Community Development Venture Capital Alliance

CDVCA

Board of Governors of the Federal Reserve
Docket No. R-1181
Jennifer J. Johnson
Secretary, Board of Governors
20th Street and Constitution Avenue NW
Washington, DC 20551
regs.comments@federalreserve.gov

April 6, 2004

Dear Federal Regulator:

Thank you for the opportunity to comment on the Joint Notice of Proposed Rulemaking on the Community Reinvestment Act (Federal Register, Vol. 69. No. 25 pp.5729+).

The Community Development Venture Capital Alliance (CDVCA) is the national trade association for community development venture capital (CDVC) funds. We have more than 110 members, more than 60 of which are CDVC funds actively investing or in formation. The CDVC industry manages $550 million of capital, much of it provided by small and large bank investors who are motivated, in part, specifically by the Investment Test in the current CRA regulations.

The Joint Notice of Proposed Rulemaking proposes three major changes to the current CRA regulations:

(1) To amend the definition of "small institution" from $250 million to $500 million in assets, without regard to any holding company assets;
(2) To count mortgage loans made to borrowers based strictly on liquidation or collateral value and without regard to the borrower's ability to pay as an abusive lending practice and to have those loans adversely affect the evaluation of the institution's CRA performance; and,
(3) To enhance the disclosure in CRA exams and CRA disclosure statements relating to loan originations and loan purchases, as well as to loans covered by the Home Ownership and Equity Protection Act (HOEPA).

As the national association for CDVC funds, CDVCA is particularly concerned with the proposal to increase the asset size for the Small Institutions examination from $250 million in assets to $500 million in assets, and to drop the test for affiliation with a holding company with $1 billion or more in assets. As you know, the Large Institution examination is comprised of three separate tests—lending, services, and investments, while the Small Institutions examination is a much more cursory examination that focuses mostly on lending. The proposed changes would eliminate the Service and Investment Tests of the CRA exam for all banks and thrifts with assets between $250 million and $500 million. Because the Investment Test is the primary concern of CDVCA and its members, our comments will focus on this matter. CDVCA strongly urges against increasing the threshold from $250 million to $500 million for the Small Institutions test.

Background Discussion on Small Institutions

In the background discussion on Small Institutions, the Proposed Rule identifies two aspects of the Large Institutions examination as particularly burdensome for institutions just above the $250 million threshold (p. 5737). The first aspect is that some small retail institutions report that they must compete with much larger institutions for suitable investments and, as a result, "sometimes invest in activities inconsistent with their business strategy, their own best financial interests, or community needs." To this we would first ask, does the Proposed Rule argue against competition in banking markets? Competition is the driving force behind innovation in community development as much as in information technologies; any move by the regulators to limit competition among banks will stifle innovation and ultimately decrease the efficiency of the market. We strongly argue against the Proposed Rules implied support to reduce competition and innovation.

CDVCA also believes that to the extent that some banks may be making poor investment decisions, it is a problem not with the Investment Test itself, but with the way certain institutions may be interpreting it. The legislation and regulations clearly prohibit CRA-related activities that are not consistent with safe and sound lending practices. If certain bank and thrift institutions are interpreting the regulations incorrectly those errors are best addressed through better education and changes to examiner training and guidance to insure that misinterpretation is prevented. In addition, as part of the "Performance Context," examiners should also keep in mind that CRA Qualified Investment opportunities, which are consistent with safe and sound banking practices, may be limited in certain areas and that Large Institutions may, for a variety of reasons, have better access to these investments.

The second aspect identified in the Proposed Rules that concerned Small Institutions is that the data collection and reporting are proportionately more burdensome for institutions just above the threshold than those far above it. First, as the Proposed Rule explains the "compliance burden on institutions just above any threshold, measured as the cost of compliance relative to asset size, generally will be proportionately higher than the burden on institutions far above the same threshold, because some compliance costs are fixed." In other words, this problem is inevitable when you have two classes of institutions. We are concerned that the increase from $250 million to $500 million represents merely a first step in ratcheting up the threshold. And, as we argue below, we see no good reason to raise it in the first place.

Factors Justifying an Increase in the Asset Size for Small Institutions

At the bottom of page 5738 (middle column) the Proposed Rule lists four factors as justifying an increase in the asset threshold for the Small Institutions test:

(1) The increase in relative compliance burden between small and large retail institutions;
(2) The number of small institutions has declined since 1995;
(3) Inflation alone is responsible for some portion of asset growth; and,
(4) The agencies are committed to reducing regulatory burden where feasible and appropriate.

We address each of these individually.

Relative Compliance Burden

The Proposed Rules notes that the disproportion in compliance burden between banks just over the $250 million threshold and those well over the threshold has grown over time. The question of course is why? The change in relative costs has everything to do with Large Institutions getting much larger, spreading the costs of compliance over ever growing asset bases, and little or nothing to do with changes in the absolute costs of compliance for banks in the $250 to $500 million asset range. In 1995 there were 421 banks with over $1 billion in assets and their average total assets was $7.9 billion; in 2003, there 424 banks with more than $1 billion in assets, and their average asset size had ballooned to $15.3 billion.[1] Bank asset size is even more skewed among the largest US banks, which at the end of last year—before two very large mergers involving four banks already on the list of the 20 largest US banks—had an average total assets of $278 billion. If the regulators true concern were the relative disproportion in compliance costs between Small and Large Institutions, doubling the threshold to $500 million for the Small Institutions would be inconsequential.

Given that dramatic differences in asset size, we contend that what should matter to the regulators is the absolute compliance burden and the compliance burden relative to each bank's assets. And on these matters the Proposed Rules cites no evidence to show that the current threshold is infeasible or inappropriate. In fact the research by the Federal Reserve shows that for a variety of reasons bank productivity has increased dramatically over the past twenty years, suggesting that net effects of CRA compliance have been trivial.[2]

Number of Small Institutions Has Declined

We see no connection between the number of Small Institutions having declined and the need to change the threshold for the Small Institutions test. Do the federal regulators have some ideal number of banks that should be in the Small Institutions category? The only issue that we can imagine is that the workload of the regulators would decrease as more banks were covered by the Small Institutions exam, which is less comprehensive. Limited bureaucratic resources is a real matter and CDVCA recognizes that regulators cannot "do everything." If this is the issue than it should be addressed head on, not through regulatory adjustments that would have negative effects on low-and-moderate income persons and communities.

Inflation

The Proposed Rules also suggests that an increase in the asset size for Small Institutions is necessary, in part, to keep up with inflation. However, the proposed change—doubling the asset size—assumes an annual inflation rate of nearly 10 percent per year (from 1995 to 2004). In fact, the annual inflation rate over this period averaged less than 2.5 percent; if the proposed change were based strictly on the consumer price index the Small Institution's asset threshold for 2003 would be raised to only $310 million. In addition, we believe that any attempt to index the asset size will prove more cumbersome than keeping the fixed threshold constant over time.

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[1] Data are from the Federal Deposit Insurance Corporation's "Statistics on Banking" web page and are for 12/31/1995 and 12/31/2003.

[2] Some research showing growing productivity in banking include: Allen Berger (2003) "The Economic Effects of Technological Progress: Evidence from the Banking Industry." *Journal of Money, Credit, and Banking*. Vol. 35.; Fred Furlong, "Productivity in Banking." Federal Reserve Bank of San Francisco's *Economic Letter* 2001-22. July 27, 2001.

Reducing Regulatory Burden

Reducing regulatory burden on covered institutions is the final justification that the Proposed Rules claims justifies an increase in the threshold for the Small Institution examination. We support efforts to reduce regulatory burden on banks and thrifts and believe that changes made to CRA in 1995—moving the emphasis on CRA examinations from process to performance—was an excellent change. The Proposed Rule seems to want to fix something that is not broken. The only comment regarding the differential costs of compliance for small versus large institutions is that institutions face a threefold increase in compliance costs as they move from the Small Institutions examination to the Large Institutions examination. First, the Proposed Rule notes that this is merely "asserted" by "some commenters" and no evidence substantiates the assertion. Second, there is no baseline offered for the "three-times increase." A small baseline cost that is increased threefold can remain quite small. Third, to the extent that thousands of banks have moved from the Small Institution exam to the Large Institution exam these incremental costs (whatever they may be) have already been incurred. There is absolutely no evidence (not even an assertion) that the *ongoing* costs of compliance with the Large Institution exam is either infeasible or inappropriate. (Nor, for that matter, is there evidence that the ongoing compliance costs are disproportionately greater for Small Institutions than for Large Institutions.) Also, thousands of banks would now be moved backward to the Small Institution examination and would incur another lump sum cost associated with reverting back to the old compliance system. Thus, in fact, the changes as proposed would actually increase regulatory burden for more than 1,100 banks.[3] At the very least, if the regulators insist on adjusting the asset size threshold for Small Institutions, they should allow institutions the option to remain covered by the Large Institution exam.

In sum, we find that the factors that the Proposed Rule relies upon to justify the dramatic increase in the threshold for the Small Bank test do not stand up to scrutiny.

Additional Concerns and Comments

In addition to the concerns with the proposed changes to the threshold for the Small Institution test, CDVCA wishes to raise additional matters, which we encourage the regulators to consider.

First, the Proposed Rule makes repeated reference to the fact that the "proportion of the nation's bank and thrift assets covered by the large retail institution test, including the Investment Test" will not be materially reduced. However, the question for local communities is not the reduction in *national* bank assets, but the reduction in *local* bank assets covered by the Investment Test. Analysis conducted by the Woodstock Institute shows that the number of Illinois institutions covered by the comprehensive CRA exam would fall by 63 percent, from 198 banks to 74. And in rural areas or small cities, the number of institutions covered by comprehensive CRA will decline by nearly 73 percent. We strongly encourage the federal regulators to recognize that the proposed changes, which appear inconsequential at the national scale, would have substantial adverse consequences in thousands of communities and disproportionately affect rural communities.

Second, increasing the threshold for the Small Institution test would mean the loss of small business lending data that is reported in CRA examinations and could materially affect the efficiency of small

[3] We can imagine a scenario where a bank that has recently gone over the $250 million threshold and implemented new compliance procedures for the Large Institution exam is forced back to the Small Institution exam; then grows its assets to over $500 million and is forced to re-adopt the Large Institution exam procedures it was forced to throw out only a short while before.

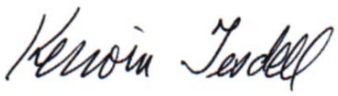
business lending markets across the country. Markets work best when all actors have access to good information. Because smaller banks (in the $250 million to $500 million range) are such a disproportionately large provider of small business lending, increasing the number of institutions exempted from the CRA reporting requirements associated with Large Institution examination would mean a dramatic decrease in our ability to analyze small business lending patterns. This is a critical issue and a major step backward for communities, researchers, lenders, and anyone interested in market-based solutions to social and economic inequities.

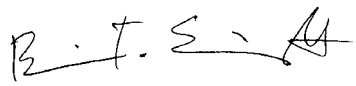
Finally, as one of many national trade associations, which collectively represent literally thousands of Qualified Investment opportunities throughout the country, we strongly encourage the federal regulators to work with CDVCA and our trade association colleagues to help educate institutions of all asset sizes about the opportunities to meet the CRA Investment Test.

Our comments have been aimed specifically at the proposed changes to the threshold for the Small Institutions examination and, in particular, the Investment Test. However, CDVCA and its members are also strong supporters of community development, fair credit terms, affordable, housing, and efficient capital markets. We wish to convey our support for the comments submitted by the National Community Reinvestment Coalition, the National Community Capital Association, and the Woodstock Institute.

Thank you very much for the opportunity to comment on the Joint Notice of Proposed Rulemaking. If you have any questions about these comments please do not hesitate to contact us.

Sincerely,





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