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MEMO

From: Kenneth H. Thomas, Ph.D.

To: Chair Jerome Powell & Vice Chair Lael Brainard via Docket No. R-1769 and RIN 7100-AG29;
Acting Comptroller of the Currency Michael Hsu via Docket ID: OCC-2022-0002; and,
Acting Chairman of the FDIC Martin J. Gruenberg via Docket No. RIN 3064-AF81

Date: August 5, 2022

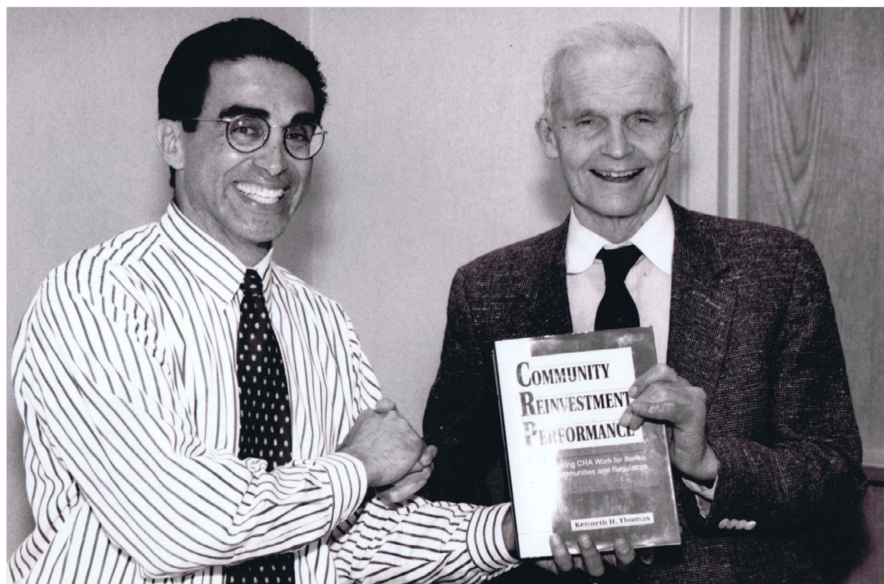
Re: Fifth CRA NPR Comment on "The NPR's Major Errors of Commission and Omission"

This is my fifth comment on this NPR on CRA Reform, and it is titled *"The NPR's Major Errors of Commission and Omission."* Before providing more details on this comment, I will first summarize my relevant background on CRA reform.

My comments represent my personal views and not those of any university, financial institution, company, or other organization with which I am or previously have been associated.

My Relevant Background on CRA Reform

My current and past expertise in CRA in general and its reform in particular are relevant to this comment. In short, I have spent the majority of my professional life since 1977 focused on the CRA. I was greatly honored to have known and spent time with former Senator William Proxmire, the "Father of CRA." The following photo was taken in 1995.



I am proud of the fact that my first book on CRA, Community Reinvestment Performance (Probus Publishing, Chicago, 1993), received the only endorsement he ever gave to any CRA publication:

> *Dr. Thomas' book,* Community Reinvestment Performance*, is far and away the best analysis of government regulation that I have seen in any field. He spotlights the regulatory problems that continue in CRA and points out precisely how they are being overcome. CRA will benefit enormously from this superlative examination and report.*

I have worked closely with numerous banks, community groups, and regulators on CRA since 1977, including training federal bank CRA examiners. Besides acting as a CRA consultant and being on the boards of various financial institutions, I am a cofounder and founder of two different CRA high impact mutual funds devoted primarily to providing CRA qualified investments to benefit LMI areas and people.

I had the privilege of testifying before Congress and federal bank regulators several times on CRA and related bank regulatory and public policy issues. Many of the recommendations in my books, including various CRA exam procedures and tests, were directly implemented into current bank regulations, and more details in this regard are found at www.CRAHandbook.com in The CRA Handbook (McGraw Hill, New York, 1998).

I was honored to receive the first "Award of Excellence" from the National Community Reinvestment Coalition (NCRC), along with Representative Joseph P. Kennedy and Comptroller Ludwig.

In summary, I have a vested interest in getting CRA reform "right," which I define as being what Senator Proxmire intended. We got it right in 1995 when I worked with Comptroller Ludwig and his OCC staff on the last major reform of CRA, and that is my goal during the present effort.

Incomplete Grade for This Fed NPR Ph.D. Dissertation

The nearly 700-page NPR, which was apparently written by some of the more than 400 Ph.D. economists at the Fed (https://www.federalreserve.gov/econres/theeconomists.htm) reads more like a Ph.D. dissertation than an NPR.

If I was forced to grade it, it would get nothing better than an *"Incomplete,"* since only a fraction (actually one of eight of the stated objectives) of the NPR is devoted to the real mission of CRA reform, namely modernization.

Unfortunately, the section of the NPR dealing with the critical modernization issue totally misses the point and, in fact, has the wrong answer (i.e., Retail Lending Assessment Areas) to the right problem (i.e., regulating branchless and other "carpetbagger banks" siphoning deposits from local communities to benefit their distant home community). Most of the rest of the NPR has unnecessarily complicated answers to the wrong problems.

As pointed out in my related comments, this entire NPR should be discarded in favor of what can be called *"CRA Reform Lite,"* which includes (1) the 5% Deposit Reinvestment Rule for branchless banks and (2) several of the improvements in the rescinded OCC Final Rule.

Some of these OCC improvements include the list of eligible community development activities and an advance notification of whether or not an activity would be eligible for CRA credit as described at https://www.occ.gov/topics/consumers-and-communities/cra/qualifying-activity-confirmation-request/index-cra-qualifying-activities-confirmation-request.html.

While the Fed's NPR was wise to cherry pick the best ideas from the rescinded OCC Final Rule, it was unwise in its failure to adopt its Deposit-Based Assessment Area concept instead of coming up with the uncommon concepts of a Retail Lending Assessment Area and Outside Retail Lending Area.

Assuming the Fed's NPR is not totally discarded as it should be, the Ph.D. and other architects should have the courtesy of at least knowing their major errors of commission and omission. The following lists identify the five major errors of commission and omission in the NPR, although there are many many more.

NPR's Five Major Errors of Commission

1. *Expanding CRA reform's goal of modernization to a complex and unnecessary major overhaul*

   This fateful error, which is discussed in detail in an accompanying comment, is a prime example of the mission creep the Fed has been criticized for by members of Congress and other outside Fed watchers.

   As pointed out in a recent article about the Fed's recent failures, including "transitory" inflation (https://www.americanbanker.com/opinion/after-recent-failures-its-clear-fed-must-be-restructured), one of the many reasons for the Fed's very poor performance as our central bank is its considerable "mission creep." This mission creep unfortunately caused the Fed to lose focus on its main job of maintaining price stability and full employment.

   It was recently criticized for research on "social policy topics" like climate change and social justice, reflecting political and normative views of unelected officials in what is supposed to be an independent agency.

   This same mission creep is evident in the 700-page NPR, which the Fed cleverly clothed as an "interagency" effort. As a result of this mission creep, where the Fed is run more like a university with 12 Federal Reserve bank campuses, the agency has become an economic jack-of-all-trades but unfortunately a master of none, unfortunately including managing inflation and reforming CRA.

2. *Concocting a Lending-Based Assessment Area vs. the needed Deposit-Based Assessment Area for branchless banks*

   This grave mistake not only demonstrates a lack of knowledge of CRA but how banks work. How many of the Ph.D.s and other Fed researchers who developed this CRA Rubik's Cube have worked in a bank or even completed a CRA exam of a bank?

   Having taught banking and finance at Wharton for over 40 years, one of the first things I emphasize is that deposits are the raw material or primary input of banking compared to loans being the primary output.

Senator Proxmire recognized this basic fact when he saw banks harvesting deposits out of Low- and Moderate-Income (LMI) communities but lending the money elsewhere. This is the primary reason why he created CRA, to encourage banks to meet the credit needs of their entire community, including LMI areas.

For this reason the CRA performance of branchless banks must be evaluated on the basis of where the deposits were sourced and whether or not the benefits accrue back to those areas. It does not make sense to evaluate a branchless bank on where it makes it loans, because the redlining or other damage may already have been done by them.

The only reason I can come up with as to why the Fed came up with the curious concept of a Retail Lending Assessment Area is because they wanted to distance themselves as much as possible from the rescinded OCC Final Rule that contained the proper Deposit-Based Assessment Area concept.

Instead of basing the Assessment Area of a branchless bank on deposits, the Fed did the exact opposite and used loans, which suggests that they wanted to be as far away as possible from what they may have considered a "Trump" era rule.

If that was the case, such a politically based decision has no place in public policy. If someone is speeding on the interstate, they should be pulled over and ticketed regardless of who is in the White House. Likewise, good public policy means taking the best ideas from any source to improve CRA and benefit LMI areas and people, again regardless of who is in the White House.

Regardless of the motivation of the Fed and its chief CRA architect, their ANPR and current NPR concepts of a Retail Lending Assessment Area and Outside Retail Lending Assessment Area make no sense and should be eliminated from any further discussion of CRA.

3. *Violating the "KISS Principle" with nearly 700 pages of complex proposals and formulae resulting in 180 questions*

Leonardo DaVinci famously said that *"Simplicity is the ultimate sophistication"* (see link at https://www.goodreads.com/quotes/9010638-simplicity-is-the-ultimate-sophistication-when-once-you-have-tasted). Based on DaVinci's quote, the NPR is a very unsophisticated effort.

The KISS ("Keep It Simple Stupid") Principle is more important than ever in public policy for examination procedures that will be enforced by a large examination force across three different federal agencies where EICs and examiners may not have the willingness or ability to understand and learn complex rules and formulae.

The CRA vehicle has been operating just fine since 1995, and it just needed to be modernized and tuned up. The Fed, however, decided to totally overhaul it with a new engine and body, neither of which were needed or requested.

The more than 400 Ph.D.s and hundreds of other analysts and researchers at the Fed are being paid to come up with answers to help maintain full employment and stable prices as part of their responsibility to improve public policy.

The few answers they came up with in the NPR, like Retail Lending Assessment Areas and Outside Retail Lending Areas, are wrong. Even worse than coming up with the wrong answers, they came up with 180 unanswered questions.

4. *No basis for new regulatory burden on Very Large Banks defined as having over $10 billion in asses when it should have been over $100 billion in assets.*

There is no doubt that the heaviest regulatory burden of the NPR is on the Fed's new category of Very Large Banks with assets over $10 billion. However, there is absolutely no justification by the Fed (or FDIC or OCC) as to why those banks were singled out for such a regulatory burden.

In fact, the day the Fed announced its NPR, one of its Board of Governors (a former banker) effectively dissented at https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20220505.htm:

> *However, there are several provisions in the proposal that will impose significant costs and burdens on banks, specifically those with assets above $10 billion.*
>
> *Under the proposal, these banks would have to collect and report extensive new information on deposit accounts, automobile loans, usage of mobile and online banking services, and community development loans and services, as well as detailed information about branches.*

According to the Fed at https://www.federalreserve.gov/releases/lbr/current/, as of March 31, 2022 there were 135 banks with more than $10 billion in assets representing 88% of all domestic bank assets. However, there are only 32 banks with more than $100 billion in assets, and they represent 75% of all domestic bank assets.

How can the Fed or any agency justify placing the 103 banks with assets between $10 and $100 billion in this new category to be subject to the heaviest regulatory burden of their NPR when they are only picking up 13% more of all domestic bank assets (going from 75% to 88%)?

The Fed's $10 billion definition of Very Large Banks in their NPR makes no sense other than being punitive and piling on to the significant CFPB and other regulatory burdens of these banks.

If the Fed wants big banks to carry the bulk of the CRA burden, they should absolutely and positively focus on the 32 with assets over $100 billion that would capture three-fourths of industry assets.

This would allow the 103 banks in the $10 to $100 billion range to focus on the business of banking rather than complying with the very complex and burdensome NPR, especially as our economy will likely be entering a Recession.

5. *Using higher asset thresholds for Small/ISB Banks to attempt to gain banking industry acceptance*

   It appears that the Fed made a politically calculated decision to totally safe-harbor small banks by nearly doubling their asset thresholds to $600 million to hopefully get the support of the politically powerful and large ICBA representing mainly small banks. Small banks would have the option under the NPR to subject themselves to the new complex Retail Lending Test, but that would be very unlikely.

   The Fed attempted to gain additional industry support for their NPR by greatly increasing the asset threshold for Intermediate Small Banks to $2 billion, although they would be subject to the new complex Retail Lending Test.

   The Fed moreover effectively safe harbored Wholesale and Limited Purpose Banks with a tailored version of their new Community Development Financing Test, and these banks and those with Strategic Plans (also generally left in tact) include some of the largest and most powerful banks.

   Again, all of this was done at the expense of Large Banks with more than $2 billion in assets and most especially Very Large Banks with more than $10 billion in assets, despite a total lack of justification for any of these higher asset thresholds other than apparently gaining NPR support from the ICBA generally representing small banks.

NPR's Five Major Errors of Omission

1. *Failing to discuss any real FINANCIAL motivations for Outstanding CRA ratings*

   The CRA Handbook and its predecessor Community Reinvestment Performance (www.CRAHandbook.com) have long argued for some real FINANCIAL motivation for an Outstanding rating such as reduced taxes, reduced deposit insurance assessments, or reduced borrowing rates for FHLB advances or at the Fed discount window. There are no such financial motivations in the NPR, so why should a bank strive for an Outstanding rating?

   The only real benefit of an Outstanding rating at the present, other than a bank putting it in Press Release or on their website, is what I call Fair Lending Downgrade Insurance (FLDI).

   In the event a bank is hit with a fair lending or similar violation mandating a one-level CRA rating downgrade, this would be hardly noticeable for a bank with an Outstanding rating, since it would just fit in with the 90% or so of banks with Satisfactory ratings. However, FLDI does not work with rare two-level (i.e., Wells Fargo) downgrades.

2. *Refusal to adopt a 5-tier final rating system with High and Low Satisfactory overall ratings*

   The CRA Handbook and its predecessor Community Reinvestment Performance (www.CRAHandbook.com) have likewise long argued for a 5-tier final rating system with both High and Low Satisfactory ratings, although this was not proposed in the NPR.

Separate High and Low Satisfactory ratings currently exist in Massachusetts, which has its own CRA regulations for state-chartered banks, credit unions, and even mortgage companies. However, as a concession to their financial institutions, that state refers to "Low Satisfactory" ratings as just "Satisfactory." This would be a big improvement over the current federal system of just four overall ratings.

Instead of roughly 90% of the industry getting a "Satisfactory" rating, with a five-tier overall rating system we would know which banks excelled with a High Satisfactory ("B") vs. those with just a barely passing Low Satisfactory ("C") rating.

This is yet another example of where the Fed appeared to side with the industry that will always prefer the broader overall Satisfactory rating rather than it being broken down between High and Low Satisfactory categories.

3. *No suggestions to improve CRA examiner training or rate examiners to expose "rogue" examiner*

Regulators never want to admit they have "rogue" examiners, but we all know they exist. The CRA Handbook and its predecessor Community Reinvestment Performance (www.CRAHandbook.com) have again long argued that the best way to expose rogue examiners is to require public ratings of them as is done for faculty members at universities.

Examiners are presently rated by banks after compliance and safety and soundness exams, but these ratings are not public. Also, bankers are reluctant to identify "rogue" examiners for fear of regulatory retaliation. While every agency has policies that specifically prevent such retaliation, no banker wants to risk alienating their prudential regulator.

This is especially the case when a bank considers appealing a questionable or outright erroneous regulatory decision or even going to the agency Ombudsman. This is because the agencies "circle their wagons" to protect their examiners, including rogue ones.

The most problematic rogue examiners are those who want to make a name for themselves among fellow examiners by being the first one to downgrade a bank with multiple Outstanding ratings or even unfairly giving out a failing CRA rating to a bank for the first time.

Rogue examiners may use their unbridled subjectivity to conclude that a bank is not satisfactorily meeting credit and other banking needs within its Assessment Area thereby disallowing any CRA credit for legitimate community development activities outside of that Assessment Area.

Rogue examiners also fail to give CRA credit to a bank that has helped its community during the Pandemic with PPP loan modifications, or other activities as explained in detail in the *American Banker* article at https://www.americanbanker.com/opinion/community-banks-are-getting-too-little-credit-for-ppp-loans.

Just as the regulators regularly encourage bankers and especially directors to attend educational and other seminars to improve themselves, the regulators themselves should improve CRA examiner training with a goal of exposing rogue examiners so they can be retrained.

4. *Failing to address Strategic Plan loopholes like setting low performance goals to ensure Outstanding rating*

The problem with the self-regulating Strategic Plan option is that a bank, with the support of friendly community groups and an apparently automatic approval of the regulatory agencies, can set and easily meet its own benchmarks for a Satisfactory and especially an Outstanding level.

Ally Bank's published Strategic Plan contains detailed data on other approved Strategic Plans in Appendix 7 titled "Support Tables for 'Outstanding' and 'Satisfactory' Goal Levels" (https://www.federalreserve.gov/consumerscommunities/files/ally-strategic-plan.pdf).

These tables documents very significant differences (FOUR to FIVE times) in the benchmarks to achieve Satisfactory and Outstanding ratings as well as in the relative differences in the benchmarks between the two ratings (up to TEN times). This is clearly way too much disparity in this self-regulating exam option.

There is no other area of bank regulation in Safety and Soundness or Compliance where a bank sets its own regulatory performance evaluation standards for its desired rating. This is totally contrary to the use of CAMELS and other regulatory ratings where banks are objectively evaluated by their regulators, regardless of input from the banks themselves, community group, or other outside parties.

The NPR states that all banks have the option to develop a Strategic Plan. It is therefore possible that this option will become the lowest common denominator of CRA evaluation procedures, if banks prefer this effectively self-regulated approach over the proposed complex and burdensome exam procedures in the NPR.

Thus, the Strategic Plan has the potential to be the CRA exam procedure of first choice and last choice for many banks not willing or able to obtain a Satisfactory or Outstanding rating under the proposed NPR exam procedures.

For the above and other reasons, it is recommended that the Strategic Plan option be eliminated OR significantly improved to correct the many problems identified that are inherent in this exam procedure. This section will summarize five key areas of needed improvement to maintain this option.

The *first* and most important needed improvement is the publication of specific guidelines or benchmarks by the regulators for both Satisfactory and Outstanding ratings, so banks know the answer to one of the most important questions in CRA: *"How much is enough?"* The regulators must then require all submitted plans to have specific measurable goals based on these guidelines.

For example, The CRA Handbook recommends that an Outstanding bank should have community development loans of at least 1% of average assets over the Review Period, and the same is true for community development investments. The combined level of both community development activities would be at least 2% of average assets.

A *second* needed improvement to maintain the Strategic Plan exam alternative is to eliminate the "fail safe" option. Under the current regulations, a bank with a Strategic Plan has the option to provide an indication in that plan of whether or not it elects to be evaluated under another assessment method *if* the banks fails to substantially meet the Strategic Plan goals for a "Satisfactory" rating. Small, intermediate, large, limited purpose and wholesale banks are not provided this fail-safe option, so it is time to eliminate this advantage from an already bank-friendly exam procedure.

A *third* needed improvement with the Strategic Plan alternative is full transparency on any and all material submitted to regulators regarding anything related to the development of the Satisfactory and Outstanding performance benchmarks. For example, a reader of the Ally Bank Strategic Plan, other than the regulator approving it, cannot really understand the basis for their rating benchmarks, since the relevant peer data and the bases for their goals are contained in two confidential exhibits.

A *fourth* needed improvement with the Strategic Plan option is to require banks submitting them to identify if they have given any direct or indirect financial or non-financial aid to any community group or other organization that submits a letter in support of a bank's Strategic Plan.

A *fifth* improvement, proposed in the current NPR, is that all banks submitting Strategic Plans are subject to the data collection, recordkeeping, and reporting requirements identified in the NPR, so there is a level playing field with other banks not using the Strategic Plan option.

Assuming these five necessary improvements are made in the Strategic Plan option, it would be preferable to maintain this option and allow banks the flexibility to determine the most appropriate exam procedure to evaluate its CRA performance.

These improvements will also have the benefit of reducing the grade inflation that exists with several of the Outstanding-rated banks with Strategic Plans. Using published CRA ratings data from the FFIEC for the nearly 80,000 CRA exams conducted and publicly reported since 1990, we find that 14% of all banks under all of the exam procedures received Outstanding ratings, but the banks with Strategic Plans reported more than THREE times that amount with an incredible *45%* Outstanding result.

This begs the following question*: "Are banks with Strategic Plans THREE times better in terms of Outstanding CRA performance than all other banks?"* The present and past analyses I have conducted since 1995 suggest that this is not the case, and that the threefold difference in Outstanding ratings is simply due to grade inflation under the Strategic Plan option.

For these and other reasons identified here and in The CRA Handbook, it is more important than ever that the improvements recommended above be immediately implemented. If this is not the case, the best public policy alternative would be to simply eliminate the Strategic Plan option, since it is the one used by the fewest banks in the nation (about 60), and there is really no place for a self-regulating exam procedure in CRA.

5. *Failing to address Community Benefit Agreements (CBAs) and the need for full disclosure by banks and community groups*

   My recommendations to the Fed and other regulators regarding the need for full disclosure of all aspects of Community Benefit Agreements (CBAs) were made at recent public hearings in March before the Federal Reserve Bank of Minneapolis regarding the proposed merger of U.S. Bancorp and MUFG Union Bank, NA and in July before the Federal Reserve Bank of Chicago regarding the proposed merger of BMO Financial Corp. and Bank of the West. My formal comments on both mergers are a matter of public record.

   The recent record $100 billion five-year CBA that accompanied the cited U.S. Bank deal, the $88 billion PNC CBA, and the forthcoming (estimated $40 billion) five-year CBA for the BMO deal represent *de facto* conditions of approval by the Fed. These CBAs also represent the "Bread and Butter" for many community groups and coalitions, and they have therefore argued that CBAs should be mandatory for all merging banks.

   However, there is a lack of full disclosure of these CBAs, especially the extent to which specific community groups and coalitions directly benefit from them.

   As in the case of previous megamergers, such plans, which are not required by the CRA or any other law, are primarily efforts to expedite the merger, a form of WD-40 to help quiet potentially squeaky community groups that would otherwise likely protest the merger.

   Otherwise, why wouldn't such a plan have been created as part of each bank's past community service and development efforts prior to the merger?

   The NPR should mandate that the Fed, FDIC and OCC must require that each and every aspect of every CBA, including correspondence between the Applicant and parties to the CBA, as well as Annual or other updates, be made public on the website of the resultant bank.

   It is not enough to make a summary of the CBA or even an abridged version available publicly as is presently being done, but rather there must be a public accounting of how the tens of billions of dollars are being allocated, including all direct and indirect benefits to community groups or coalitions.

   As asked in my testimony on these mergers, "*How much of this money is going to communities and how much is going to the groups?"*

   This is critically important because while all community groups should first and foremost be serving their community, some may be more focused on serving their group rather than their community.

   The lack of such complete and full CBA disclosure is a serious public policy problem because these CBAs are really *de facto* conditions of approval whereby the opposing community groups and coalitions support the merger, thus allowing the regulators to approve it.

Section 3 of the Bank Holding Company Act and the Bank Merger Act require this or any proposed merger meet the convenience and needs of the community to be served. But, *how do we know if the public interest is being met when all of the details and financial accounting on these deals are Confidential.*

The CBAs are the real basis for meeting the convenience and needs statute today, and all aspects of them should be public.

This recommendation is not just about these recent CBAs but the 19 CBAs made by the National Community Reinvestment Coalition (NCRC) with megamerging banks totaling $541 billion and the $50 billion of CBAs made by the California Reinvestment Coalition (CRC) per the respective websites of these two coalitions.

These and other coalitions and community groups must understand that this public policy recommendation is in the public interest. That is, they could shine some needed sunlight on this process if they published on their website all of the details and correspondence with the subject banks and regulators on every CBA rather than a brief summary of them as has been done.

Furthermore, the Fed and the other primary regulators should not only monitor these CBAs but also enforce them to help ensure the resultant merger is truly meeting the convenience and needs of the subject community and the overall public interest.