reg. 5,729 (2004).
12. OCC News Release, "OCC Will Withdraw CRA Regulatory Proposal," July 16, 2004. *See* also, Fed press release of date same.
13. OTS Press Release, "OTS to Modify CRA Small Institution Benchmark," July 16, 2004.
14. FDIC Press Release, "FDIC Seeks Additional Comments on "Small-Bank" CRA Threshold," August 16, 2004.
15. 69 Fed. Reg. 51,611 (2004).
16. 70 Fed. Reg. 10,023 (2005).

> while at the same time maintaining and improving the effective implementation of the CRA. Moreover, we believe that it is important to take steps at this time to develop and propose rules to achieve these goals, and **to work toward achieving standards that ultimately can apply on a uniform basis to all banks subject to the CRA.**[18]

The March 2005 proposal primarily addresses the small bank examination issue and includes elements from the February 2004 proposal and the November 2004 FDIC proposal. It maintains the $250 million small bank asset threshold, but adjusts the threshold for inflation based on the Consumer Price Index. It creates a new examination structure for banks with assets of at least $250 million and less than $1 billion ("Intermediate Small Banks"), also adjusted for inflation. These banks will now be subject to both the streamlined small bank examination and a new test that is intended to assess an Intermediate Small Bank's community development lending, investment, and service activities. Intermediate Small Banks, like banks with under $250 million in assets, would be exempt from certain large bank loan data reporting requirements.

The March 2005 proposal addresses another issue raised in the February 2004 proposal by providing that evidence of discrimination will adversely affect a bank's CRA evaluation. The banking agencies note that such evidence would include, but not be limited to, violations of the Equal Credit Opportunity Act,[19] Fair Housing Act,[20] Real Estate Settlement Procedures Act,[21] Truth in Lending Act,[22] Home Ownership and Equity Protection Act,[23] and Federal Trade Commission Act.[24] Moreover, a bank's evaluation could be adversely affected by discriminatory practices both within and outside of a bank's CRA assessment area, as well as by evidence of such practices by an affiliate, if any loans of that affiliate have been considered in the bank's CRA evaluation.

17. 70 Fed. Reg. 12,148 (2005).
18. *Id.* 12,150 (emphasis supplied).
19. 15 U.S.C. §§1691 et seq.
20. 42 U.S.C. §§3601 et seq.
21. 12 U.S.C. §2607.
22. 12 U.S.C. §1601 et seq.
23. 15 U.S.C. §1639.
24. 15 U.S.C. §45(a)(1).

Finally, the March 2005 proposal expands the definition of "community development" to include affordable housing and community development activities in rural areas and areas affected by disasters. Comments on the March 2005 Proposal are due by May 10, 2005.

The Current State of CRA Regulation

As of this writing, CRA compliance for banks regulated by the Board, OCC, and FDIC is essentially unchanged from the rules promulgated in 1995. If adopted, the most significant impact of the pending March 2005 proposal would be on Intermediate Small Banks, which would be subject to a different examination process and reduced data reporting requirements. All banks, including those with assets of $1 billion or more, will benefit from a more flexible definition of CRA-eligible community development activities. In addition, the evaluation of a bank's CRA compliance will consider not only the bank's fair lending record but also that of its affiliates.

In contrast, the already implemented OTS changes significantly affect every institution under that agency's jurisdiction and arguably lower the bar for CRA compliance. Increasing the small bank threshold from $250 million to $1 billion means that approximately 89 percent of OTS-regulated institutions qualify for the streamlined small bank examination.[25] By permitting the remaining institutions to decide how much, if any, investment and service activities should be factored into the final CRA evaluation, the OTS may, albeit inadvertently, have created a significant disincentive for CRA-related investments and services.

Conclusion

The split between the OTS and the federal banking regulators raises several important legal and policy questions. It is a fundamental principle that laws should be uniformly applied. Consistent with this principle, neither a bank's duty to comply with the CRA nor the degree of compliance scrutiny it receives should vary according to the agency from which it obtained its charter. Thus, as the Board, the FDIC, and the OCC suggest in their March 2005 proposal, the need for uniform standards for all banks subject to the CRA cannot be underestimated. The

25. "O]f the nearly 900 savings associations OTS regulates, only about 100 are large," 70 Fed. Reg. 10,026 (2005).

OTS's insistence upon implementing its own unique view of the CRA, at the very least, fosters the appearance that the OTS is less interested in CRA compliance than the other federal banking regulators. That is an impression that banks and regulators can ill afford.

Furthermore, the lack of unanimity among federal regulations in and of itself raises questions about the wisdom and necessity of the regulations adopted by the OTS. The OTS's unilateral decision to raise to $1 billion the asset threshold for small banks seems questionable, and perhaps even reckless, given the fact that all the other regulators eventually concluded that it was a bad idea and found another way to reduce the regulatory burden on banks with less than $1 billion in assets.

Even more troubling is the OTS's decision to give banks the option of reducing the weight given to investment and service activities. Some commenters objected that this change will ultimately discourage and decrease community investment.[26] The OTS, however, responded that rather than rely on such predictions it has chosen instead to focus "on the common-sense economic principle that allowing a savings association greater freedom to specialize in those things at which it is relatively more efficient should result in more, not less, real community development being delivered."[27]

However, reality does not always live up to common sense expectations. Consequently, the more measured approach of the other regulators seems more prudent. By refusing their larger banks the option of excluding investments and services from their CRA score, but adopting a more flexible approach to defining community development, the Board, the FDIC, and the OCC both minimize the burdens that banks may incur in meeting the investment and service tests and lessen the risk that banks will be less aggressive in meeting their communities' needs for CRA-related investments and services. ■

26. Richard. E. Rubin & Michael Rubinger, *Don't Let Banks Turn Their Backs on the Poor*, N.Y. Times, Dec. 4, 2004, at A19
27. 70 Fed. Reg. 10,030 (2005).