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CREDIT WHERE IT COUNTS: MAINTAINING A STRONG COMMUNITY REINVESTMENT ACT*

MICHAEL S. BARR[1]

The Community Reinvestment Act (CRA) has helped to revitalize low- and moderate-income communities and provided expanded opportunities for low- and moderate-income households. Recent regulatory steps aimed at alleviating burdens on banks and thrifts are unwarranted, and may diminish small business lending as well as community development investments and services. This policy brief explains the rationale for CRA, demonstrates its effectiveness, and argues that the recent regulatory proposals should be withdrawn or significantly modified.

INTRODUCTION

In 2004, two of the four federal banking regulatory agencies pulled out of a joint CRA rulemaking process. First the Office of Thrift Supervision (OTS) made a unilateral announcement that the agency was going to curtail CRA examinations for nearly 90 percent of thrifts that it regulates, treating those institutions holding less than $1 billion in assets as "small," and the Federal Deposit Insurance Corporation (FDIC) proposed a similar rule for banks that it regulates.[2] The Federal Reserve Board and the Office of the Comptroller of the Currency initially balked at this move.[3] A few

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2. *See* OTS, Community Reinvestment Act Regulations, 69 Fed. Reg. 51,155 (Aug. 18 2004); FDIC, Community Reinvestment, 69 Fed. Reg. 51,611 (Aug. 20, 2004).

3. Press Release, Board of Governors of the Federal Reserve System, "Board's Intention to Withdraw Proposed Amendments to Community Reinvestment Act Regulations" (July 16, 2004); Press Release, Office of the Comptroller of the Currency, "OCC Will Withdraw CRA Regulatory Proposal" (July 16, 2004).

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months later, OTS proposed to let any savings and loan, regardless of size, opt out of the investment and service tests under CRA.[4] Then, in February 2005, the Fed, the OCC, and the FDIC all agreed to raise the small bank threshold to $1 billion but added a new "community development test" for institutions with between $250 million and $1 billion in assets.[5]

At bottom, debate over these changes revolves around competing views of the underlying purposes of CRA, as well as its costs and benefits. This brief thus explores the background and operation of CRA, then demonstrates that CRA has helped low- and moderate-income households at low cost, and finally examines the current policy debate and provides policy recommendations.

BACKGROUND ON CRA

The Community Reinvestment Act of 1977 (CRA) encourages federally insured banks and thrifts to meet the credit needs of the communities that they serve, including low- and moderate-income areas, consistent with safe and sound banking practices. Federal banking agencies examine banks periodically on their CRA performance and rate the institutions. Regulators consider a bank's CRA record in determining whether to approve that institution's application for mergers with, or acquisitions of, other depository institutions. Banks and thrifts must have a satisfactory CRA record if they, or their holding companies, are to engage in newly authorized financial activities, such as certain insurance and securities functions.

Changes to CRA regulations issued in 1995 focused evaluations on objective performance measures rather than previously used process-oriented factors.[6] These regulations require large banks and thrifts to disclose information about their small-business, small-farm, and community-development lending. The regulations provide for tailored examinations of large banks, small banks, and wholesale or limited-purpose institutions that more closely align

4. Community Reinvestment Act—Community Development, Assigned Ratings, 69 Fed. Reg. 68,257, 68,262 (proposed Nov. 24, 2004).

5. *See* Joint Press Release [OCC & FDIC], "Federal Banking Agencies Propose Revisions to Community Reinvestment Act Regulations" (Feb. 22, 2005); Press Release, Board of Governors of the Federal Reserve System, Feb. 24, 2005 (joining proposal).

6. On CRA regulations, see generally 12 CFR 25 (applying to nationally-chartered banks), 12 CFR 228 (applying to state-chartered banks), and 12 CFR 563e (applying to thrifts).

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with the business strategies of each institution type. Large banks are evaluated on a three-part test of their lending, investments, and services, while small banks undergo a streamlined review of lending.

For large banks, the lending test accounts for 50 percent of the bank's CRA rating and evaluates its performance in home mortgage, small-business, small-farm, and community-development lending. Examiners consider the number and amount of loans to low- and moderate-income borrowers and areas, and "innovative or flexible lending practices." Under the investment test, which accounts for 25 percent of the bank's CRA grade, the agency evaluates the dollar amount of the bank's investments, investment innovation, and its responsiveness to community needs. Under the service test, which makes up the remaining 25 percent of the bank's evaluation, the agency analyzes "the availability and effectiveness of a bank's systems for delivering retail banking services and the extent and innovativeness of its community development services." The agency assesses an institution's record under these tests in light of the "performance context" in which the institution is operating, including economic and market factors; the bank's capacities, constraints, and business plans; and "the performance of similarly situated lenders."

Since enactment, CRA has been, and remains today, the subject of extensive debate. Many legal scholars vigorously question the theoretical and empirical claims that motivated CRA, and many also advocate eliminating the law.[7] These critics argue that CRA is trying to address a nonexistent problem, and that even if intervention is warranted, CRA is an inappropriate tool. Many critics also suggested that CRA was having little, if any, positive effect, and at a high cost. However, a forthcoming article systematically rebuts these prior criticisms of CRA and lays a solid theoretical and empirical foundation for the act.[8] Those findings are summarized here.

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7. *See, e.g.*, Jeffery W. Gunther, "Should CRA Stand for 'Community Redundancy Act?'" *Regulations* 23 (3) (2000): 56-60; Jeffrey M. Lacker, "Neighborhoods and Banking." *Economic Quarterly* 81 81 (2) (1995): 13-38; Jonathan R. Macey and Geoffrey P. Miller, "The Community Reinvestment Act: An Economic Analysis." *Virginia Law Review* 79 (291) (1993): 291-348; Lawrence J. White, "The Community Reinvestment Act: Good Intentions Headed in the Wrong Direction." *Fordham Urban Law Journal* 20 (281) (1993): 281-291.

8. Michael S. Barr, "Credit Where it Counts: The Community Reinvestment Act and its Critics." *New York University Law Review* 80 (101) (2005).

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CRA Reasonably Addresses Market Failures in Low-Income Communities

At its core, CRA helps to overcome market failures in low-income communities. By fostering competition among banks in serving low-income areas, CRA generates larger volumes of lending from diverse sources, and adds liquidity to the market, decreasing the risk of each bank's loan. Encouraged by the law, banks and thrifts have developed expertise in serving low-income communities, and they have created innovative products that meet the credit needs of these areas with manageable risks.

These market innovations have taken several forms. Banks and thrifts have engaged in special marketing programs to targeted communities; experimented with more flexible underwriting and servicing techniques to serve a broader range of households, and funded credit counseling for borrowers. Many larger institutions have developed specialized units that focus on the needs of low- and moderate-income communities. Others have formed partnerships with community-based organizations and community development financial institutions (CDFIs). CDFIs provide local expertise and financial education, and assume portions of risk that banks do not want to bear. Spurred in part by the CRA investment test, banks have invested in CDFIs in record numbers, strengthening their ability to serve low-income markets.

CRA also facilitates coordination among banks to reduce information costs. Because the law requires all insured depositories to lend in their communities, it reduces "free rider" problems. It has spurred the development of multi-bank community development corporations and loan consortia to serve low- and moderate-income communities more effectively. Moreover, banks get CRA consideration for both originating and purchasing loans, creating a trading system. Institutions can also get credit under the CRA investment test for purchasing loan securities. The development of this secondary market has increased liquidity and transparency.

A positive lending cycle has thus begun in many communities once ignored by mainstream lenders. Under CRA, lenders know that other banks will be making loans to a community, reducing all institutions' liquidity risk, speeding the gathering and dissemination of information, and producing positive information externalities. Experience suggests that increased lending to low-income communities has occurred and has not led to the kind or the extent of unprofitable, excessively risky activity predicted by critics.

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Studies have found evidence that CRA improved access to home mortgage credit for low-income borrowers during the 1990s, as CRA regulatory intensity increased.[9] Research by Brookings and Harvard's Joint Center for Housing Studies found that, between 1993 and 1999, depository institutions covered by the CRA and their affiliates made over $800 billion in home mortgage, small business, and community development loans to low- and moderate-income borrowers and communities.[10] The number of CRA-eligible mortgage loans increased by 39 percent between 1993 and 1998, while other loans increased by only 17 percent. Even excluding affiliates, banks increased their lending to low- and moderate-income borrowers and areas by 10 percent over this period, compared with no growth at all for these lenders in their other markets. As a result, the share of all mortgage lending by CRA-covered institutions and their affiliates directed to these borrowers and areas increased from 25 to 28 percent.

A series of factors beyond CRA contributed to these gains. Strong economic growth and low inflation during the 1990s led to rapid income growth, low unemployment rates, and low real interest rates. Innovation helped drive down the costs of lending. Consolidation in the financial services sector enhanced competition among national players with economies of scale and scope. And other laws—such as fair lending and secondary mortgage market regulations—operated in intensified ways during this period.

Controlling for the effects of these factors, however, CRA

9. *See* Michael S. Barr and others, "The Community Reinvestment Act," in C. Guene and E. Mayo, eds., *Banking and Social Cohesion: Alternative Responses to a Global Market* (Charlbury, Oxfordshire: Jon Carpenter, 2001); Robert B. Avery and others, "Trends in Home Purchase Lending: Consolidation and the Community Reinvestment Act." *Federal Reserve Bulletin* 85 (1999); Robert B. Avery and others, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages." Federal Reserve Bulletin 82 (1996); Douglas D. Evanoff and Lewis M. Siegal, "CRA and Fair Lending Regulations: Resulting Trends in Mortgage Lending." *Economic Perspectives* 20 (1996); Michael LaCour-Little, "Does the Community Reinvestment Act Make Mortgage Credit More Widely Available? Some New Evidence Based on the Performance of CRA Mortgage Credits." Conference paper presented at the Midyear Meeting of the American Real Estate and Urban Economics Association meeting, Washington, May 4, 1998.

10. Robert E. Litan and others, "The Community Reinvestment Act After Financial Modernization: A Baseline Report" (U.S. Treasury Department, 2000); Robert E. Litan and others, "The Community Reinvestment Act After Financial Modernization: A Final Report" (U.S. Treasury Department, 2001). For further analysis of these reports, see Eric Belsky, Michael Schill, and Anthony Yezer, "The Effect of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending" (Harvard University Joint Center for Housing Studies, 2001).

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lenders increased their CRA-eligible home purchase lending faster than those not regulated by CRA from 1993 to 1999.[11] The Joint Center concluded: "CRA-regulated lenders originate a higher proportion of loans to lower-income people and communities than they would if CRA did not exist."[12] By one estimate, the Joint Center found that CRA's effect on increasing home mortgage lending to low-income borrowers was equivalent to a 1.3 percentage point decrease in unemployment. Another study found that CRA boosts the number of small businesses that can access credit by four to six percent, increasing payrolls and reducing bankruptcies—without crowding out other financing available to small businesses or adversely affecting bank profitability or loan performance.[13] In sum, recent evidence shows that CRA provides important benefits to low-income communities.

Critics of CRA assert that it leads to unprofitable lending. But the weight of evidence suggests otherwise. In a Federal Reserve Board survey of CRA-covered institutions, most responded that CRA lending was profitable or marginally profitable, and not overly risky.[14] Pushing further into low-income markets has not weakened banks' profitability and soundness. In the small "special programs" that serve as banks' CRA laboratories, most institutions reported a net charge-off rate of zero for loans made under these programs.

Current Policy Debate and Recommendations

Much of the current debate focuses not on the profitability of CRA lending, but on banks' and thrifts' costs for complying with CRA regulations. Yet reforms put into place in 1995 reduced compliance costs for all banks and streamlined CRA regulations even further for the smallest institutions. In 2002, the Independent Community Bankers of America surveyed its membership about the

11. Litan and others, "The Community Reinvestment Act After Financial Modernization: A Final Report"; Belsky, Schill, and Yezer, "The Effect of the Community Reinvestment Act on Bank and Thrift Home Purchase Mortgage Lending."

12. Harvard University Joint Center for Housing Studies, "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System" (2002).

13. Jonathan Zinman, "Do Credit Market Interventions Work? Evidence from the Community Reinvestment Act" (Federal Reserve Bank of New York, 2002).

14. Board of Governors of the Federal Reserve System, *The Performance and Profitability of CRA-Related Lending*, report submitted to the Congress pursuant to Section 713 of the Gramm-Leach-Bliley Act of 1999, July 17, 2000.

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cost of CRA regulation.[15] Although the study is designed to highlight the high compliance costs of CRA, the data reported in the study suggest otherwise. The mean employee cost for CRA compliance was $84,445 per year for small banks (average assets of $216 million) and about $30,000 more per year for larger "community" banks (average assets of $666 million). Average CRA employee costs as a percentage of assets were thus negligible—0.017 percent for larger "community" banks, and 0.039 percent for small banks.

Under the regulatory agencies' new plans, banks and thrifts with less than $1 billion in assets would be considered "small" for purposes of CRA, and thus exempt from the investment and services tests applicable to large banks, exempt from small business loan data disclosure, and subject to a streamlined lending test. Even banks and thrifts that are part of mammoth holding companies would be considered small, as long as the bank or thrift itself—not the holding company—held less than $1 billion in assets. By contrast, under current law, banks and thrifts are considered small if they have assets of $250 million or less and are independent, or are part of a holding company with under $1 billion in bank and thrift assets.

This section first discusses the reasons for maintaining CRA's basic framework. Next, it explains why proposals to raise the small bank threshold, and the OTS proposal abandoning the investment and service tests, are ill-conceived. Finally, it comments on the proposal by the Federal Reserve Board, OCC, and the FDIC to add a "community development" test for the institutions that would be considered "intermediate small banks." The analysis leads to four policy recommendations regarding the regulators' recent proposals.

1. *Maintain CRA's Basic Framework*

The CRA regulations have worked exceedingly well in expanding access to credit—far more so than the authors of the 1995 revisions could have expected. The Fed's study suggests that this significant expansion of credit has come at a relatively modest cost, if any, in terms of performance and profitability. Moreover, the costs to banks, and to the agencies, of changing the regulations

15. Grant Thornton LLP, Independent Community Bankers of America, "The High Cost of Community Bank CRA Compliance: Comparison of 'Large' and 'Small' Community Banks" (2002). The ICBA surveyed banks with assets up to $2 billion, rather than the $1 billion asset level in the proposed rule. The ICBA survey had only a 28 percent response rate and thus may not be representative of similar institutions.

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could be high.[16] It has taken quite some time for banks and the agencies to work through complicated interpretive issues, operational and information system problems, and the training of bank employees and agency examination staff. Community-based organizations, state and local governments, and other bank partners have organized community development activities in response, to some degree, to the current structure of CRA. New regulations might lead to high transition costs. It would be one thing if the changes led to significant improvements, but as discussed below, the proposals actually go in the wrong direction.

2. *Retain the Current Definition of Small Banks*

Under the agencies' plans, banks and thrifts with less than $1 billion in assets, regardless of the size of their holding company or affiliates, would be considered "small" for purposes of CRA. The rules would exempt nearly 94 percent of all-FDIC insured depositories from the full-scope review.[17] In effect, these institutions would no longer be required to record or make public data on small business lending, and would no longer be judged under the investment or retail services tests for CRA.

Lending has rightly been the focus of a statute aimed at the "credit needs" of communities, but investment and services play critical roles as well in meeting credit needs and are thus appropriately evaluated under CRA. Investments help build local financial and community infrastructure, while stabilizing and broadening the economic base of low- and moderate-income communities. Investments also help expand access to credit by enhancing the capacity of specialized local lenders such as Community Development Financial Institutions (CDFIs) to provide credit. By stabilizing a local community with direct investment, banks also enable loans to be made in the community in a more safe and sound manner.

The importance of services to the provision of credit has been less well understood in the past, but research shows that services play a critical role in expanding access to credit.[18] Access to an

16. *See generally* Gregory Elliehausen, "The Cost of Bank Regulation: A Review of the Evidence" (1998), online at http://www.federalreserve.gov/pubs/staffstudies/171/ss171.pdf [accessed April 2005].

17. Author's calculations based on FDIC, Statistics on Depository Institutions.

18. *See* Michael S. Barr, "Banking the Poor." *Yale Journal of Law and Regulation* 21 (2004): 121-327 (describing how it is more difficult to establish credit or qualify for loan without bank account); Michael Stegman and Robert Faris, "Creating a Scorecard for the CRA Service Test" (Washington: Brookings Institution, 2003).

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appropriate bank account for most low-income "unbanked" individuals could mean the opportunity for lower transaction costs, greater consumer protection, better access to loans, and increased savings as a cushion against financial emergency and as a predicate for borrowing.

With respect to the asset threshold, the agencies presented no evidence that banks between $250 [million] and $1 billion faced special burdens from the full-scope review. The ICBA study described above, upon which some commentators on the rule relied, provides little justification for an exemption for full scope review for these institutions. If particular burdens do exist, it would be better to deal with them through modifications of the investment and services tests, rather than eliminate the tests for those firms entirely.

Moreover, it makes little sense to eliminate the investment and services tests for this particular class of institutions. Regulators already have the authority to be flexible on the investment test.[19] For example, to broaden investment options for smaller firms, regulators may count out-of-area investments, not just local ones. As for the service test, small institutions often have a comparative advantage in providing retail services tailored to their local communities. These services are often vital to low- and moderate-income households, partly because such services are gateways to access to credit. Because there is little justification for the current exemption of small banks from the service test, it seems all the more ill-advised to expand the category of institutions not subject to the test.

Smaller banks may be more important to small business lending, too, since smaller institutions often have a comparative advantage relative to large banks in relationship lending to small businesses.[20] When large banks merge, they often lose market

19. Ryan Trammell, "Understanding the Relationship Between Investment Test Examination Criteria and Investment Test Ratings." Federal Reserve Bank of San Francisco, Center for Community Development Investments (2004) (finding that qualitative factors, not solely investment volumes, drive CRA investment test ratings).

20. *See, e.g.*, Robert B. Avery and Katherine A Samolyk, "Bank Consolidation and Small Business Lending: The Role of Community Banks." *Journal of Financial Services Research* 25 (2004): 291-325 (finding that small banks gain market share from large banks during consolidations); David A. Carter, James E. McNulty, and James A. Verbrugge, "Do Small Banks have an Advantage in Lending? An Examination of Risk-Adjusted Yields on Business Loans at Large and Small Banks." *Journal of Financial Services Research* 25 (2004): 233-252 (finding that small banks have informational advantage in evaluating small business loans); Jonathan A. Scott, "Small Business and the Value of Community Financial Institutions." *Journal of Financial Services Research* 25 (2004): 207-230 (discussing small bank informational advantages).

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share in small business loans that instead are offered by local players. For these local institutions, geographic distance still matters.[21] Most small businesses rely on lenders with a local presence for credit.[22] This is consistent with a theory of informational advantage for local creditors in assessing highly opaque small business assets and other data.[23] Thus, it makes little sense to avoid collecting small business data and evaluating all institutions, including small banks and the new "intermediate small banks," on their small-business-lending performance.

Perhaps most problematic is the proposal to ignore the asset size of the holding company when determining whether to consider a bank "small" for purposes of CRA. First, banks within holding companies are less in need of regulatory "burden relief" than similarly-sized independent institutions. Holding companies provide scale economies to their subsidiaries in complying with bank regulations.[24] Banks that are part of holding companies face lower regulatory burdens from the same regulation than their non-affiliated counterparts of similar size. Thus, affiliation should generally be weighed, not ignored, in determining tradeoffs between regulatory burdens and benefits.

Second, banks that are part of holding companies have available to them the range of expertise of the holding company, which is useful for developing programs to meet community needs under CRA. The holding company is effectively part of the bank's performance context. Along with its subsidiaries, it can offer a range of services to the bank in helping the bank meet its CRA performance goals, such as innovative loan products, securitization, or expertise in investments. These affiliates do affect a bank's CRA performance, and banks in larger holding companies should be as-

21. Kenneth P. Brevoort and Timothy H. Hannan, "Commercial Lending and Distance: Evidence from Community Reinvestment Act Data." Board of Governors of the Federal Reserve Working Paper (2004) (finding that "distance is negatively associated with the likelihood of a local commercial loan being made and that deterrent effect of distance is consistently more important, the smaller the size of the bank").

22. Myron L. Kwast and others, "Market Definition and the Analysis of Antitrust in Banking." *The Antitrust Bulletin* 42 (1997): 973-995 (finding median distance at or under six miles between small businesses and their bank providers of most credit products); Jonathan A. Scott and others, "Credit, Banks, and Small Business—The New Century" (National Federation of Independent Business Research Foundation, 2003) (finding median travel time of 6-10 minutes between small business and its bank) online at http://www.nfib.com/object/3747922.html [accessed April 2005].

23. *See, e.g.*, Arnoud W.A. Boot, "Relationship Banking: What Do We Know?" *Journal of Financial Intermediation* 9 (2000): 7-25.

24. Elliehausen, "The Cost of Bank Regulation: A Review of the Evidence."

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sessed using the CRA test for large retail institutions, which effectively takes account of the expertise and resources of the parent institution.

Third, affiliate activity is critical to understanding the performance of a bank under CRA. Regulations already provide that evidence of illegal credit practices, whether within the depository institution or its affiliate (regardless of whether the bank opted to include the affiliate in the examination) affects an institution's CRA rating. Moreover, regulators now give CRA consideration for "promoting" borrowers from the subprime to the prime market. The effectiveness of this approach depends on adequate supervision of the relationship between the bank and its affiliates to assess whether borrowers with good credit history are "upstreamed" from subprime affiliates and offered prime products, or conversely are steered to higher-cost subprime products. For these reasons, affiliates should not be ignored when computing the size of the institution for purposes of determining the appropriate kind of CRA examination.

3. *Withdraw the OTS Plan to Eliminate the Investment and Service Tests*

The OTS plan to permit all institutions, regardless of size, to avoid the investment and service tests is also deeply misguided. The OTS plan essentially makes the investment and services test optional for all institutions, without any requirement similar to the existing "strategic plan" option that provides for input from the public and approval by the regulators in assessing the institution's proposed method for evaluating its performance. As discussed at the outset, the lending test is central to a determination of whether an institution is meeting the credit needs of the community. The investment and service tests, however, also play critical roles. Investments help to stabilize communities and build local institutions that help banks and thrifts to expand access to credit. Services tailored to low- and moderate-income consumers and communities—including access to bank accounts—are the critical first steps toward their gaining the opportunity to access credit. Both the investment and the service tests are critical to the future of CRA and should be retained.

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4. *Support the Agency Proposals to add a Community Development Test*

While it remains preferable to maintain the current approach for these "intermediate small banks" (with assets from $250 million to $1 billion), rather than creating a new structure, the proposed "community development test" does reduce some of the harm that will be caused by adopting the OTS position, which simply removes such institutions from full-scope CRA review. Under the community development test, such banks would be evaluated on their community development lending, investment and services as a whole, in lieu of separate investment and services tests. Community development services would include retail services benefiting low- and moderate-income households. An intermediate small bank could not achieve an overall CRA rating of satisfactory unless both its lending performance and its record under the community development test were found to be satisfactory.

Because a bank could not achieve a satisfactory rating overall without achieving a satisfactory rating on the proposed community development test, the test is likely to continue to give these intermediate small banks an incentive to provide a mix of community development lending, investment and services to lower-income communities and households. These institutions may, however, move away from providing investments or services as a result of dropping the individual tests, and many smaller communities lack large banks that could fill the void. Moreover, small business lending data would no longer be recorded or made public, which might significantly decrease incentives for these institutions to reach further into low- and moderate-income communities to improve their small business lending performance. Thus, any community development test should explicitly include measures of small business lending performance.

CONCLUSION

CRA is working for America's communities. Now is not the time to cut it back. The agencies' recent proposals to increase the small bank threshold, and the OTS plan to make the investment and services tests effectively optional, should be withdrawn. If the small bank threshold is increased, it is critical for the agencies to continue to measure community development lending, investment,

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and services and to maintain the small business lending data component of the CRA regulations for these banks and thrifts. In that way, CRA can continue to help grow small businesses and strengthen communities in the years ahead.

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