State of New York
Office of the State Comptroller
Division of Management Audit

NEW YORK STATE BANKING DEPARTMENT

COMMUNITY REINVESTMENT ACT REGULATION OF BANK COMPLIANCE

REPORT 95-S-123

H. Carl McCall

Comptroller

State of New York
Office of the State Comptroller

Division of Management Audit

Report 95-S-123

Ms. Elizabeth McCaul
Acting Superintendent
NYS Banking Department
Two Rector Street
New York, NY 10006

Dear Ms. McCaul:

The following is our audit report on the Department's regulation of bank compliance with the Community Reinvestment Act.

We did this audit according to the State Comptroller's authority as set forth in Section 1, Article V, of the State Constitution, and Section 8, Article 2, of the State Finance Law. We list major contributors to this report in Appendix A.

Office of the State Comptroller
Division of Management Audit

October 30, 1997

Executive Summary

New York State Banking Department Community Reinvestment Act Regulation Of Bank Compliance

The Federal Community Reinvestment Act (CRA) was enacted in 1977 in response to concerns that banks and other thrift institutions (banks) were not offering comprehensive banking services to residents and businesses located in low-and moderate-income communities (a practice known as "redlining"). Under CRA, Federal regulators must encourage banks to help meet the credit needs of the local communities they serve. Since 1978, New York State has required State-licensed banks to comply with these same provisions. The New York State Banking Department (Department) is responsible for monitoring, assessing and reporting on CRA compliance by the 180 banks it oversees.

In May 1995, Federal regulators refocused their examination efforts on evaluating the amount of money actually finding its way into the communities the banks were serving. The State expects to but has not yet incorporated these refocused procedures into its CRA examination guidelines. This audit, therefore, focuses on the Department's compliance with established regulations.

Our audit addressed the following questions regarding Department regulation of bank compliance with CRA:

- Do Department examiners comply with established CRA assessment guidelines, and document their reasons for the specific CRA assessments they render?
- Do Department examiners review and analyze bank service area delineations when assessing bank compliance with CRA?
- Do existing CRA assessment procedures address the availability of banking services between communities?

Audit Observations and Conclusions

The majority of examiner CRA ratings report positive bank compliance. However, our review of ten assessments and the related workpapers found that there often is no evidence that Department examiners actually review the information necessary to assess bank compliance and to support their respective CRA ratings. In addition, our review of mortgage loan activity of selected metropolitan area banks indicated that CRA results should be further analyzed to determine whether it is achieving its objective of fair lending practices in minority communities.

Examiners are required to assess bank compliance with CRA using 12 factors stipulated by Law including: bank assessment of community credit needs; and bank efforts to extend credit in low- and moderate-income areas. We reviewed the CRA reports for ten banks during calendar years 1993 to 1995, and found that, in several cases, the files did not contain documents supporting the CRA ratings the banks were assigned. For example, five of the files did not include

the names of the community groups contacted by bank officials in their reported efforts to assess community needs, nor any details of how community needs were being addressed by the sampled banks. Moreover, examiners do not verify the accuracy of documents submitted by banks to illustrate their reported efforts to address community needs. (See pp. 5-11)

When banks apply to the Department for a license to operate, or for branch expansion, mergers and acquisitions, they are required to outline their proposed geographic service areas and the products to be offered. Banks subject to CRA regulation are required to submit updates of their geographic service areas as part of their annual CRA statements. Of the 10 CRA assessment reports we reviewed, eight indicated that the banks' service areas complied with at least one of the three established criteria detailed in Department regulations (e.g., complete political jurisdiction). However, in these eight reports, the examiner did not state the reason for such approval. In one of the two remaining reports, the examiner did not render a conclusion as to whether the bank's service area complies with any of the established criteria. In the other, the examiner indicated that the delineated service area was too narrow within the respective counties of operation. From our review, it appears that the service areas for eight of the 10 sampled banks include or exclude specific communities or political jurisdictions without explanation as to how they comply with the governing criteria. (See pp. 13-15)

We analyzed the mortgage loan activity of several metropolitan area communities based on income levels and percentage of minority concentration. The loan applications submitted by residents of minority communities were denied at a noticeably higher rate than those submitted by individuals earning comparable incomes but living in areas with a low minority concentration. Several relevant variables, such as applicant employment history, were not readily available and thus were not used in our analyses. Thus, we do not conclude that the sampled banks acted improperly. However, we believe that our analyses is worthy of Banking Department follow up to ensure that these loan approval rate variances are justified and not the result of unfair lending practices. (See pp. 13-17)

Comments of Department Officials

Department officials believe that they have performed their CRA examinations in compliance with law and existing guidelines. They also informed us that they have subsequently instituted procedures to enhance the degree of documentation maintained in examiner files, and they have purchased specialized software to aid them in analyzing mortgage lending data between communities. They believe that these enhanced procedures, and the proposed revisions to existing evaluation guidelines, make moot many of the points included in our report. In addition, they assert that the primary objective of CRA is meeting community credit needs, and not ensuring the fair and equitable distribution of banking services betweeen communities.

Contents

Introduction

Background

As part of the Housing and Community Development Act of 1977, Congress enacted the Community Reinvestment Act (CRA). CRA was created in response to concerns that banks and other thrift institutions (banks or institutions) were not offering comprehensive banking services to residents and businesses located in low- and moderate-income communities (a practice known as "redlining"). CRA requires Federal regulators to encourage banks to help meet the credit needs of the local communities they serve, without jeopardizing their own financial safety and soundness. In 1978, New York State adopted the components of the Federal CRA, requiring New York State-licensed banks to comply with these same provisions. Part 76 of the General Regulations of the New York State Banking Board (Board) requires the New York State Banking Department (Department) to monitor and report on the degree of CRA compliance achieved by the 180 New York State banks it oversees.

The evaluation of a bank's CRA performance is based on 12 assessment factors, as set forth in the Banking Law and the General Regulations promulgated by the Board. Among these factors are:

(1) activities conducted by the bank to determine the credit needs of the community it serves, including the extent of its efforts to disseminate information about the credit services it provides;

(2) the banking organization's record of opening and closing branch offices, and the level of services it provides at these branches;

(3) the bank's participation, including investments, in local community development and redevelopment projects or programs; and

(4) the bank's ability to meet various community credit needs based on its financial condition, size, legal impediments, local economic condition, and other factors.

In May 1995, Federal regulators implemented revised CRA regulations to address industry concerns that CRA assessments had been focused on process rather than results; were inconsistent; and were based on information that did not ensure complete and accurate measures of bank performance. As a result, Federal examiners refocused their efforts on evaluating the amount of money actually finding its way into the communities the banks were serving, de-emphasizing the process by which it got there. The Department's former Superintendent informed us that he expects that the State of New York will eventually incorporate these refocused procedures into its own CRA examination guidelines. However, as of August 26, 1997, the State had not yet

adopted the new regulations. This audit, therefore, focuses on the Department's compliance with established regulations.

Audit Scope, Objectives and Methodology

We audited the Department's regulation of bank compliance with CRA for the period January 1, 1993 through October 31, 1996. Our objectives were to determine whether Department examiners comply with the Department's CRA examination guidelines, and whether they document their examination methodologies and the support for their assessments. We also performed several analyses to determine whether the CRA has been a catalyst for banks to provide communities with fair and equitable banking services.

To accomplish these objectives, we interviewed Department officials and staff, and reviewed Department CRA assessment reports and related workpapers. We also compared the percentage of approved credit applications of the applications submitted, as reported by banks, between several communities in New York City that have varying ethnic and economic characteristics.

We did our audit according to generally accepted government auditing standards. Such standards require that we plan and do our audits to adequately assess those operations which are included in our audit scope. Further, these standards require that we understand the Department's internal control system and compliance with those laws, rules and regulations, that are relevant to the operations which are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records, and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on operations identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Comments of Department Officials

We provided a draft copy of this report to Department officials for their review and comment. Their comments have been considered in preparing this report and are attached in their entirety as Appendix B.

Within 90 days after the final release of this report, as required by Section 170 of the Executive Law, the Superintendent of the Banking Department shall report to the Governor, the State Comptroller and leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein and, where recommendations were not implemented, the reasons therefor.

Effectiveness of Department Examinations

Federal CRA regulations require each of the banks it oversees to:

- prepare an annual CRA statement that delineates the local community it serves and lists the specific banking products it extends to community residents; and

- make available to the public signed comments received from community residents regarding their opinions about the level of its compliance with CRA, as well as a copy of the public section of the Department's most recent CRA performance evaluation report.

In addition, State regulations require subject banks to respond to the Department's Annual CRA Informational Request (Request), which is intended to illustrate bank compliance with the requirements of CRA as outlined in Section 28-b of the Banking Law. Department examiners are also required per State regulations to check for compliance with these Federal requirements as part of their State's CRA evaluation.

There are two types of CRA assessments: on-site and off-site. The on-site assessment consists of a review of CRA-related documents maintained at the institution's head office and selected branches. It also includes interviews with bank officials and their CRA personnel. It is generally conducted once every three years for each regulated institution. The off-site assessment consists of a desk review and evaluation of the bank's annual CRA statement, and documentation of the policies and procedures followed in the institution's CRA Program. It comprises the majority of CRA assessments and is performed during years when no on-site review is conducted.

The Department has developed guidelines and procedures that examiners are to follow when they perform CRA assessments. These guidelines and procedures require examiners to solicit and review CRA-relevant information, such as the annual CRA statement or Home Mortgage Disclosure Act (HMDA) data, in order to determine compliance with the 12 assessment factors outlined in the Law. However, the guidelines and procedures do not delineate the specific tests and analyses examiners should perform to arrive at their assessment; nor do they specify the documentation they should retain to support their assessment.

The Law does not identify any individual factor(s) as being more significant in the assessment process than any others. Department officials explained that

examiners may consider strong bank performance in one or more assessment factors as compensation for deficiencies in others.

The institutions are assigned numerical ratings ranging from 1 to 4, with “l” representing an outstanding level of CRA compliance, and “4" representing substantial noncompliance. Ratings of “3" and “4" may be considered by examiners as impediments to the approval of any application that an institution might file with the Department for opening branches, merging, or purchasing assets.

Of the 495 CRA examinations required to be performed in the past 3 years, just 20 (4 percent) have resulted in ratings of “3" and “4". Since none of these six banks has applied for applications to open branches, merge, or purchase assets during our audit scope period, we could not determine whether examiners actually consider these specific CRA evaluations in the application process. However, we did see evidence that examiners referred to CRA assessments when reviewing the applications submitted by other banks. Upon the completion of an assessment, the examiner prepares a written report summarizing the results of the review, assigns a rating, and sends it to the institution’s Chief Executive Officer.

We selected a sample of CRA files for ten banking institutions of varying asset size and geographic service areas to determine whether the Department’s examiners have been complying with established CRA assessment procedures, and whether existing procedures are adequate for the task of helping the examiners arrive at an objective and accurate CRA rating. Our review focused on 4 of the 12 assessment factors that we believe are fundamental to the achievement of CRA objectives:

- Assessment Factor No. 1 - Activities conducted by the banking institution to determine the credit needs of its service area.

- Assessment Factor No. 5 - The geographic distribution of the institution’s credit extensions, credit applications, and credit denials.

- Assessment Factor No. 7 - The bank’s record of opening and closing branch offices, and the level of service it provides at these branches.

- Assessment Factor No. 8 - The level of the bank’s participation, including investments, in local community development and redevelopment projects or programs.

Our review of the sampled files found that, for the most part, examiners do obtain the information that is necessary to assess CRA performance. However, there is often no evidence that examiners actually review and assess retrieved

data; nor do they document the specific factors used to support their respective CRA ratings. For example:

Assessment Factor No. 1 (Assessment of Community Needs) is designed to measure "activities conducted by banking institutions to ascertain the credit needs of their community, including the extent of the banking institution's efforts to communicate with community members." Department procedures require the examiner to determine from the bank's records, and through the interview process, the extent to which the institution has communicated with members of its local community or has otherwise attempted to identify the credit needs of its service area. Such activities might include studies it has conducted or reviewed, or a communications program directed to groups such as religious and neighborhood organizations.

In five of the ten cases we reviewed, the examiner reports and files listed broad categories of community groups and organizations reportedly contacted by these banks (e.g., professional groups, real estate brokers, etc.). However, no specific names of organizations were listed; thus, we were unable to verify that the bank had actually contacted such groups. Moreover, with the exception of one bank, we saw no indication in the examiners' CRA files of the frequency with which the banks communicated with these groups, whether the banks actually assessed the community's needs, and whether the banks had formulated plans to address those needs. In three of the five files, where the specific community contacts were not listed, the examiner noted that the banks had performed studies on community needs. However, neither copies of the studies nor their results were included in the examiners' files.

Assessment Factor No. 5 (Geographic Distribution of Loans) is designed to assess the "geographic distribution of an institution's credit extensions, credit applications and credit denials." Department procedures call for the examiner to use the financial data that banks supply (known as HMDA), which illustrate a bank's lending activities by geographic area and community culture (ethnic makeup, for example) as they pertain to housing-related credit. To assess the credit extensions for other types of loans, the examiner may rely on management interviews and reviews of the institution's loan files. "Geocoding" (plotting the geographic locations of loans made by the banks) is another method the examiner can use to assess credit distribution.

We found no evidence in eight of the ten files we reviewed that examiners had analyzed the HMDA data retrieved from institutions as they relate to the banks CRA performance. Instead, those eight files contained a computer-generated report produced by the Department's EDP unit, which according to Department officials, presented HMDA data in a more uniform or consistent format. For example, loans were categorized by type: mortgage, equity and car loans.

Assessment Factor No. 7 (Branch Openings, Closings and Services) assesses the bank's history of branch openings and closings, the effects of both types of events on the communities served, and the level of service in the existing branches. Banks are required to file reports of branch office closings with the Banking Department, in accordance with the General Regulations of the Banking Board. This report includes a statistical analysis of the deposit and lending activities of the office to be closed, as well as the availability of alternate financial services within the geographic area and the potential socioeconomic impact on the affected community. The Department requires the examiner to review these reports for banks that have already closed branches, in the interest of determining whether the corresponding communities were affected adversely and disproportionately as compared with other communities.

The examiner reports for nine of the banks we reviewed contained statements that the banks had opened or closed branches during our audit period. However, for five of these banks, we saw no evidence that the examiner had reviewed the impact of the openings/closings in the affected communities. We also noted that, in nine of the 10 sampled cases, examiner reports contained no information regarding the service needs of the communities, nor how the sampled banks were meeting those needs. In fact, Department guidelines do not define what service needs should be assessed. Such guidelines would enable the examiners to identify the specific services relevant to a particular community and assess the availability and delivery of those services.

Department officials replied that while the guidelines do not define what services should be assessed, the 12 factors used for the CRA evaluation include only one factor regarding the bank's record of opening and closing branches that pertains to services. Under the Federal and proposed State regulations, banking services constitutes one of three new tests, and thereby enhances the attention paid to "banking services." Nevertheless, if the guidelines do not include a definition of services to be assessed there is a potential that examiners will not always review this issue.

Assessment Factor No. 8 (Community Development) addresses the bank's participation, including investments, in local community development and redevelopment projects or programs. Examiners are required to review the bank's written lending policies and to interview its lending officers to determine whether the community's credit needs are being satisfied. Examples of community development activities include:

- HUD's Community Development Block Grant Program.
- Local neighborhood preservation efforts.

- Community development corporations.
- Financing for local development corporations.
- Neighborhood housing services.
- Investments in, or coordination with, Minority Enterprise Small Business Investment Corporations or Small Business Investment Corporations.

According to the Department's CRA manual, community development activities will constitute a substantial portion of many institutions' CRA efforts. This is particularly true for wholesale banks, which do not ordinarily do business with individuals.

We found that examiner reports usually list a variety of community organizations to which banks have reportedly made grants or loans. All ten banks reviewed reported specific loan amounts and, all but one, noted the purposes for which the loans were made. However, there was no evidence in any of these cases that the examiner had evaluated the extent of the loans made in terms of the community's needs and the bank's financial condition. We also noted that the examiners did not verify the loan payments reportedly made by the banks. Thus, there is no assurance the loans were actually made; or that, if they were made, the funds were used for their intended purposes.

Finally, none of the ten case files we reviewed contained evidence of supervisory review, as required by Department procedures. Such reviews are essential to ensure the quality and objectivity of the CRA assessment.

Department officials told us that examiners place a low priority on certain assessment factors. While the officials agreed that factors No. 5 and No. 8 were important, they said they did not believe that factors No. 1 and No. 7 were as vital in terms of evaluating CRA compliance. They expressed the opinion that the main concern of CRA is the dollar value of actual loans extended; and that maintaining documentation of community assessments, a policy that is de-emphasized under the new Federal regulations, is just a means to that end. They also noted that such documentation is not required under current Federal CRA assessment regulations. They also note that bank examinations are not intended to substitute for internal or external audits, and verification of HMDA data would duplicate the efforts of their Federal counterparts. However, there was no evidence in the examiners' files that they had obtained any internal or external audit reports addressing CRA-related issues, documents to support that the HMDA data was verified by the Department's Federal counterparts, or branch closing reports prepared by other Department staff.

Department officials claim that supervisory reviews have always been performed and a tracking sheet has recently been developed to evidence such. A recent CRA examination that was not a part of our audit sample was cited as evidence that documentation of those reviews had recently been enhanced.

We agree with Department officials' contention that current Federal CRA assessment procedures do not require examiners to document the files they review or the examination steps applied when reviewing them. However, if the files do not contain such documentation, there is no assurance that the examiners actually did review the necessary documents or that they had access to adequate information that would be deemed relevant in formulating an opinion on a bank's compliance with CRA. In addition, assessing community needs (Factor No. 1) and reviewing branch openings closings and services (Factor No. 7) are required by law.

An October 1994 New York City Public Advocate report and a 1996 series of news articles published by a major metropolitan area newspaper expressed the belief that several of the area's low- to moderate-income communities are not receiving their fair share of banking services. For example, the Public Advocate's report stated: "Remaining bank branches in lower-income areas are much less likely to offer extended weekday or Saturday hours or 24-hour automatic teller machines (ATMs) than branches elsewhere." Due to the significance of this issue and the impact it can have on the affected communities, we believe it is important that regulators apply objective and adequate CRA assessment procedures to identify and evaluate bank compliance in this area.

In response to our draft report, Department officials explained various actions they are taking, which commenced under the immediate past Superintendent, designed to enhance the CRA examination process. These actions include redesigned CRA assessment report formats, improved evaluation procedures, the installation of new computer software and mandatory training for applicable Department staff. They have proposed a biennial on-site evaluation process to replace the requirement for annual CRA evaluations. Department officials admit that this will give the examiners greater ability to verify information during on-site evaluations. In addition, they are creating relevant databases for use in the evaluation process and have begun using new tools for enhanced measure of home mortgage lending. Furthermore, Department officials indicated that they held Department-sponsored conferences across the State including: a CRA workshop to introduce CRA to community groups and encourage their participation in Department efforts to review the CRA performance of financial institutions; Small Business Technical Assistance to increase emphasis on encouraging loans to small business; and Community Development Investment Opportunities to inform community groups and banks about an important new area of CRA.

Recommendations

1. Revise CRA assessment guidelines to ensure that adequate attention is given to all assessment factors contained in the CRA regulations.

2. Require examiners to document the information used in developing CRA ratings.

3. Require supervisors to review all examiner files to ensure that required documents have been reviewed by examiners and that CRA ratings are objective, consistent, accurate, and adequately supported.

Bank Service Areas

As previously explained, the focus of the CRA examination is to assess a bank's performance within its approved service area (i.e., the community which the bank outlines as its operating area). When banks apply to the Department for a license to operate -- or to expand by adding a branch, merging or acquiring another bank -- they are required to outline their proposed geographic service areas and the products they plan to offer. Department staff review and approve these applications after assessing the geographic reasonableness of the proposed service areas, as well as the banks' financial ability to service the areas adequately. Each year thereafter, banks subject to CRA regulation are required to submit annual updates of their geographic service areas as part of their annual CRA statements.

For example, if a banking institution's service area is the borough of Queens, Department examiners will be assessing the bank's branch service operations, community development endeavors, and credit extensions offered to the residents, businesses, and community groups living in Queens. Although this hypothetical bank may receive deposits from persons/businesses outside of Queens, the assessment of its CRA compliance is restricted to Queens.

According to CRA regulations, banks must comply with at least one of the following criteria when they define their service areas:

1) "Existing boundaries such as those of standard metropolitan statistical areas or counties in which the bank's office or offices are located . . . " (Where appropriate, portions of adjacent areas should be included.)

2) The bank's "effective lending territory, which is defined as that local area or areas around each office or group of offices, where it makes a substantial portion of its loans and all other areas equidistant from its offices as those areas."

3) "Any other reasonably delineated local area that meets the purposes of the [CRA]."

We reviewed a sample of service area delineation maps submitted by ten banks during the 1995 calendar year, as well as the respective examiner CRA assessment reports, to determine whether examiners had actually reviewed bank service areas for compliance with the above criteria as part of their CRA assessments. The service area maps reviewed were as follows:

- Map #1 - Kings, Queens, Nassau, Suffolk, Westchester, and Rockland counties.

- Map #2 - Monroe County; and parts of Genesee, Livingston, Ontario, Orleans, Wayne, and Erie counties.

- Map #3 - Orange, Sullivan, Ulster, and Dutchess counties; and various areas surrounding the bank's branches in the states of New Jersey and Pennsylvania.

- Map #4 - Midtown Manhattan.

- Map #5 - Areas surrounding the bank's branches located in Mid-Manhattan and Woodside and Flushing, Queens.

- Map #6 - Kings, Queens, and New York counties; and parts of Nassau, Suffolk, and Westchester counties.

- Map #7 - All five counties of New York City; Nassau, Suffolk, Westchester, and Rockland, Monroe, Oneida, Onondaga, Broome, Chemung, and Erie counties; and portions of Albany, Rensselaer, Schenectady, and Saratoga counties.

- Map #8 - Most of New York State.

- Map #9 - Portions of Kings, Bronx, Queens, and Nassau counties.

- Map #10 - Bronx, Kings, New York, Queens, Nassau, Suffolk, Westchester, Rockland, Putnam, Dutchess, and Orange counties and parts of Sullivan and Ulster counties.

Of the ten corresponding CRA assessment reports we reviewed, eight contained indications that, in the examiner's opinion, the outlined service areas complied with at least one of the three aforementioned criteria. However, the specific criteria in each case was not identified. In one of the remaining reports, Map #4, the examiner did not conclude that the bank had complied with any of the governing criteria; and in the last report, Map #9, the examiner indicated that the service area delineated by the bank was too narrow within the respective counties of operation.

From our own review, it appears that the delineated service areas in Maps #3 and #5 meet the governing criteria by mapping out complete political jurisdictions (counties) or the areas surrounding branches. However, in the other six maps we reviewed where the examiner indicates bank compliance, the service areas appear to include or exclude specific communities either within

or adjacent to political jurisdictions without explaining how the areas comply with the governing criteria. There is no evidence that the delineated service areas were actually considered by the examiners when they rendered their CRA assessments in these cases. For example, the areas reportedly served by the bank in Map #6 surround and exclude one of New York City's major political jurisdictions -- the Bronx -- without explanation. In Map #9, the bank's service area includes only portions of Kings, Queens, Bronx, and Nassau counties. Neither case offers documentation that the examiners considered such issues before they rendered a CRA rating for these institutions.

In addition, two Maps (#4 and #7) do not illustrate the location of bank branches within their delineated service areas. Thus, examiners did not have sufficient information to assess the distribution of banking services between the various communities. For example, bank branches might be concentrated in upper-income neighborhoods within their geographic service areas, with only limited or absent presence in moderate- and low-income neighborhoods. Furthermore, since the branch locations were not identified on the Maps, the examiner had no way of verifying the parameters of their delineated service areas.

Department officials agreed that examiners should have provided their reasons for approving such [service] delineations. They also note that their proposed State CRA regulations will no longer require regulators to approve service area delineations. However, these regulations have not yet been adopted and Department officials should not reduce the amount of attention paid this area since it is required under the existing regulations.

We asked Department officials whether they had done any comparative assessments of bank mortgage lending practices for various communities, to determine whether the results of CRA regulations had been as successful as their CRA ratings indicate. Department officials provided us with a copy of a study they completed in 1992, of mortgage lending policies and practices at ten banks located in the New York City metropolitan area. The purpose of the study was to determine whether the sampled banks' mortgage lending policies and practices were discriminatory toward female and minority applicants.

The Department examined the underwriting standards used by banks for residential first mortgage loans on one- to four-family homes, condominiums, and cooperatives that were in effect during 1989. It concluded that the policies of four of the ten banks reviewed had some aspect, such as the minimum size of the required down payment for mortgages, that could inherently and disproportionately affect minority, female, and low-income applicants in an adverse manner.

However, according to their study, the banks' policies were generally applied consistently and in a nondiscriminatory manner. The study noted, however, that the number of applications received from, and loans granted to, these particular focus groups was small, in comparison with the population size. Thus, more bank outreach is needed to encourage submission of loan applications by members of these groups. No follow-up study had been performed.

We performed our own analysis of mortgage loan activity, comparing several New York City area communities based on income levels and minority concentration. The 1994 income level and community resident information used in our analysis was obtained from HMDA data provided by banks to the Federal Deposit Insurance Company (FDIC) and subsequently to the Department. Several relevant variables such as loan applicant credit histories and property values were not readily available, and thus were not used in our analysis.

Our analysis focused on the counties of the Bronx, Kings, and Richmond, which collectively represent many diverse ethnic groups and income levels. We found that based on this data, there appears to be an unequal distribution of mortgage loans favoring high-income, low-minority residential communities. For example, the sampled communities in which the median income ranged from $18,756 to $30,012, and the minority concentration exceeded 90 percent, 46 percent of the mortgage loan applications were denied. However, in sampled communities with the same median income range, where the minority concentration approximated less than 10 percent, just 21 percent of the mortgage loan applications had been denied. Similar statistics were reported in a series of articles recently published in a major metropolitan area newspaper. In addition, an April 1994 report issued by the NYC Public Advocate indicated that: "The New York City area's bank branch network has been substantially reconfigured during the last 15 years, with a severe erosion of branch networks in low-income areas and continued expansion in the suburbs."

Because our analysis relied on unaudited data and did not consider such variables as applicant credit histories and property values, it would not be fair to conclude that these sampled banks were unjustified in denying a higher percentage of loan applications from selected communities. However, the Banking Department should do further analysis to ensure that loan approval rate variances we identified are justified and not the result of unfair lending practices.

Department officials replied that additional in-depth analysis has to be done before reaching our conclusions regarding the lending practices in minority communities. However, they added that they seek to root out unfair

lending practices and "share the Report's interest in ensuring that minority communities are not victimized by illegal fair lending practices and have taken measures to enhance their efforts in this area." For example, on-site reviews of loan files are performed during the Department's Consumer Compliance examination process and specifically assess bank performance in this area. The Department has also requested approval to hire a "Fair Lending Specialist" to coordinate the examiners' analyses.

We are pleased that the Department has taken action to improve its efforts in this area.

Department officials informed us that they have recently purchased geographic information systems software that would enable them to perform the types of studies and analyses we recommend as useful in CRA regulation.

Recommendations

4. Require examiners to document their review and assessment of delineated service areas when rendering CRA ratings to banks.

5. Periodically analyze the distribution of banking services between communities to identify problems not addressed adequately by the current CRA examination process.

Major Contributors to This Report

William P. Challice
David R. Hancox
Carmen Maldonado
Dominick B. Vanacore
John Gimberlein
Frank Patone
Keith Dickter
Adrian Wiseman
Donna Sylvester
Mark Geller
James Thompson
Marticia Madory

STATE OF NEW YORK
BANKING DEPARTMENT
TWO RECTOR STREET
NEW YORK, NY 10006

August 26, 1997

David R. Hancox
Audit Director
State of New York Office of the Comptroller
A.E. Smith State Office Building – 13th Floor
Albany, NY 12236

Dear Mr. Hancox:

I am enclosing the Department's response to the draft audit report (95-S-123) pertaining to the monitoring of compliance with the Community Reinvestment Act (CRA) pursuant to Section 170 of the Executive Law.

Very truly yours,

Gideon Weingarten
Director, Internal Audit

Encl.

CC: Elizabeth McCaul, Acting Superintendent
Stacey M. Cooper, Deputy Superintendent
Andrew D. Kelman, Director, Community Reinvestment Monitoring Unit
Deirdre A. Taylor, Associate Budget Examiner, Division of Budget, Albany
John Cape, Budget Examining Unit Head, Division of Budget, Albany
Joseph J. Burns, Chief Administrative Officer
Diana Rulon, Budget Officer

Response to Draft Audit Report 95-S-123
"Community Reinvestment Act Regulation of Bank Compliance"

INTRODUCTION

The Banking Department (the "Department") has reviewed the draft audit report 95-S-123 (the "Report"). The audit covers a period from 1993 through 1995 (the "audit period").

Since 1995, many steps have been taken to enhance the Banking Department's ability to evaluate CRA performance and accordingly, many of the points raised in the audit are moot.

In addition, and as noted below where appropriate, it is the view of the Banking Department that the objective of the audit to determine whether "CRA is achieving its goal of providing communities with fair and equitable banking services" is flawed. The purpose of CRA was and is to encourage banking institutions to help meet community credit needs.

During the audit period, the Banking Department evaluated CRA performance based on the 12 assessment factors set forth in Section 28-b of the New York State Banking Law and Part 76 of the General Regulations of the Banking Board. Upon the appointment of Neil D. Levin to the position of Superintendent of Banks in January 1995, Mr. Levin expressed concern that, under the previous administration, New York State's oversight of CRA failed to appropriately consider community credit needs or the efforts and performances of banks.

Thereafter, in April 1996, Superintendent Levin announced a series of CRA enforcement reforms. These initiatives included:

- New Community Reinvestment Act ("CRA") assessment report formats: In previous years, the CRA assessment reports lacked consistency and were often imprecise. In an effort to ensure greater consistency among reports, an entirely new format was implemented.

- Installation of new computer software: Superintendent Levin ordered the purchase and/or leasing of state-of-the-art hardware and CRA software equipment. With these systems on-line, the Department has been able to more effectively analyze loan data, produce maps of loan locations, and convert street addresses to census tracts.

- Staff Training: Personnel in the Division's Community Reinvestment Monitoring Unit, which is specifically charged with reviewing CRA data, have received intensive training on new federal and contemplated state CRA regulations and their incorporation into New York State Banking Department policy.

Superintendent Levin recognized the need to lay a foundation to ensure more timely and consistent CRA assessments. To this end, and continuing under the direction of the current Acting Superintendent, Elizabeth McCaul, the Banking Department and Banking Board have taken the following steps:

- The Banking Board authorized the issuance for comment of new CRA regulations which will allow the Banking Department to perform biennial, rather than annual evaluations. This will substantially eliminate the need for off-site evaluations and contribute to the accomplishments of then Superintendent Levin's important goals.

- The Department is currently in the process of creating several databases that will provide examiners with important information about community development. These databases will ensure consistent results.

- The Department has developed and begun utilizing new tools to measure home mortgage lending. Specifically, these tools include: demand adjusted analyses which view lending based on demand; aggregate analyses which allow examiners to compare particular lenders against all lenders; and peer analyses that compare lenders directly against similarly situated lenders.

- A proactive outreach program was launched to disseminate information and obtain feedback on community credit needs. Department-sponsored conferences were held across the state including:

'CRA Workshop' – This series was held in Syracuse, Binghamton, Albany, New York City, Buffalo and Chautauqua County. The events introduced CRA to community groups and encouraged their participation in Department efforts to review the CRA performance of financial institutions. More than 270 persons attended the conferences during the Summer and Fall 1996.

'Small Business Technical Assistance' – Paralleling CRA's increased emphasis on encouraging lending to small businesses, the Department sponsored conferences in Rochester and New York City in November 1996. The 200 attendees represented a variety of community organizations and financial institutions.

'Community Development Investment Opportunities' – This summer, the Department sponsored conferences in Syracuse, Buffalo and New York City to inform community groups and banks about an important new area of CRA. There were more

than 450 registrants for this conference series including 300 for the New York City event held last month.

- The Department launched a web site on the internet. More than 25,000 consumers and industry professionals have logged onto the site since its debut in August 1996.

Furthermore, while CRA doesn't primarily focus on banking services, the Department has nevertheless initiated efforts to encourage establishment of additional branches and ATMs as exemplified by the promotion of interstate branching and the approval of new ATM locations.

The following responds to several comments made in the Report.

Due Diligence

The Report states that "there is often no evidence that examiners actually review and assess" information obtained from banks (page 6). The Department acknowledges that it generally accept the accuracy of information obtained from banks as part of the off-site evaluation process. As a result of the requirement to perform annual CRA evaluations, many reports were performed off-site based on data submitted by various institutions. Admittedly, examiners have a greater ability to verify information during on-site evaluations. In this regard, we are pleased that the proposed state regulations eliminate the need for most off-site reports, thereby strengthening the ability of the Department to devote needed resources to the more meaningful on-site reports.

In addition, with regard to the review of residential mortgage data, we note that examiners use charts and tables to analyze Home Mortgage Disclosure Act ("HMDA") data supplied by banks. The information is produced by Department data support personnel using software that creates meaningful comparisons and presentations. Examiners, therefore, would not necessarily provide separate evidence in the files that they have analyzed the HMDA data. The reports' charts, tables and narrative constitute the evidence.

Moreover, the bank examination process is not intended to substitute for internal or external audits, nor should it duplicate them. Verification of HMDA data is performed by our federal counterparts. It would not be a constructive use of examiners' time to duplicate these efforts.

Examiners review branch closing reports that have been prepared by other Department staff. These reports do assess the degree to which affected communities are impacted.

Examiners do not verify that loan payments are actually made, as the Report correctly notes (page 8). We routinely accept bank management's written word that such loans were made.

Examiner Guidelines and Procedures

The Report asserted that the guidelines and procedures used by examiners "do not delineate the specific tests and analyses" to be used and do not specify the "documentation" that examiners should retain. The Department notes the accuracy of these comments for the audit period and has taken measures to address them. While the guidelines and procedures do not enumerate the specific tests and analyses, we have developed templates that lead examiners through a step-by-step process of assessing an institution. Additionally, during the past year, a series of official memoranda have been provided to examiners, which set forth specific guidance as to evaluating CRA performance. Examiners are instructed about proper record retention in the internal procedures guidelines.

CRA Ratings

The Report alleges that only 1% of the ratings issued over a three year period were "3" or "4" (6 of 495 examinations). The facts are quite different. The Department actually issued a total of 20 "3" and "4" ratings from January 1, 1993 through December 31, 1995. This constituted 4% of the total number of ratings. As a point of reference, the four federal regulators issued "3" and "4" ratings in 2% of the ratings they issued in 1996.

Service Needs

The Report is critical of the fact that Department guidelines do not define "what service needs should be assessed" (page 7). As stated above, the Banking Department utilized the 12 factors contained in Section 28-b of the Banking Law and Part 76 of the General Regulations of the Banking Board during the audit period to evaluate CRA performance. We note that only one of these twelve factors pertains to "services." Specifically, this factor directs examiners to consider the bank's record of opening and closing branch offices. The other eleven factors overwhelmingly relate to the extension of credit. This is consistent with the legislative intent of CRA, which was to eliminate deposit exportation and to encourage local lending. The provision of "banking services" is distinct from the provision of credit and accordingly, examiners, during the audit period, appropriately focused their attention on a bank's ability to help meet community credit needs. For your information, banking services constitutes one of three new tests contained in the federal and proposed state regulations, and thereby enhances the attention paid to "banking services."

Supervisory Review

Each report is reviewed by at least one reviewer/supervisor, with most reports being reviewed by two or three reviewers, including the Director of the Community Reinvestment Monitoring Unit. All reports are reviewed by the Deputy Superintendent

as well. Since February 1995, a tracking sheet is attached to reports to verify the reviews that are performed and the time periods involved.

Report's Mortgage Lending Study

The Report included a summary of a study of 1994 residential mortgage lending in Richmond, Bronx and Kings Counties performed by the auditors. The study found a substantially higher loan declination rate in minority neighborhoods. The Department concurs with the Report's statement that "it would not be fair to conclude that these sampled banks were unjustified in denying a higher percentage of loan applications from selected communities."

The Department seeks to ensure that unfair lending practices are rooted out. As described below, measures have been taken to bolster the Department's efforts in this area and we do an on-site, loan file review on each state CRA-regulated institution as part of our Consumer Compliance examination process.

Fair Lending

The Report notes "CRA may not be achieving its objective of fair lending practices in minority communities". We question whether this conclusion can be drawn from the Report's analysis of loan application declination ratios. Fair lending evaluations require extensive file reviews and rigorous analyses. A simple comparison of declination ratios fails to determine whether there were legitimate credit reasons for the denials. For example, suppose an institution wanted to increase its lending to minority communities and aggressively marketed its products and solicited applications. By casting "a bigger net," the institution would likely garner a significant number of applications from marginally qualified and unqualified prospective borrowers, resulting in a higher than usual declination ratio. However, we share the Report's interest in ensuring that minority communities are not victimized by illegal fair lending practices and have taken measures to enhance enforcement efforts including seeking approval to hire a Fair Lending Specialist to coordinate the examiners' analyses. In addition, the Department through actions taken this year, is in the forefront of monitoring fair lending.

Service Area Delineations

The Report notes that examiners generally fail to provide explanations as to how the service area delineations comply with "governing criteria." We agree that examiners should have provided their reasons for approving such delineations. However, we note that the federal and proposed state CRA regulations no longer require regulators to approve service area delineations and accordingly, an institution's delineation does not impact its rating.

CRA Software

Contrary to the Report's statement (from "Comments of Banking Officials"), the software is not primarily used to assist in analyzing the distribution of banking "services." The software contains mortgage lending and U.S. Census data. We are, however, compiling a geocoded database of bank branch locations and analyzing the proximity of the branches to LMI areas[1]. It should be noted that with respect to "services," we go beyond our federal counterparts in our CRA evaluations and branch closing application analyses. Specifically, the proposed state CRA regulations explicitly recognizes those branches that border, and presumably serve, LMI areas but are not located within the area.

CRA Statements; Public Files

Contrary to the Report's assertions (page 4), there is no requirement in the New York State CRA regulations that mandates institutions to prepare a CRA Statement. Additionally, there is no state requirement that institutions maintain a public file containing community comments on the CRA performance of an institution. These are federal requirements. We do, however, ask institutions to make their CRA evaluation reports available to the public, though the regulation is silent as to whether the evaluation should be in a public file. Examiners are asked to check compliance with the federal requirements.

1 For the purpose of this report, the term low and moderate income neighborhoods, or LMIs, refer to those census tracts where according to the 1990 Census data, the median family income is less than 80% of the area median family income. In the case of tracted areas which are part of a Metropolitan Statistical Area ("MSA") or Primary Metropolitan Statistical Area ("PMSA"), this would relate to the median family income from the MSA or PMSA in which the tracts are located.

RECOMMENDATIONS

1. *Revise CRA assessment guidelines to ensure that adequate attention is given to all assessment factors contained in the CRA regulations.*

This is moot, given the anticipated adoption of the proposed state regulations. Nevertheless, we believe that all assessment factors have received attention in proportion to their importance.

2. *Require examiners to document the information used in developing CRA ratings.*

While many reports during the audit period were not as clear and concise as possible, the Banking Department has made a sustained effort since January, 1995 to improve the reports. During the Pataki Administration, the Banking Department has strived to prepare evaluation reports that provide clear and concise evidence to support the ratings. Aside from the narrative, charts and tables, there is a summary page with bullet points describing important factors.

3. *Require supervisors to review all examiner files to ensure that required documents have been reviewed by examiners and that CRA ratings are objective, consistent, accurate and adequately supported.*

As stated above, each report is reviewed by at least one reviewer/supervisor, with most reports being reviewed by two or three reviewers, including the Director of the Community Reinvestment Monitoring Unit. All reports are reviewed by the Deputy Superintendent as well. Since 1995, our primary goal has been to improve the consistency and accuracy of the CRA ratings awarded by the Banking Department.

4. *Require examiners to document their review and assessment of delineated service areas when rendering CRA ratings to banks.*

We agree that examiners should have provided an explanation in each report of why a delineation was accepted or rejected. As discussed above, federal and proposed state regulations direct examiners to focus less attention on this area and, in fact, guide them to adjust the delineation (assessment area) when necessary for the purposes of the examination. The new regulations do not direct examiners to make a judgment as to whether the delineation should be accepted or rejected.

5. *Perform periodic reviews and assessments of the geographic distribution of banking services between communities to identify problems not addressed adequately by the current CRA examination process.*

The Department is unclear as to what area or authority this recommendation refers. If the Report is asking that banking "services," as distinct from credit, be studied, the Department has noted above the increased attention paid to services in the federal and proposed state regulations. Additionally, the Department is geocoding branch locations. It is intended that such geocoding will permit more sophisticated studies of branch closings and the analyses of the adequacy of the geographic distribution of branch services. As previously mentioned, the Department has a more refined perspective than its federal counterparts in that it also look at branches that serve LMI areas from middle and upper income locations.

If, however, the Report is referring to studies of credit extensions, the Department concurs that geographic analyses are useful to ascertain the additional efforts that are required to ensure that credit needs are met in all communities, including LMI areas. The Department intends to perform these studies going forward although it recognizes that the results will not indicate whether or not the CRA has been successful, since the role of state-supervised financial institutions is only one of several crucial factors in determining the economic health of communities.