

July 7, 2005

MEMORANDUM TO: The Board of Directors

FROM: Michael J. Zamorski
Director
Division of Supervision and Consumer Protection

William F. Kroener, III
General Counsel

SUBJECT: Final Joint Rulemaking on the Community Reinvestment Act
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Recommendation

In the last of a series of notices of proposed rulemaking (NPRs), on March 11, 2005, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Board of Governors of the Federal Reserve System (FRB) (“the agencies”) published an NPR seeking comments on changes in the regulations implementing the Community Reinvestment Act (CRA), 12 U.S.C. 2901 *et seq.*, 70 Fed. Reg. 12148 (Mar. 11, 2005).

The NPR proposed amending the CRA-related definition of “small bank” from a bank with total assets of less than \$250 million that was independent or an affiliate of a holding company that had total assets of less than \$1 billion to a bank with total assets of less than \$1 billion, with no consideration of holding company affiliation. The NPR also proposed adding a new, separate “community development” test, in addition to the current small bank lending test, for “intermediate small banks,” defined as banks with assets between \$250 million and just below \$1 billion. The NPR definitions of “small bank” and “small intermediate bank” both included an annual inflationary component. The NPR proposed amending the “community development” definition, by including “underserved rural” and “designated disaster” areas, and proposed clarifying the impact of discrimination or other illegal credit practices on a bank’s CRA performance.

Upon review and consideration of the nearly 4,000 comments received by the FDIC, and a similar number or more received by the OCC and FRB, the agencies now propose to issue a joint final rule. As in the NPR, the attached joint final rule raises the small bank threshold to \$1 billion with an inflationary component, and replaces the lending investment and service tests for intermediate small banks with two separately rated tests: the small bank lending test and a more flexible, but no less meaningful, community development test. In addition, the definition of “community development” is revised to

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include activities that revitalize or stabilize designated disaster areas and distressed or underserved nonmetropolitan middle-income tracts, in addition to low- and moderate-income **TRACTS COVERED UNDER THE EXISTING RULE**. Finally, the rule clarifies the current regulation's provision on the adverse aspect of discriminatory or other illegal credit practices on CRA performance

We recommend that the Board approve the attached joint final rule and authorize its publication in the *Federal Register*. We also recommend that the Board authorize the Executive Secretary and the General Counsel (or their designees) to make technical, non-substantive, or other conforming changes where necessary to ensure that the FDIC, the OCC and the FRB can jointly issue the final rule in the *Federal Register* and to take such other actions and issue such other documents related to the rule as they deem necessary or appropriate to fulfill the Board's objective in connection with this matter.

Background

In 1995, following a number of public hearings and publication of two proposed rules (58 Fed Reg. 67466 (Dec. 21, 1993) and 59 Fed. Reg. 51232 (Oct. 7, 1994)), respectively), the banking agencies jointly amended their CRA regulations to establish a performance-based system to assess institutions' performance in helping to meet their communities' credit needs. At that time, the banking agencies agreed that "[a]ny regulatory changes that are determined to be necessary to improve the rule's effectiveness will be made at that time." 60 Fed. Reg. 22156, 22177 (May 4, 1995).

On July 19, 2001, the banking agencies published an advance notice of proposed rulemaking (ANPR) seeking comments on a number of issues dealing with the regulations implementing the CRA. 66 Fed. Reg. 37602 (July 19, 2001). The ANPR addressed a number of issues regarding the existing CRA regulations.

In the February 6, 2004, NPR, the banking agencies stated the belief that the CRA regulations are essentially sound, but were in need of some updating to keep pace with changes in the financial services industry. 69 FR 5729 (Feb. 6, 2004). First, the banking agencies proposed an amendment to the definition of "small bank" to mean an institution with total assets of less than \$500 million, without regard to any holding company affiliation. Second, to better address abusive and predatory lending practices in CRA evaluations, the banking agencies proposed amending their regulations to more completely describe circumstances in which an institution, (or any of an institution's affiliates, the loans of which have been considered for CRA purposes), that has engaged in discriminatory, illegal, or abusive credit practices in connection with certain loans, would have such practices adversely affect the evaluation of the institution's CRA performance. Finally, the banking agencies addressed other issues raised in connection with the ANPR through additional interpretations, guidance, and examiner training.

The banking agencies received over 900 comments on the February 6, 2004, NPR. Following receipt of those comments, the banking agencies took different paths. On August 18, 2004, the OTS published a final rule raising the "small savings association" threshold to \$1 billion, without regard to any holding company affiliation. 69 FR 51155 (Aug. 18, 2004). The OCC and Fed announced separately that they

intended to withdraw their respective February proposals. On August 20, 2004, the FDIC issued a new proposal on the evaluation of "small banks." 69 FR 51611 (Aug. 20, 2004). The FDIC's proposal expanded the category of "small banks" to those under \$1 billion, regardless of any holding-company size or affiliation. For small banks with assets greater than \$250 million up to \$1 billion, the FDIC proposal added to the five performance criteria of the current streamlined small bank test a new sixth criterion taking into account a bank's record of community development lending, investments, or services "based on the opportunities in the market and the bank's own strategic strengths." While, the community development activities would not have been a separately rated test, as proposed in that NPR, the FDIC requested comment on whether it should apply a separate community development test in addition to the existing streamlined performance criteria. The FDIC also requested comment on what weighting a community development test should have in assigning an overall performance rating.

The FDIC also proposed to expand the definition of "community development" to include activities that benefit rural areas and individuals in rural areas. The FDIC did not define "rural" and asked for comment on how it might be defined.

The FDIC's proposal generated approximately 11,500 comment letters. These comments were sent by a wide spectrum of commenters, including thousands of letters from community bankers, community organizations, and individuals. As with the February 2004 inter-agency proposal, the commenters were divided on the issues presented in the August proposal.

On March 11, 2005, the FDIC, OCC, and FRB published a new NPR, after considering comment letters from the February and August NPRs. 70 Fed. Reg. 12148 (Mar. 11, 2005). The March NPR maintained the proposal of raising the threshold for a "small bank" in the CRA regulations from \$250 million to include those banks with under \$1 billion in assets, regardless of any holding company size or affiliation. The proposal added an inflationary component tied to the Consumer Price Index for Urban Wage Earners and Clerical Workers.

Under the March NPR, a new "Community Development Test" would be added for banks with at least \$250 million and less than \$1 billion in assets (newly defined as "intermediate small banks") that would be separately rated in CRA examinations. The community development test would provide greater flexibility to intermediate small banks than under the large bank tests applicable to them currently, by enabling them to engage in a flexible combination of community development loans, investments and services based on the needs of their community. To ensure equal weighting, an intermediate small bank would not receive an overall CRA rating of "satisfactory" unless it received a "satisfactory" rating on both the small bank lending test and the community development test. In addition, intermediate small banks would not be required to collect and report certain CRA loan data.

The NPR would also expand the definition of community development to include activities such as affordable housing in underserved rural areas and designated disaster

areas. The agencies sought comment on the best way to identify "underserved" rural areas to ensure that CRA activities are targeted to the rural communities and persons in those communities most in need of community development and affordable housing. The proposal also would address the adverse effect of discriminatory or other illegal activities on bank CRA ratings.

Comments to the March, 2005, NPR

The FDIC received approximately 4,000 comment letters on the March 2005 NPR. These comments were sent by a wide spectrum of commenters, including over 1,500 from bankers and banking organizations, approximately 150 from various community organizations, and over 2,000 from individuals. As with prior proposals, the commenters were divided on the issues presented in the March proposal. Nevertheless, many of the commenters on all sides of the issues stated that this proposal struck a better balance than prior proposals.

As with prior proposals, nearly all of the comments received from bankers and banking organizations supported a change in the small bank dollar threshold, primarily as a way to reduce administrative burden and as a way to remove the current data collection requirements for banks from \$250 million up to \$1 billion in assets. Over 1,000 comment letters from bankers stated that a separate, flexible evaluation of community development activities for intermediate small banks, based on community needs, represented an acceptable compromise. Some bankers opposed a separate community development test. These commenters generally supported either including "community development" as a performance criterion in the current streamlined test for small banks, or keeping the streamlined small bank test in its current form for all small banks. Nearly all of the banking commenters opposed the proposed amendments that would clarify the current regulations regarding evidence of discriminatory or other illegal credit practices. These commenters stated that such evidence would fall under other statutory provisions that should be considered separately from CRA considerations.

Community groups opposed increasing the small bank threshold and tying future increases to inflation. These commenters asserted that the burden argument made by banks did not justify a change. If the Agencies were going to increase the threshold, many, but not all, commenters in this group opposed the flexibility in community development test, because of a concern that permitting banks to choose one or more lending, investment and service activities would lead to cut backs in investments and services currently required under the large bank test. The community group commenters opposed removing the data collection, reporting and disclosure requirements for small intermediate banks and supported the proposed amendments that would augment the current regulations regarding evidence of discriminatory or other illegal credit practices.

A comment letter from Representative Frank and several other members of Congress stated that the flexibility offered by the separate community development test, if accompanied by expanding the range of appropriate activities that qualify for CRA

credit (as discussed in the preamble to the March proposal), can benefit low- and moderate-income communities.

Commenters were generally supportive of the addition of “underserved rural” to the definition of “community development.” A few commenters provided suggestions as to the definition of this term, including Community Development Financial Institutions **Fund** (CDFI) designated investment areas, areas targeted by a government agency for development, and rural areas targeted by a government agency for housing and economic needs.

The Joint Final Rule

The proposed joint final rule addresses key points raised by commenters. It responds to community banks concerned about undue regulatory burden by extending the exemption from data reporting to banks under \$1 billion without regard to holding company affiliation. It addresses the concerns of community organizations that urged the agencies to continue to evaluate larger community banks’ community development participation, by providing that the community development records of banks from \$250 million up to \$1 billion (these banks are referred to as “intermediate small banks”) would be separately evaluated and rated. On the other hand, it provides for a more flexible combination of community development activities than under the current large bank test. In short, the new proposal tries to strike a balance between burden reduction for community banks and effective evaluation of community development by those banks.

“Small bank” threshold

The agencies proposed to reduce undue regulatory burden by extending the exemption from data reporting to banks under \$1 billion without regard to holding company affiliation. In addition, the agencies proposed to categorize small banks with assets from \$250 million to less than \$1 billion as “intermediate small banks.” The proposal also would annually adjust the asset size for small and intermediate small banks based on changes to the Consumer Price Index.

The attached proposed joint final rule would adopt the proposal without change. Therefore, the attached joint final rule amends the definition to read:

(u) Small bank—(1) Definition. Small bank means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than \$1 billion. Intermediate small bank means a small bank with assets of at least \$250 million as of December 31 of both of the prior two calendar years and less than \$1 billion as of December 31 of either of the prior two calendar years.

(2) Adjustment. The dollar figures in paragraph (u)(1) of this section shall be adjusted annually and published by the FDIC, based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each twelve-month period ending in November, with rounding to the nearest million.

This change would account for most of the cost savings and paperwork reduction for intermediate small banks. This amendment would have the effect of removing the requirements on banks formerly under the CRA large bank test to collect data regarding originations and purchases of small business, small farm, and community development loans, see 12 C.F.R. § 345.42. In addition, the amendment will, ultimately, impact the requirement to collect and report information about the location of property securing certain home loans outside metropolitan areas under the Home Mortgage Disclosure Act (HMDA), see 12 CFR 203.4(e). While this particular HMDA regulation, which incorporates CRA law, will not be amended by this rule, the FRB will post an FAQ on the FFIEC--HMDA web site incorporating the change.

Separate “community development” test

The March proposal would have added a new community development test that would be separately rated in CRA examinations for intermediate small banks. The new community development test would evaluate an intermediate small bank’s community development loans, qualified investments, and community development services, resulting in a single rating for community development performance. Overall CRA ratings for intermediate small banks would be based on ratings for this community development test and the streamlined small bank lending test.

The proposed joint final rule adopts the proposed community development test for intermediate small banks without change. The number and amount of community development loans, qualified investments, and community development services, by an intermediate small bank will be evaluated in the context of the bank’s capacities, business strategy, the needs of the relevant community, and the number and types of opportunities for community development activities.

The community development test will be applied flexibly to permit a bank to apply its resources strategically to the types of community development activities (loans, investments, and services) that are most responsive to helping to meet community needs, even when those activities are not necessarily innovative, complex, or new. In providing this flexibility for intermediate small banks, the federal banking agencies, as stated in the attached preamble, do not intend to suggest that a bank may simply ignore one or more categories of community development or generally decrease the level of such activities. Nor does the joint final rule prescribe any required threshold proportion of community development loans, qualified investments, and community development services for these banks. The federal banking agencies believe that providing more flexibility to intermediate small banks on how to apply their community development resources to respond to community needs through more strategic use of loans, investments, and services will reduce burden on these banks while making the evaluation of their community development records more effective. The agencies will incorporate these considerations as appropriate into examination guidance and procedures to ensure flexible application of the standards.

To ensure that community development performance and retail lending are appropriately weighted, an intermediate small bank would have to achieve a rating of at least satisfactory on both tests to be assigned an overall rating of satisfactory.¹

“Community Development” definition

The regulations’ present definition of “community development” has been criticized for failing to recognize the unique community development needs of rural areas. The FDIC’s August, 2004, NPR proposed including individuals from rural areas in addition to the current definition that only included individuals with low- and moderate-incomes. Commenters to that proposal raised the concern that this definition could include rural individuals with high incomes. Therefore, based on those comments, the March, 2005, NPR proposed amending the “community development” definition to cover “underserved” rural areas that support affordable housing and revitalization and stabilization of these areas. This term was not otherwise defined in the proposal, and the agencies asked for comments to a series of proposed definitions revolving around quantifiable benchmarks, such as the percentage of nonmetropolitan median family income or statewide median family income, as well as examiner discretion. The NPR also proposed including in the revised community development definition, individuals in a “designated disaster area,” which would be defined as an area that has received an official designation as a disaster area.

Following a thorough review of the potential alternatives, including those discussed in the comments received, the agencies will designate “distressed or underserved nonmetropolitan middle-income geographies” in which bank revitalization or stabilization activities are eligible for community development consideration, in addition to low- and moderate- income tracts already eligible under the existing regulation. The agencies will publish and periodically update a list of these eligible tracts on the web site of the Federal Financial Institutions Examination Council.

The designations will be based on objective and generally accepted criteria. A middle-income, non-metropolitan tract will be designated if it is in a county that meets one or more of the following triggers that the CDFI Fund employs as “distress criteria”: (1) an unemployment rate of at least 1.5 times the national average, (2) a poverty rate of 20 percent or more, or (3) a population loss of 10 percent or more between the previous and most recent decennial census or a net migration loss of 5 percent or more over the five-year period preceding the most recent census.

A middle-income, non-metropolitan tract will also be designated if it meets criteria for population size, density, and dispersion that indicate the area’s population is

¹ The agencies are not revising the provision in the existing regulations that permits any small bank, including an intermediate small bank, to choose to be evaluated under the large bank lending, investment, and service tests at its option. Any small bank that opts to be evaluated under the lending, investment, and service tests would be required to collect and report small business, small farm, and community development loan data. See 12 CFR 345.21(a)(3).

so sufficiently small, thin, and distant from a population center that communities in the area are likely to have difficulty financing the fixed costs of meeting essential community needs, specifically, needs for essential infrastructure and community facilities. The agencies will use as the basis for the designations the “urban influence codes” maintained by the Economic Research Service of the United States Department of Agriculture. In these areas, bank financing for construction, expansion, improvement, maintenance, or operation of essential infrastructure or facilities for health services, education, public safety, public services, industrial parks, or housing generally will be considered to meet essential community needs, so long as the infrastructure or facility serves low- and moderate-income residents. Other activities will be considered on a case-by-case basis following guidance in *the Interagency Questions and Answers Regarding CRA*, which is updated periodically

The agencies are also revising the definition of “community development” to make bank activities to revitalize or stabilize designated disaster areas eligible for CRA consideration. Disaster areas may be designated by federal or state government. A designation will expire for purposes of CRA when it expires according to the applicable law under which it was declared.

Illegal Credit Practices

Finally, modifying a proposal from the February, 2004, NPR, the March, 2005, proposal would have provided examples, in the regulation, of the types of illegal credit practices that could have a negative effect on a bank’s CRA performance. These would have largely involved violations of a variety of consumer protection laws, several of which were identified in interagency CRA Q&As already issued by the agencies. The proposal would have covered such credit practices in any geography by the bank or in any assessment area by any affiliate whose loans have been considered as part of the bank’s lending performance.

The proposed joint final rule revises the agencies’ regulations to address the effect of evidence of discrimination or other illegal credit practices as proposed. The rule includes an illustrative, but not exhaustive, list of such practices. We believe that specifying examples of violations that give rise to adverse CRA consequences in the CRA regulations, rather than solely in interagency guidance on the regulations, will improve the usefulness of the regulations and provide critical information in primary compliance source material.

Effective Date

The joint final rule will become effective on September 1. The agencies expect to develop interagency examination procedures for interim intermediate small banks that will be released prior to the effective date of the regulation.

A draft of the proposed Federal Register notice is attached.

Attachment

Concur:

Jodey Arrington
Chief of Staff to the Chairman