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July 2006

TREASURY'S BANK ENTERPRISE AWARD PROGRAM

Impact on Investments in Distressed Communities Is Difficult to Determine, but Likely Not Significant

GAO-06-824

Highlights of GAO-06-824, a report to congressional committees

Why GAO Did This Study

Established in 1994, the Department of the Treasury's Bank Enterprise Award (BEA) program provides cash awards to banks that increase their investments in community development financial institutions (CDFI) and lending in economically distressed communities. CDFIs are specialized institutions that provide financial services to areas and populations underserved by conventional lenders and investors. In 2005, Treasury provided nearly $10 million in BEA awards.

The BEA program has faced longstanding questions about its effectiveness and experienced significant declines in funding in recent years. This report (1) examines the extent to which the BEA program may have provided banks with financial incentives and (2) assesses the BEA program's performance measures and internal controls.

To complete this study, GAO reviewed relevant award data; interviewed Treasury, bank, and CDFI officials; and assessed the BEA program's performance measures and internal controls against GAO's standards for effective measures and controls.

What GAO Recommends

GAO recommends that Treasury strengthen its internal controls to ensure proper award payments. Treasury disagreed with aspects of GAO's analysis but agreed to implement the recommendation.

www.gao.gov/cgi-bin/getrpt?GAO-06-824.

To view the full product, including the scope and methodology, click on the link above. For more information, contact George A. Scott at (202) 512-5932 or scottg@gao.gov.

July 2006

TREASURY'S BANK ENTERPRISE AWARD PROGRAM

Impact on Investments in Distressed Communities Is Difficult to Determine, but Likely Not Significant

What GAO Found

The extent to which the BEA program may provide banks with incentives to increase their investments in CDFIs and lending in distressed communities is difficult to determine, but available evidence GAO reviewed suggests that the program's impact has likely not been significant. Award recipients GAO interviewed said that the BEA program lowers bank costs associated with investing in a CDFI or lending in a distressed community, allowing for increases in both types of activities. However, other economic and regulatory incentives also encourage banks to undertake award-eligible activities, and it is difficult to isolate and distinguish these incentives from those of a BEA award. For example, banks may have economic incentives to lend in distressed communities because of the potential profitability of such lending. Although it is difficult to determine the BEA program's impact, available evidence suggests that the impact likely has not been significant. For example, the size of a BEA award for large banks (which was .0004 percent of assets in 2005) suggests that a BEA award does not have much influence on such banks' overall investment and lending decisions (see figure). However, BEA awards may allow large banks to incrementally increase their award-eligible investments and lending.

The BEA program's performance measures likely overstate its impact, and GAO identified weaknesses in certain program internal controls. To assess the BEA program's performance, Treasury, among other measures, annually aggregates the total reported increase in CDFI investments and distressed community loans by all applicants but does not account for other factors, such as economic and regulatory incentives that also affect bank decisions. GAO also found that Treasury has limited controls in place to help ensure that BEA program applications contain accurate information. In particular, Treasury provides limited guidance to application review staff to identify potential errors and does not require the reviewers to completely document their work. As a result, GAO found that the BEA program is vulnerable to making improper payments.

Average BEA Award as a Percentage of Large Banks' Assets,[a] 2003 through 2005

Year	Number of banks[b]	Average award as percentage of total assets
2003	21	.0005
2004	17	.0004
2005	22	.0004

Source: GAO analysis of Treasury data.

[a]Large banks, for purposes here, are those with assets of $1 billion or more.

[b]Large banks received 43 percent of all BEA dollars in 2003, 8 percent in 2004, and 38 percent in 2005.

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Abbreviations

BEA	Bank Enterprise Award
CDFI	community development financial institution
CRA	Community Reinvestment Act of 1977
OMB	Office of Management and Budget
Treasury	U.S. Department of the Treasury

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United States Government Accountability Office
Washington, DC 20548

July 31, 2006

The Honorable Christopher Bond
Chairman
The Honorable Patty Murray
Ranking Minority Member
Subcommittee on Transportation, Treasury,
the Judiciary, Housing and Urban Development,
and Related Agencies
Committee on Appropriations
United States Senate

The Honorable Joe Knollenberg
Chairman
The Honorable John W. Olver
Ranking Minority Member
Subcommittee on Transportation, Treasury,
and Housing and Urban Development, the Judiciary,
the District of Columbia and Independent Agencies
Committee on Appropriations
House of Representatives

Established in 1994, the Department of the Treasury's (Treasury) Bank Enterprise Award (BEA) program was designed to provide financial incentives for FDIC-insured banks and thrifts (hereafter referred to as banks) to increase their investments in community development financial institutions (CDFI)[1] and lending within eligible distressed communities as defined by statutory and regulatory requirements.[2] CDFIs are private for-profit or not-for-profit financial institutions that provide financial services (e.g., loans) to communities traditionally underserved by conventional lenders and investors and that Treasury may certify for participation in the

[1]For purposes of this report, investments in CDFIs are equity investments, equitylike loans, grants, loans, deposits or shares, and technical assistance.

[2]See 12 C.F.R. §1806.200, which requires a BEA award applicant to designate one or more distressed communities in which it will carry out distressed community financing or service activities and establishes minimum eligibility and distress requirements for such a community.

BEA program and other related programs.[3] CDFIs include community development banks, which may receive BEA awards because they are FDIC-insured; credit unions, which are ineligible for BEA awards because they are not FDIC-insured; loan funds; and venture capital funds.[4] Due to statutory and regulatory requirements, community development banks, which tend to be small institutions, receive relatively larger BEA awards for increasing certain award-eligible investments and lending compared to traditional banks.[5] In providing banks with incentives to increase their award-eligible activities, the BEA program seeks to build the financial capacity of CDFIs, so they may better serve their customers, and the availability of direct lending within distressed communities.

However, the BEA program has faced long-standing questions about its effectiveness and experienced significant funding declines in recent years. A 1998 GAO report, as well as a 2002 review by the Office of Management and Budget (OMB), both questioned the extent to which the BEA program provided banks with financial incentives to increase their award-eligible activities.[6] For example, we and OMB stated that the Community Reinvestment Act of 1977 (CRA) provides banks with incentives to make similar investments and loans that the BEA program awards and that it can

[3]Treasury has a process for certifying a CDFI, which means that the institution meets certain CDFI eligibility requirements—including having a primary mission of promoting community development and a predominant business activity of providing financial products, development services, or other similar financing to a target population or an investment area. 12 C.F.R. § 1805.201.

[4]As of January 1, 2006, Treasury had certified 752 CDFIs. Among these, 55 were community development banks that FDIC insures, 146 were credit unions that the National Credit Union Share Insurance Fund insures and therefore are ineligible for BEA awards, 505 were loan funds, 22 were venture capital funds, and 24 were depository-holding companies. For purposes of this report, depository-holding companies are considered banks.

[5]Community development banks, for purposes of this report, are those Treasury has certified as such banks. Traditional banks, for purposes of this report, are noncommunity development banks. BEA awards to community development banks can be as much as three times higher than awards to traditional banks that make similar investments and loans.

[6]GAO, *Community Development: CDFI Fund Can Improve Its Systems to Measure, Monitor, and Evaluate Awardees' Performance*, GAO/RCED-98-225 (Washington, D.C.: July 15, 1998); and Office of Management and Budget, *Bank Enterprise Award Assessment* (Washington, D.C., 2002).

be difficult to distinguish CRA's incentives from those of a BEA award.[7] Further, from fiscal years 2000 through 2005, BEA program funding declined from over $46 million to about $10 million, the number of award recipients declined from 159 to 53, and Treasury has increasingly been unable to award all qualified applicants.[8] The average BEA award amount also dropped from almost $292,000 to about $187,000 during the period.

Noting concerns about funding reductions to the BEA program and other related programs within Treasury, as well as the lack of a recent third-party evaluation, a fiscal year 2006 report by the Senate Committee on Appropriations requires us to assess the BEA program, particularly the extent to which it affects bank behavior in providing financial services to distressed communities.[9] As agreed with committee staff, this review also includes an assessment of certain aspects of Treasury's administration of the BEA program. Accordingly, this report (1) examines the extent to which the BEA program may have provided banks with financial incentives to increase their investments in CDFIs and lending in distressed communities and (2) assesses the BEA program's performance measures and certain internal controls designed to ensure proper award payments.

To conduct our work, we reviewed relevant program statutes, regulations, guidelines, memorandums, and reports; interviewed Treasury officials regarding the BEA program's impact and administration; interviewed CDFI trade associations regarding their views of the program; and interviewed a nonprobability sample of nine BEA award recipients and five CDFI beneficiaries participating in the fiscal year 2005 round of awards.[10] While

[7]Pub. L. No. 95-128, title VIII, 91 Stat. 1147 (Oct. 12, 1977) (*codified at* 12 U.S.C. §§ 2901–08). CRA requires financial regulators, for each institution they regulate, to assess the institution's record of meeting the credit needs of all areas in the community served, consistent with safe and sound banking operations, and to take that record into account in evaluating the institution's applications for a deposit facility, such as opening new branch offices. 12 U.S.C. § 2903.

[8]Treasury's inability to award all eligible activities has resulted in some banks' reported activities, such as increased lending in distressed communities, not receiving BEA award dollars. For fiscal year 2006, the Senate Committee on Appropriations expressed an expectation that the BEA program would be funded at no less than $11,000,000. *See* S. Rep. No. 109-109, 129 (July 26, 2005).

[9]S. Rep. No. 109-109, 129 (July 26, 2005).

[10]For purposes of this report, CDFI beneficiaries, also known as CDFI partners, consist of community development banks, credit unions, loan funds, and venture capital funds. They are the recipients of a BEA awardee's investment.

results from these interviews cannot be projected to the entire population of BEA award recipients and beneficiaries, we selected these recipients and beneficiaries for interviews to assure variation on a range of characteristics, including differing asset sizes, frequency of program participation, award-to-asset percentages, and CDFI type. Our interviews with award recipients included both community development banks and traditional banks. We also assessed the BEA program's performance measures and internal controls against our standards for effective measures and controls.

We conducted our work from October 2005 through July 2006 in Washington, D.C., in accordance with generally accepted government auditing standards. Appendix I provides a description of our scope and methodology in greater detail.

Results in Brief

The extent to which the BEA program may provide banks with incentives to increase their investments in CDFIs and lending in distressed communities is difficult to determine, but available evidence we reviewed suggests that the program's impact likely has not been significant. According to Treasury officials and some BEA award recipients we interviewed, the BEA program produces a range of benefits, such as lowering bank costs associated with investing in a CDFI or lending in a distressed community, which encourages and allows banks to increase both types of activities. According to Treasury officials, the BEA program has also encouraged partnerships between banks and CDFIs. However, independently evaluating and isolating the BEA program's impact is difficult because other economic and regulatory incentives also affect bank behavior. For example, banks have economic incentives to lend in distressed communities because BEA-eligible loans can be profitable. In addition, CRA provides banks with a regulatory incentive to undertake award-eligible activities. In accordance with CRA, federal regulators examine and assess banks based on their efforts to provide financial services (e.g., investments in CDFIs or loans in distressed communities) in all areas of the community they serve and may consider inadequate compliance when reviewing a bank's application to merge or expand operations. Moreover, even when not accounting for other economic and regulatory incentives, BEA awards for large banks may be small and, therefore, may not have much influence on their overall investment and lending decisions, although the awards may provide such banks with the capacity to incrementally increase their award-eligible activities. In addition, until 2003, BEA awards may have provided certain community development banks with incentives to benefit financially from activities

that were inconsistent with program goals, and available studies indicate that certain CDFIs have been able to raise an increased amount of capital from banks concurrent with recent declines in BEA program funding and participation.

The BEA program's performance measures likely overstate the program's impact; in addition, we identified weaknesses in certain BEA program internal controls. To assess the BEA program's performance, Treasury, among other measures, annually aggregates the total reported increase in CDFI investments and distressed community loans by all applicants and attributes this increase solely to the BEA program. For example, Treasury attributed a reported $100 million increase in applicants' CDFI investments and distressed community loans to the $10 million in BEA awards it distributed in 2005. Because this and similar BEA program performance measures do not isolate the prospect of BEA award receipt from other economic and regulatory incentives, such as loan profitability and CRA requirements, they likely attribute more influence to the program than can be substantiated. Furthermore, we identified weaknesses in the BEA program's system of internal control, which increase its vulnerability to improper payments. Specifically, we found that Treasury has limited controls in place to ensure that BEA applications contain accurate information upon which to make award determinations (i.e., bank-financed properties are located in eligible distressed communities as defined by statutory and regulatory requirements). We also found that Treasury provides limited guidance to its application review staff to identify potential errors in the reporting of a financed property's location and does not require the reviewers to completely document their work.

This report recommends that Treasury revise its guidance to application review staff and require staff to document their work to help ensure that errors in the reporting of property location are identified and the risk of improper payments is minimized. Treasury provided written comments on a draft of this report that are reprinted in appendix II. In its comments, Treasury agreed with our conclusion that determining the BEA program's impact is difficult, but disagreed with certain aspects of our analysis. For example, Treasury said that our examination of the BEA program's impact on bank behavior bases many of its conclusions on information that is overly general, outdated, or developed for purposes other than to evaluate the BEA program. Treasury also said that we did not adequately consider evidence the department provided regarding the BEA program's impact. We believe the information and evidence used to support our conclusions is appropriate and continue to conclude that the BEA program's impact on bank behavior has likely not been significant. Treasury did agree to

implement our report's recommendation. Treasury's comments and our evaluation of them are discussed in greater detail at the end of this report. Treasury also provided technical comments that we have incorporated, as appropriate.

Background

The BEA program's goals are to encourage banks to increase their investments in CDFIs and lending and other financial services in distressed communities.[11] Unlike grant programs, which are usually prospective—meaning they award applicants based on their plans for the future—the BEA program is retrospective, awarding applicants for activities they have already completed. Under the program's authorizing statute, BEA award recipients are not limited in how they may use their award and, therefore, may use their award proceeds in any manner they deem fit.

To encourage increased investment and lending, the BEA program awards applicants on the basis of their increased activities from one year (known as the baseline year) to the next (the assessment year).[12] For example, for the fiscal year 2005 round of awards, calendar year 2003 was the baseline year and calendar year 2004 was the assessment year. When applying for awards, applicants may submit an application for any of the following three award categories: (1) CDFI-related activities, (2) distressed community financing activities, and (3) service activities. CDFI-related activities are primarily investments in CDFIs, such as equity investments (including grants and equitylike loans), loans, and insured deposits. Distressed community financing activities are primarily loans, such as affordable housing loans, small-business loans, commercial real estate loans, and education loans. Service activities include the provision of

[11]According to BEA program regulations, a distressed community is defined as a geographic area where at least 30 percent of its residents have incomes less than the national poverty level; the unemployment rate is at least 1.5 times greater than the national average; and (a) the population of that area is at least 4,000 residents if any portion of the area is located in a metropolitan area with a population of 50,000 or greater, (b) the population must be at least 1,000 residents if no portion of the area is located within such a metropolitan area, or (c) the area is located entirely within an Indian reservation. 12 C.F.R. § 1806.200; and 69 Fed. Reg. 54718, 54719 (Sept. 9, 2004). Further, under program regulations, distressed communities with poverty rates as low as 20 percent may qualify under certain circumstances.

[12]In 2003, Treasury changed the baseline and assessment periods from 6 months each to 12 months each.

financial services such as check-cashing or money order services, electronic transfer accounts, and individual development accounts.

Pursuant to statutory and regulatory requirements, BEA awards are percentage matches of an applicant's reported increase in activities; that is, banks qualify for a BEA award equal to the sum of the percentage increase in the three program areas. For equity investments in CDFIs, the percentage match for both community development banks and traditional banks is the same—15 percent (see table 1). However, community development banks are eligible to receive awards three times higher than traditional banks for increasing CDFI support activities (e.g., increasing insured deposits in other CDFIs) or increasing their lending and service delivery in distressed communities. For distressed community financing activities, a priority factor of 3.0 or 2.0 is assigned to each type of eligible loan a BEA applicant originates—for example, a small-business loan is assigned 3.0 and an affordable housing development loan is assigned 2.0. The change in award-eligible activity (i.e., the increase in lending from the baseline to the assessment year) is multiplied by the applicable priority factor, and the result (or weighted value) is then multiplied by the applicable award percentage, yielding the award amount for that particular activity.

Table 1: Percentage of Reported Increase in Award-Eligible Activities, Fiscal Year 2005 and 2006

Percent

	CDFI-related activities			
BEA-eligible activity	**Equity investments (includes grants and equitylike loans)**	**Support activities (includes insured deposits)**	**Distressed communities financing activities**	**Service activities**
Community development bank	15	18	9	9
Traditional bank	15	6	3	3

Source: GAO.

To illustrate how the BEA program works, suppose a community development bank that did not have any investments in other CDFIs or loans in eligible distressed communities during the baseline year. During the assessment year, the bank makes the following investments or loans in

CDFIs: $300,000 in insured deposits in three community development credit unions (three insured certificates of deposits of $100,000 each), $500,000 in small-business loans, and $1 million in affordable housing development loans in distressed communities (total increased investments and loans of $1.8 million). Under this example, the bank would be eligible for a BEA award totaling $369,000[13] (a 20.5 percent return on investment).[14] Under the same scenario, a traditional bank would be eligible for a BEA award of $123,000 (or a return on investment of 6.8 percent).[15]

According to Treasury officials, the BEA program is seasonal and employs the equivalent of about six staff annually, who work on the program on an as-needed basis. A program manager oversees the BEA program on a day-to-day basis. During the program's peak application season, Treasury reassigns roughly 10 staff members from other job responsibilities to review BEA applications over a period of approximately 10 business days. During fiscal year 2005, it cost approximately $1.2 million to administer the BEA program. These costs are composed of personnel compensation, information technology, and administrative contracting services, among other costs.

CRA requires federal bank regulators to assess how well the banks they regulate meet the credit needs of all areas of the community they serve, including low- and moderate-income areas (insofar as is consistent with safe and sound operations) and to take this performance into account when considering a bank's request for regulatory approval of a regulated action, such as opening a new branch or acquiring or merging with another bank. Federal regulators conduct examinations for compliance with CRA requirements on a frequency that varies depending on an institution's size and prior rating.[16] When conducting examinations, regulators check to see

[13]There is currently a $500,000 cap on the award any one bank may receive in a given year.

[14]That is, the bank would be eligible for $54,000 for making $300,000 in insured deposits in the credit unions ($300,000 x 18 percent), $135,000 for increased small-business lending ($500,000 x weighting factor of 3.0 = $1.5 million x 9 percent = $135,000), and $180,000 for increased affordable housing lending ($1 million x weighting factor of 2.0 = $2 million x 9 percent = $180,000). In sum, $54,000 + $135,000 + $180,000 = $369,000.

[15]That is, the bank would receive $18,000 for $300,000 in insured deposits ($300,000 x 6 percent), $45,000 for $500,000 small-business lending ($1.5 million x 3 percent = $45,000), and $60,000 for affordable housing lending ($2 million x 3 percent = $60,000). In sum, $18,000 + $45,000 + $60,000 = $123,000.

[16]For example, the frequency would be no more than every 5 years for a small bank with an outstanding rating and every year for a large bank with less than a satisfactory rating.

whether a bank's CRA compliance activities are an ongoing part of the bank's business and generally apply three tests to make this determination:[17]

- A lending test evaluates the number, amount, and income and geographic distribution of a bank's mortgage, small business, small farm, and consumer loans.
- An investment test evaluates a bank's community development investments, including its investments in CDFIs.
- A service test evaluates a bank's retail service delivery operations, such as branches and low-cost checking services.

Upon completing examinations, regulators assign one of four ratings to a bank: outstanding, satisfactory, needs improvement, or substantial noncompliance.

The BEA Program Reportedly Produces Benefits, but Available Evidence Suggests That the Program's Impact Has Likely Not Been Significant

Treasury officials and some BEA award recipients we interviewed said that the BEA program provides banks with incentives to increase their investments in CDFIs and lending in distressed communities. However, determining the program's impact is difficult because other economic and regulatory incentives also encourage banks to undertake award-eligible activities. Although it is difficult to determine the BEA program's impact, the available evidence we reviewed suggests that the program's impact has likely not been significant. For example, for large banks, a BEA award (when compared with total bank assets) is small and likely not large enough to have much influence on such banks' overall investment and lending decisions. Other evidence also indicates that the BEA program's impact has likely not been significant. In particular, until 2003, BEA awards may have provided certain community development banks with incentives to benefit financially from activities that were inconsistent with BEA program goals, and available studies indicate that certain CDFIs have been able to raise an increased amount of capital from banks, while BEA program funding and participation have declined.

[17] Other tests may be applied. A community development test is applied for certain institutions known as wholesale or limited-purpose banks, and the small-bank performance standards are applied in evaluating the performance of a small bank or a bank that was a small bank during the prior calendar year. See, for example, 12 C.F.R. § 345.21(a)(2) and (3) (FDIC).

According to Treasury Officials and Some Award Recipients, the BEA Program Produces a Range of Benefits

According to Treasury officials and some award recipients, the BEA program allows award recipients to increase their lending and investment levels beyond those that would occur without the program. Award recipients we interviewed stated that one of the program's main benefits is reduced transaction costs. Transaction costs are primarily the time and expense associated with researching markets or borrower qualifications and underwriting loans within distressed communities. Award recipients stated that transaction costs are higher in distressed communities than in other communities because, for example, loans are typically smaller (thus generating less interest income) and have a higher risk of default. Because BEA awards are in cash, award recipients said that award proceeds can be used to provide more loans, on more favorable terms, than are otherwise possible. Award recipients said that such an arrangement benefits both BEA award recipients and loan borrowers.

Another benefit that award recipients cited is the formation of partnerships between banks and other financial institutions, including CDFIs. When investing in a CDFI—the activity awarded with the highest payout—applicants identify and select a CDFI in which to invest, such as a community development bank, credit union, loan fund, or venture capital fund. According to officials from banks and CDFIs, the resulting investment in the CDFI produces two benefits. First, the investment increases the CDFI's capacity by providing it with capital, often at below-market rates, which in turn allows the CDFI to provide more loans in distressed communities. Second, according to one CDFI official we interviewed, the partnership allows traditional banks to learn about and understand the work of CDFIs. For example, the CDFI official we interviewed noted that the partnership formed through the BEA program allowed officials from a traditional bank to sit on the CDFI's board of directors, which exposed the traditional bank officials to the products and services of the CDFI. When initially established, Treasury intended the BEA program to encourage traditional banks to become involved in community development banking activities by, for example, investing in a CDFI or lending in a distressed community.

A third benefit of the BEA program, according some award recipients we interviewed, is the provision of capital needed to help the community development banking industry grow and develop during its early years and sustain its level of operations today. An official representing the community development banking industry noted that there were only three Treasury-certified community development banks in the mid-1990s when the BEA program began, but today there are over 50 such banks, growth the official attributes to the BEA program. Some award recipients

we interviewed also stated that award proceeds have allowed them to sustain their current level of operations within distressed communities, where, as previously noted, transaction costs are higher than in other areas. Accordingly, the BEA program is said to help community development banks remain true to their core missions of serving the financing and developmental needs of their community.

Isolating the BEA Program's Impact from Other Existing Economic and Regulatory Incentives Remains Difficult

Independently evaluating and isolating the BEA program's impact on bank investment and lending decisions is difficult because other economic and regulatory incentives also affect bank behavior. In 1998, we reported that the prospect of receiving a BEA award, while one factor, was not always the primary reason banks undertook award-eligible activities.[18] In 2000, the Federal Reserve Board completed a survey providing additional evidence that loan profitability can be an important factor in banks' community development lending decisions.[19] This survey, which focused on the performance and profitability of CRA-related lending, found that a majority of respondents' community development loans were profitable. The survey also found that a majority of respondent's CRA special lending programs, which target low-income borrowers and areas, were profitable.[20] Because community development loans can be profitable, as noted in the Federal Reserve Board's survey, banks have economic incentives to make these loans even without the incentive of potentially receiving a BEA award.

In addition to economic incentives, regulatory incentives can also encourage banks to undertake award-eligible activities. In our 1998 report, we found that compliance with CRA was a major reason banks made investments in CDFIs and loans in distressed communities. CRA incentives may be particularly strong for banks that plan to open a new branch or merge with other banks because federal regulators may consider inadequate compliance when reviewing banks' requests to merge with other banks or expand their operations. However, Treasury officials said that the BEA program provides banks with more targeted incentives than

[18] GAO/RCED-98-225.

[19] Board of Governors of the Federal Reserve System, *The Performance and Profitability of CRA-Related Lending* (Washington, D.C., July 17, 2000).

[20] One limitation of this report is that no small banks (those with less than $950 million in assets) responded to the report's survey and only 21 percent of banks with $950 million to $5 billion in assets responded.

CRA requirements do. For example, the officials said that the BEA program provides banks with incentives to provide financial services in the most distressed communities—communities that banks are not required to service in their efforts to comply with CRA.

To obtain feedback on the BEA program's design and implementation, Treasury has conducted surveys of BEA program applicants. Treasury's most recent survey, conducted in 2002, suggests that both the BEA program and CRA requirements are responsible for banks' increased investments in CDFIs and lending in distressed communities. For example, the 2002 survey of 115 program applicants found that both the prospect of a BEA award and credit for CRA compliance motivated banks to undertake many CDFI-related activities, including providing CDFIs with loans, grants, and technical assistance, but found that the BEA program contributed toward the development of new financial products. The survey also found that, in many cases, neither the BEA program nor credit for CRA compliance motivated banks to lend in distressed communities. Rather, the banks reported making loans in distressed communities because such lending is part of their community development mission or part of their everyday business activities.

Available Evidence Suggests That the BEA Program's Impact Has Likely Not Been Significant

Although it is difficult to determine the BEA program's impact, the available evidence we reviewed suggests that the program's impact has likely not been significant for large traditional banks, although it may allow for incremental increases in award-eligible activities. The available evidence also suggests that the BEA program may have provided some community development banks with incentives to benefit financially without furthering program goals. Further, available studies we reviewed indicate that some CDFIs have raised an increased amount of capital from banks while BEA program funding and participation have declined. Specifically, we found the following:

- *For large traditional banks, as noted in our 1998 report, BEA awards are likely not large enough to provide a meaningful financial incentive.* As shown in table 2, the size of a BEA award when compared with the assets of large traditional banks (those with over $1 billion in assets) was .0004 percent of assets in 2005. For these banks, the prospect of receiving a BEA award, independent of any economic and regulatory incentives the banks may have, is unlikely to serve as a significant financial incentive for increased CDFI investment or distressed community lending. However, BEA awards may provide large traditional banks with the capacity to incrementally increase their award-eligible activities, offset some of the

cost associated with doing so, and increase the profits of related lines of business. Large traditional banks may also derive public and community relations value from receiving a BEA award that outweighs its financial benefit.

Table 2: Average BEA Award as a Percentage of Large Banks' Assets,[a] 2003 through 2005

Year	Number of banks[b]	Average award as percentage of total assets
2003	21	.0005
2004	17	.0004
2005	22	.0004

Source: GAO analysis of Treasury data.

[a]Large banks, for purposes here, are those with total assets of $1 billion or more.

[b]Large banks received 43 percent of all BEA award dollars in 2003, 8 percent in 2004, and 38 percent in 2005.

- *Until 2003, many BEA program participants engaged in a now-prohibited practice called deposit swapping that improved their financial condition without necessarily furthering program goals.* According to a Treasury official, beginning around 1998, a group of about 30 community development banks began to purchase insured certificates of deposit in one another—that is, swap deposits—to increase their CDFI investments and thereby receive BEA awards. At the time, Treasury provided a 33 percent award match for community development banks that increased their deposits in other community development banks. Following the 2003 prohibition, the percentage of total BEA dollars awarded for CDFI investments fell substantially—from 87 percent of all BEA dollars awarded in 2002 to only 18 percent in 2003 (by contrast, total BEA dollars awarded for increased lending and services in distressed communities increased from 13 percent in 2002 to 82 percent in 2003). According to a Treasury official, the prohibition on deposit swapping was, in fact, the primary reason for the substantial decline in CDFI investments. This decline suggests that, until 2003, banks may have been responding to financial incentives that were inconsistent with the BEA program's goals, which include increasing lending within distressed communities.

- *Community development loan funds have raised an increased amount of capital from banks, thrifts, and credit unions, while BEA program funding and bank participation in the program have declined.* According to data from a consortium of CDFIs, community development loan funds—the most numerous type of CDFI and thus the largest group of potential BEA program beneficiaries—have continued raising capital from

banks, thrifts, and credit unions concurrent with a decline in funding and bank participation in the BEA program.[21] According to the consortium's data, the percentage of capital loan funds raised from banks, thrifts, and credit unions increased from 47 percent in fiscal year 2003 to 56 percent in fiscal year 2004. As discussed previously, BEA program funding also declined substantially in recent years from over $46 million in fiscal year 2000 to about $10 million in fiscal year 2005. We note that one limitation of the consortium's data for purposes of this analysis is that it includes credit unions, which are ineligible for BEA awards. However, an official involved with completing the studies said that loan funds raised most of the capital from banks and thrifts, which are eligible for BEA awards. According to the CDFI consortium, financial institutions are a growing source of capital for loan funds because loan funds provide a safe investment, allow banks to earn CRA credit, and are flexible partners.

The BEA Program's Performance Measures Likely Overstate Its Impact, and Treasury's Internal Controls to Ensure Proper Award Payments Have Weaknesses

Treasury's performance measures for the BEA program likely overstate its impact on bank investments in CDFIs and lending in distressed communities. In addition, we identified weaknesses in Treasury's system of internal control for ensuring proper award payments. Specifically, we found that Treasury has limited controls in place to help ensure that bank applicants finance properties located in eligible distressed communities. We found that Treasury also provides limited guidance to its application review staff to identify potential errors in the reporting of a financed property's location and does not require the reviewers to completely document their work.

[21]The CDFI Data Project, *Providing Capital, Building Communities, Creating Impact, Fiscal Year 2003*, 3rd ed.; and *Providing Capital, Building Communities, Creating Impact, Fiscal Year 2004*, 4th ed. Loan funds are typically nonprofit organizations that provide financing and development services to businesses, organizations, and individuals in low-income communities. There are about 500 Treasury-certified loan funds.

BEA Program Performance Measures Likely Overstate Program Impact

To assess the BEA program's performance, Treasury publicly reports bank applicants' total reported increase in CDFI investments and distressed community lending.[22] To establish targets for this measure, Treasury assumes a complete, causal linkage between the BEA program and applicants' increases in award-eligible activities. For example, in 2005, Treasury attributed a reported $100 million increase in award-eligible activities to BEA awards of approximately $10 million distributed that year. In reporting results for this measure, Treasury does not account for other factors that also affect bank lending and investment decisions, such as loan profitability and CRA compliance. By not accounting for such factors, Treasury's performance measure likely overstates the BEA program's impact. As a result, Treasury lacks accurate information needed to assess program accomplishments and make changes to ensure that the BEA program is meeting its goals. GAO's standards for effective performance measures state that measures should be objective—that is, they should be reasonably free of any significant bias or manipulation that would distort an accurate assessment of performance.[23]

Treasury internally tracks other BEA program data, but these data also likely overstate the program's impact. For example, as part of a BEA application, Treasury requests that applicants provide such data as the number of full-time equivalent jobs created or maintained and the number of housing units developed or rehabilitated in distressed communities. Treasury uses this information to monitor and measure the BEA program's impact. Similar to its externally reported measure, Treasury assumes a direct one-to-one correlation between these outcomes (new jobs and housing units) and the BEA program. Treasury does not account for external factors, such as economic and regulatory incentives that could also contribute to an increase in jobs created or housing units developed. Further, these data are self-reported and, according to Treasury, not verified. Therefore, they could be subject to the type of bias and manipulation that would distort an accurate assessment of performance.

We acknowledge that developing performance measures for the BEA program is challenging. As stated in our 1998 report, to an extent that

[22]Treasury reports results for this measure in its annual *Performance and Accountability Report*.

[23]For a more thorough discussion of criteria for effective performance measures, see GAO, *The Results Act: An Evaluator's Guide for Assessing Agency Performance Plans*, GAO/GGD-10.1.20 (Washington, D.C.: April 1998).

neither we nor Treasury can quantify, banks are receiving awards for investments and loans they would have made without the prospect of receiving a BEA award. The available evidence discussed in this report (e.g., the relatively small size of BEA awards for large banks) further supports this analysis. While it may have been advisable for Treasury to attribute less influence to the BEA program when developing its performance measures, it is not clear that a reliable and appropriate methodology exists to accurately measure the BEA program's impact on bank behavior.

Treasury Has Not Established Effective Controls to Help Ensure That Bank-Financed Properties Are Located in Eligible Distressed Communities

According to a Treasury official, one of the most significant risks the BEA program faces is that applicants may provide inaccurate information regarding the location of properties financed by their activities. That is, the potential exists for banks to receive BEA awards based on loans that finance properties, such as commercial or affordable housing development loans, that were not located in eligible distressed communities. While Treasury has established controls to mitigate this risk, these controls are not fully consistent with federal internal control standards, which state that policies and procedures, including appropriate documentation, should be designed to help ensure that management's directives, such as verification procedures, are carried out and that appropriate supervisory oversight of established processes is exercised. Without sufficient controls to help ensure that properties are located in eligible distressed communities, the BEA program is vulnerable to making improper payments.

According to a Treasury official, application review staff are to perform the following procedures to ensure that properties are located in eligible distressed communities:

- Use an online Treasury system, for all loans of $500,000 or more, to verify that borrower addressers or, in some cases, properties secured by the loans (collateral) are located in eligible census tracts (generally referred to as loan geocoding).
- Geocode a sample of loans valued at $250,000 to $500,000 to verify that borrower or collateral addresses are located in eligible census tracts.

Treasury officials said that BEA program application review staff have identified properties that were not located in eligible distressed communities. For example, a Treasury official said that, in one case, the address of the borrower (a developer), which was located in an eligible

distressed community, was given as a basis for the bank to receive a BEA award.[24] However, the official said that the address of the property under development was not in an eligible distressed community. The official said that she was familiar with the area where the property was located and knew that it did not meet eligibility requirements, which prompted her to do follow-up analysis. According to the official, Treasury staff disallowed this particular loan as a basis for the bank to receive a BEA award.

While a Treasury official said that the department has established controls to mitigate errors in the reporting of property locations, we identified limitations with the guidance that Treasury provides to its application review staff. For example, Treasury's guidance states that for loans of $500,000 or above and for a sample of loans from $250,000 to $500,000, staff should geocode the borrower's address. However, for development loans where the address of the borrower (such as a developer) may differ from the address of the property under development, the guidance does not specifically require staff to geocode the property address. A Treasury official confirmed that the department has not provided specific guidance to reviewers on geocoding property addresses in such instances. As noted previously, Treasury staff have identified at least one example in which the location of the borrower was in a distressed community but the location of the property was not, although this identification was largely because of the reviewer's familiarity with the area where the property was located. By not specifying in the guidance that reviewers should geocode property addresses where appropriate, the potential exists that banks will receive BEA awards based on erroneous information.

We reviewed two banks' BEA applications for the fiscal year 2004 and 2005 rounds of BEA awards (a total of four applications) to conduct a limited test of Treasury's implementation of procedures for verifying certain application data. Each bank in our review received the maximum $500,000 award in the 2005 funding round. The files we reviewed did not contain any documentation of the staff's geocoding of property location data (for loans exceeding $250,000 or $500,000). A Treasury official we interviewed agreed that the files did not contain any documentation of the staffs' geocoding effort. Further, our review of Treasury's BEA application guidance found that the guidance does not establish specific documentation requirements for the program staff's geocoding efforts.

[24]BEA application materials may contain both the address of the borrower and the address of the property financed through reported bank lending activities.

Without such guidance and documentation requirements, Treasury management and supervisors, as well as outside reviewers, cannot be assured that the geocoding is being conducted or that errors in the reporting of property location are detected.

To assess the potential for improper BEA award payments, we used Treasury's online geocoding system to determine the locations of properties contained in the 2004 and 2005 applications for the two banks. We identified 1 commercial and 5 affordable housing development loans among these applications, out of a total of 18 such loans with a value of $250,000 or more, where we had questions as to whether properties financed by the loans were located in eligible distressed communities. For example, we identified an affordable housing development loan of approximately $423,500 that was made to purchase an apartment building. Our geocoding analysis determined that the address of the property was not in an eligible distressed community, whereas the address of the borrower was in a distressed community that could qualify under certain circumstances. In this case, according to a Treasury official, the reviewer probably geocoded the address of the borrower rather than the address of the property. The Treasury official also suggested that the address of the property may have been in an eligible distressed community at the time the application was made in 2004. However, our analysis of census data indicates that the relevant census tract was not an eligible distressed community in 2004. Consequently, Treasury's decision to provide a BEA award to this bank may have been based in part on erroneous information.

Conclusions

Because of other economic and regulatory incentives that also affect bank behavior, it remains difficult to isolate and determine the BEA program's impact on banks' decisions to invest in CDFIs and lend in distressed communities. Treasury's BEA program performance measures do not provide additional insights into the program's impact because they assume that all reported increases in eligible investment and lending occur solely because of the program's financial incentives. However, based on available evidence we reviewed, it is reasonable to conclude that the program likely does not provide significant financial incentives for large banks, due to the typical award's relatively small size for such institutions. To an extent that is unquantifiable, a significant percentage of reported large bank increases in CDFI investments and distressed community loans each year would likely have occurred without the BEA program. Further, the program also appears to have provided certain community development banks with financial incentives and opportunities to benefit financially without furthering program goals. On the other hand, the BEA program may

provide some banks, including large banks, with additional incentives and capacity to incrementally increase their award-eligible activities, offer public and community relations benefits to some award recipients, contribute to the development of new financial products, and help establish partnerships between banks and other CDFIs.

Treasury's internal controls to ensure proper award payments are insufficient. Treasury's guidance to its BEA application review staff does not require them to geocode property addresses, even though evidence exists that applications may contain errors in reported information. The guidance also does not establish standards for documenting verification efforts. Consequently, the BEA program is vulnerable to making improper payments.

Recommendation for Executive Action

To help ensure the integrity of the BEA award payment process, we recommend that the Secretary of the Treasury revise the guidance for reviewing program applications so that program staff are required to (1) geocode property addresses where appropriate and (2) document their efforts to verify property addresses.

Agency Comments and Our Evaluation

We provided a draft of this report to the Department of the Treasury for its review and comment. Treasury provided written comments that are reprinted (with annotations) in appendix II. In its comments, Treasury agreed with our conclusion that determining the extent to which the BEA program provides banks with incentives to increase their investments in CDFIs and lending in distressed communities remains difficult given the number of external factors that drive such decisions. However, Treasury stated that our report bases many of its conclusions on information that is overly general, outdated, or developed for other purposes and, as a result, does not reflect an accurate portrayal of the BEA program or its importance within the banking industry. Treasury also said that we did not adequately consider evidence the department provided regarding the BEA program's impact. Treasury did agree to implement our recommendation that application review staff (1) geocode property addresses, where appropriate; and (2) document their efforts to verify property addresses. Further, Treasury stated that it will adopt a policy requiring applicants to report addresses for transactions; provide program staff with updated instructions to geocode all transactions over $250,000 (not just transactions over $500,000, as is the current practice); and initiate and implement steps to analyze a statistically significant sample of transactions less than $250,000.

In its comments, Treasury stated that the focus of our report was inherently flawed. Treasury said our report did not assess, as it expected, whether the BEA program, as currently structured, is effective at motivating banks to undertake community development financing activities they would not normally undertake or, if the program were found to be ineffective, recommend changes to its structure. In fact, we did seek to assess whether the BEA program, as currently structured, is effective at motivating banks to undertake activities they would not normally undertake. However, as was the case when we initially evaluated the BEA program in 1998 and as we state in this report, because of other economic and regulatory incentives that affect bank behavior, it is difficult to isolate the BEA program's impact from these other incentives. We note an absence of change in the banking industry since 1998 that would facilitate isolating the BEA program's impact for this review. On the contrary, isolating the BEA program's impact may be more difficult today than in 1998 because the average BEA award amount and number of banks participating in the program have declined significantly in recent years. Although isolating the impact of the BEA program is difficult, we believe available evidence suggests that its impact has likely not been significant.

Treasury also stated that our report relied on inappropriate information and data to form conclusions and that we did not consider other evidence. For example, Treasury stated that none of the studies cited in the report—including our 1998 report, a 2000 Federal Reserve survey on CRA-related lending, and two studies by a consortium of CDFIs—is an explicit evaluation of the BEA program. Treasury also stated that we undertook only a limited review of current program participants. Contrary to Treasury's assertions, our 1998 report includes an assessment of the BEA program. Moreover, the Federal Reserve survey and reports by a consortium of CDFIs address issues that we believe are critical to independently evaluating the BEA program's effectiveness. In particular, the Federal Reserve survey indicates that community development lending can be profitable, which suggests that a variety of factors—including economic and regulatory factors—influence bank lending decisions. The variety of factors that can influence bank lending decisions increase the difficulties associated with isolating and determining the BEA program's impact. As discussed in this report, the data from the consortium of CDFIs also provide evidence that community development loan funds have been able to raise an increased amount of capital from banks despite recent declines in BEA program funding and participation. Regarding our interviews with program participants, as we note in appendix I, we chose program participants for interviews based on a variety of characteristics—including differing bank asset sizes, frequency of program participation,

status as a traditional bank or community development bank, and CDFI type—to elicit a wide range of views and perspectives on the BEA program.

Further, Treasury stated that we did not adequately refer to its 2002 survey of BEA program participants in our draft report. Treasury stated that evidence from the survey clearly demonstrates that the BEA program plays a role in program applicant investment decisions. While we recognize that surveys of program beneficiaries can play an important role in program evaluations, we believe that their results must be interpreted with caution. For example, survey respondents who are program beneficiaries have a financial incentive to overstate a program's impact. To compensate for this limitation, we sought to obtain and analyze independent evidence, including available studies, to assess the BEA program's impact. Even so, the findings of Treasury's 2002 survey are consistent with the findings of our report. For example, our report states that prior to 2003, when deposit swapping was prohibited, the BEA program may have provided certain community development banks with incentives to make investments that benefited them financially but were inconsistent with program goals. In Treasury's 2002 survey, CDFI deposits was the only category in which a majority of bank respondents (52 percent) said that the BEA program was the primary reason they made an award-eligible investment. Overall, Treasury's 2002 survey indicates that various factors, which include, but are not limited to, the prospect of receiving a BEA award, motivate banks' decisions to invest in CDFIs and lend in distressed communities. In fact, Treasury's 2002 survey found that in many cases, neither the BEA program nor credit for CRA compliance motivated banks' decisions to lend in distressed communities. Rather, as we state in our report, the survey found that respondents undertook lending activities because they were part of their community development mission or part of their everyday business activities.

Additionally, Treasury said that some conclusions in the report appear to reflect a lack of understanding of the BEA program and the banking industry. Specifically, Treasury stated the following:

- *GAO's analysis of the size of a BEA award relative to large banks' total assets was overly general and did not consider that many banks (in particular large banks) carry out CDFI financing within specific lines of business, such as community development business lines.* Rather than comparing a large bank's BEA award amount with its total assets, as we did, Treasury said a more appropriate and meaningful analysis would have been to consider the bank's BEA award to the assets of a particular

business line or its relative importance in lowering the bank's transaction costs. In response to this comment, we added language to the report that, for large traditional banks, BEA awards may provide additional capacity to incrementally increase award-eligible investments and lending, offset some of the costs associated with doing so, and increase the profits of related lines of business. In interviews for this report, officials from one large bank said BEA awards have allowed their bank to provide more loans than they would have in the program's absence, and officials from another large bank said BEA awards have allowed their bank to provide loans on more favorable terms. However, the officials said that other factors, such as CRA compliance and loan profitability, also influence their community development lending decisions. Further, officials from both banks said their banks would continue community development lending in the BEA program's absence, although officials from one bank said their bank would continue such lending to a lesser extent. Therefore, we continue to believe that the BEA program likely does not have a significant impact on large banks' overall investment and lending decisions, although there may be an incremental impact.

- *GAO's discussion of the now-prohibited practice of deposit swapping was based on outdated information, as Treasury moved to prohibit this practice four years ago*. Treasury said it did not understand why we chose to include a discussion of deposit swapping in a report on the BEA program's current status. In response to this comment, we assert that our report sought to assess the BEA program's impact on bank behavior over time, rather than at a single point in time. Thus, we believe that our discussion of deposit swapping, which focuses on bank behavior in response to incentives that the BEA program provided until 2003, is appropriate. We note that deposit swapping provides evidence that, until 2003, the BEA program's impact in encouraging some banks to make productive investments and loans in distressed communities likely was not significant. We also note that funding for the BEA program, and bank participation in it, were highest prior to 2003 when Treasury prohibited deposit swapping, adding significance to the issue of deposit swapping and its connection to bank behavior.

- *GAO's report failed to mention other important program benefits*. In support of this statement, Treasury cites its 2002 survey in which 19 percent of respondents indicated that the prospect of receiving a BEA award prompted them to launch innovate financial products, services, or educational programs to meet the needs of underserved households or communities. In response to this comment, we revised our report to reflect this survey finding. Treasury also stated that it would have been useful if our report studied the underlying data from the consortium of

CDFIs to, among other things, determine the BEA program's impact in initiating productive relationships between banks and CDFIs. Our draft report stated that a benefit of the BEA program is that it encourages partnerships between banks and CDFIs. However, it was not possible to determine from the CDFI consortium data we reviewed whether the loan funds cited in the reports formed partnerships with banks participating in the BEA program. For example, the consortium reports did not specifically identify the loan funds and banks that were surveyed for inclusion in the reports. Therefore, based on information in the reports, we were unable to conduct the types of analyses Treasury proposes in its comments.

We are sending copies of this report to the Secretary of the Treasury and other interested congressional committees. We will also make copies available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions regarding this report, please contact me at (202) 512-7215 or scottg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix III.

George A. Scott
Acting Director, Financial Markets
and Community Investment

Appendix I: Objectives, Scope, and Methodology

The objectives of this report were to (1) examine the extent to which the Bank Enterprise Award (BEA) program may have provided banks with financial incentives to increase their investments in community development financial institutions (CDFIs) and lending in distressed communities and (2) assess the BEA program's performance measures and certain internal controls designed to ensure proper award payments.

To address our first objective, we reviewed relevant documents and data, including BEA program statutes, regulations, memorandum, guidelines, and reports; GAO's 1998 report on the CDFI Fund and BEA program; a 2000 Federal Reserve Board study on the performance and profitability of Community Reinvestment Act-related lending,[1] and two studies by the CDFI Data Project, which is an industry consortium that gathers and reports financial data on the CDFI industry.[2] We also interviewed three trade associations representing various segments of the CDFI industry to obtain their views on the BEA program. Further, we interviewed a nonprobability sample of nine BEA award recipients and five CDFI beneficiaries from the fiscal year 2005 round of BEA awards. We selected these award recipients and CDFI beneficiaries for interviews based on a range of characteristics, including differing bank asset sizes, frequency of program participation, status as a traditional bank or certified community development bank, and CDFI type. Our sample selection criteria was intended to obtain a diverse pool of respondents possessing a range of views and perspectives on the BEA program.

To address our second objective, we interviewed Treasury officials to obtain information on the BEA program's measures and internal controls. We compared the program's performance measures to GAO's standards for effective measures, as outlined in publications we have issued in connection with the Government Performance and Results Act. We also compared the BEA program's internal controls to GAO's Standards for

[1] GAO/RCED-98-225; and the Board of Governors of the Federal Reserve System, *The Performance and Profitability of CRA-Related Lending* (Washington, D.C., July 17, 2000).

[2] The CDFI Data Project, *Providing Capital, Building Communities, Creating Impact, Fiscal Year 2003*, 3rd ed.; and *Providing Capital, Building Communities, Creating Impact, Fiscal Year 2004*, 4th ed.

Internal Control in the Federal Government.[3] To further assess the program's internal controls, we reviewed application documents for two banks that each received multiple BEA awards from 2000 through 2005 and used Treasury's online geocoding system to determine the locations of properties contained in the 2004 and 2005 applications for the two banks. We also reviewed BEA program application review guidance.

We conducted our work from October 2005 through July 2006 in Washington, D.C., in accordance with generally accepted government auditing standards.

[3]GAO, *The Results Act: An Evaluator's Guide for Assessing Agency Performance Plans*, GAO/GGD-10.1.20 (Washington, D.C.: April 1998); *Agency Performance Plans: Examples of Practices That Can Improve Usefulness for Decisionmakers*, GAO/GGD/AIMD-99-69 (Washington, D.C.: Feb. 26, 1999); *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

Appendix II: Comments from the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS FUND
601 THIRTEENTH STREET, NW, SUITE 200 SOUTH
WASHINGTON, DC 20005

July 21, 2006

George A. Scott
Acting Director, Financial Markets and Community Investments
Government Accountability Office
441 G St., NW
Washington, DC 20548

Dear Mr. Scott:

The Community Development Financial Institutions Fund (CDFI Fund) has reviewed the Government Accountability Office (GAO) report on the Bank Enterprise Award (BEA) Program ("Treasury's Bank Enterprise Award Program: Impact on Investments in Distressed Communities is Difficult to Determine, But Likely Not Significant for Some Banks"). The CDFI Fund agrees with the GAO's conclusion that measuring the extent to which the BEA program provides an incentive to banks to increase their investments in CDFIs and lending in distressed communities is difficult, given the number of external factors that drive these decisions.

The CDFI Fund also agrees with GAO's observations that the BEA Program has provided a critical source of capital to many smaller CDFI banks, which is certainly consistent with the statutory intent of the BEA Program. However, as discussed in greater detail below, the CDFI Fund believes that the GAO bases many of its conclusions upon information that is overly general, outdated, or developed for other purposes than to evaluate the BEA Program. As a result of these flawed methodologies, we believe the report does not reflect an accurate portrayal of the BEA Program and/or its importance in connection with the community development activities of the banking industry.

<u>**CDFI Fund Comments**</u>

1. The focus of the report was inherently flawed.

The CDFI Fund had expected the GAO report to opine as to whether the program as currently structured was effective in motivating banks to undertake community development financing activities that they would not undertake in the normal course of business and, if it was not, to make recommendations on how to change the program structure to increase its effectiveness. Instead, the GAO report, in our judgment, critiques the difficulty of measuring the impact of the BEA program on bank behavior, yet still makes conclusions suggesting the program is having minimum impact. While we agree that there are inherent limitations to analyzing bank behavior, we are also well aware of available evidence indicating the positive impact that the BEA Program has had on the community development activities of many banks.

We shared evidence of these positive impacts with GAO during interviews and through written materials; yet, we see little reference to this in the report. For example, we provided the GAO with the results of a comprehensive survey of program participants undertaken by the CDFI Fund in FY 2002. The results of this survey, clearly demonstrate that the prospect of receiving a BEA Program award plays a role in an applicant's decision to engage in BEA-eligible investments in CDFIs, even when the positive responses regarding the now-prohibited practice of making deposits in CDFIs is disregarded. Not including the responses relating to deposits, for each other eligible CDFI-Related Activity, between 43% and 100% of respondents indicated this was the case, and these facts seem to be given little weight or credence by the GAO.

2. The information and data relied upon by GAO to form its conclusions was inappropriate, and other evidence was not considered.

In undertaking its evaluation, the GAO focused on information that was overly general (e.g., the size of the award relative to bank asset size), outdated (the now-prohibited practice of "deposit swapping"), or developed for other purposes (e.g., a study of the profitability of community development lending). In several parts of the report, the GAO refers to "the available evidence" ("The BEA Program reportedly produces benefits but available evidence suggests….”). As listed in Appendix I, the evaluative evidence seems to consist of only two studies, both significantly outdated.

One is the GAO's 1998 report on the monitoring and measurement approaches the CDFI Fund used in connection with each of its programs, among which is BEA, and a 2000 Federal Reserve Board study on the performance and profitability of CRA-related lending. In addition two CDFI Data Project reports are referenced. None of these sources is a study or explicit evaluation of the BEA Program. Moreover, the GAO undertook only a limited survey of current program participants. The CDFI Fund had hoped the GAO would conduct a larger scale review of participant and/or would build from the CDFI Fund's 2002 survey of program participants. Notwithstanding the small sample size the GAO chose, the results of interviews that the GAO conducted with nine BEA Program awardees appear to support the CDFI Fund's previous findings that the BEA Program has positive impact on the community development activities of many banks. However, it appears that the GAO chose to not consider this evidence in their report.

3. Some conclusions appear to reflect a lack of understanding of the BEA Program and the banking industry.

The CDFI Fund believes that the GAO's assertion that the BEA Program has not been effective for some banks, because the size of a BEA Program award is small relative to the asset size of large traditional banks, misses the point of the program and reflects a lack of understanding of the banking industry. For a traditional bank with assets in the billions of dollars, comparing the size of the BEA Program award (which averages about $200,000) to its total assets is not a suitable measure.

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In actual practice, large traditional banks use BEA Program awards to mitigate risk and improve the economies of individual CDFI-related transactions. Many banks (and, in particular, large banks) carry out CDFI financing within a specific line of business (community development activities). These specific business units must demonstrate profitability. Therefore, a more appropriate and meaningful analysis would have been to consider the size of a BEA Program award relative to the assets of this particular line of business within a bank, or its relative importance in lowering the transaction costs.

Another indicator used by the GAO to assess program effectiveness was the now-prohibited practice of "deposit swapping" among CDFI banks. As the CDFI Fund pro-actively moved to prohibit this practice four years ago (in the regulatory revisions effective with the FY 2003 funding round), it is unclear to us why the GAO has chosen to mention the issue in a report on the current status of the BEA Program. As we explained to the GAO, the practice was engaged in by a limited subset of applicants and was prohibited for the exact reason the GAO cites: it was inconsistent with the goals of the program.

The GAO report also notes that it is difficult to isolate and distinguish other economic and regulatory incentives from those of the BEA Program award. The CDFI Fund acknowledges that bank behavior is affected by such influences – especially that of the CRA – but we believe that it is possible to make distinctions between the BEA Program and the CRA. Congress established the BEA Program as a source of direct monetary assistance to banks for activities that are complementary to their regulatory CRA goals.

The BEA Program, however, was not intended as a mechanism for a bank to improve its CRA rating. While BEA-eligible transactions typically receive favorable consideration during a bank's CRA examination, banks do not need to participate in BEA eligible transactions in order to comply with the CRA. Indeed, while participation in the BEA Program can be an important part of a successful CRA strategy, it is too highly targeted – and the size of the awards too small – to be the primary focus of any bank's CRA strategy.

See comment 1.

The GAO failed to consider an important distinction between the BEA Program and the CRA: the different levels of geographic targeting. In evaluating banks' CRA performance, the regulatory agencies take into consideration activities in Low and Moderate Income census tracts within their respective service areas. Using the 2000 census, there are 18,379 such CRA census tracts throughout the country. The BEA Program, on the other hand, employs a stricter standard. Specifically, a BEA-qualified Distressed Community is a census tract or a group of census tracts that have at least a 30 percent Poverty Rate and an Unemployment Rate of at least 1.5 times the national average. Using 2000 Census data, there are 2651census tracts that qualify for the BEA Program on their own merit. Thus, the BEA Program is far more targeted than the CRA.

See comment 2.

As the GAO points out, the BEA Program is retrospective, rewarding applicants for their past activities, and places no restrictions on the use of awards. This is a statutory requirement of the BEA Program. Although the GAO raises this as an issue, it makes no recommendation that changes should be made to the BEA Program to require awardees to use their award dollars for additional community development activities. Nor does the GAO recognize that, in fact, many applicants have stated that they do plan to use their awards to further their community development efforts. The CDFI Fund's survey of FY 2002 BEA applicants revealed that applicants planned to use 80 percent of their total anticipated awards for additional community

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development activities, including additional loans to CDFIs, continued financing to underserved communities, investments in low-income businesses and communities, and covering the operating costs of their community development programs.

See comment 3.

4. The GAO report also fails to mention other important program benefits.

For example, the CDFI Fund's survey of FY 2002 BEA applicants asked if the prospect of receiving a BEA award prompted them to launch any innovative financial products, services or educational programs designed to meet the needs of underserved households or communities. Of the 104 applicants that responded to this question, 20 (19 %) responded affirmatively.

The GAO notes that "community development loan funds have raised an increased amount of capital from banks, thrifts and credit unions while BEA program funding and bank participation in the program have declined," (pg. 16). We address the issue of program funding below. The implication of this paragraph, albeit GAO draws no conclusion in its report, is that the BEA program may be unnecessary to promote lending relationships between CDFIs and banks due to the size of the awards.

It would have been useful had GAO studied the underlying data to determine whether the CDFIs that the CDFI Data Project indicates have (1) increased their borrowings from banks which had been previous participants in the BEA program; (2) whether the BEA Program is responsible for initiating a positive lending relationship that has continued; (3) or whether the BEA Program caused the banks to initiate relationships with CDFIs that were not eligible under the BEA Program based on their positive experience with eligible CDFIs.

See comment 4.

5.The CDFI Fund notes that the GAO report does not correctly describe the relative funding for the program.

Specifically, the GAO correctly notes that the budgetary authority for the BEA Program has declined in recent years – from $46 million in FY 2000 to just under $10 million in FY 2005. However, since the CDFI Fund's annual appropriation in its entirety has declined in recent years, the CDFI Fund has had less budgetary authority to award. Thus, the BEA Program has not declined as a priority for the Fund, but rather BEA Program funding as a percentage of the total amount available for the CDFI Fund monetary programs has stayed roughly the same – and even increased: 28 percent in FY 2000, 33 percent in FY 2002, and 30 percent in FY 2006.

<u>CDFI Fund response to the GAO Recommendation</u>

The GAO report makes one recommendation to the CDFI Fund: to revise the guidance for reviewing program applications so that program staff are required to (1) geo-code property addresses where appropriate, and (2) document their efforts to verify property addresses. In response to the GAO's recommendation, the CDFI Fund will adopt a policy requiring applicants to report addresses for all transactions. CDFI program staff will be provided with updated instructions to geo-code all transactions over $250,000 (not just all transactions over $500,000 as is current practice) – and to provide documentation of such efforts. CDFI program staff will

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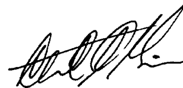
initiate and implement steps to analyze a statistically significant sample of transactions less than $250,000 to provide additional assurance that such transactions are carried out in eligible census tracts and will document the results.

Conclusion

While the CDFI Fund agrees that it is difficult to measure the causal effect a BEA Program award has on bank investments, the CDFI Fund believes that the BEA Program is meeting its goal of encouraging banks to increase their investments in CDFIs for lending and other financial services in distressed communities. The CDFI Fund has provided evidence to GAO in support of this conclusion. As our comments reflect, we are disappointed that the GAO Report did not give fair weight to this evidence, and instead chose to focus its findings on outdated studies and on a very limited sample of program participants. The CDFI Fund requests that GAO remove the discussion to the now prohibited practice of deposit swapping. Notwithstanding our disappointment in the methodologies employed by GAO and its findings with respect to overall program impacts, the CDFI Fund concurs with GAO's recommendation with respect to increasing administrative oversight of program activities, and will move to implement this recommendation in the 2007 BEA program round.

Sincerely,



Arthur A. Garcia

Director
Community Development Financial Institutions Fund

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The following are GAO's comments on the Department of the Treasury's letter dated July 21, 2006.

GAO Comments

1. Our report includes a statement by Treasury officials that the BEA program provides banks with incentives to provide financial services in the most distressed communities—communities that banks are not required to service in their efforts to comply with CRA. However, as discussed in our report, measuring the purported impact of the BEA program is difficult.

2. Census tracts that qualify for the BEA program can exceed those specified in Treasury's letter. For example, census tracts with poverty rates as low as 20 percent may qualify under certain circumstances. Therefore, the BEA program may not be as targeted as Treasury claims.

3. Our report does not address this issue. However, we note that requiring BEA award recipients to use their award proceeds for additional community development activities would pose complexities. For example, it would require Treasury to develop information about current award recipients' overall community development activities and a mechanism for monitoring recipients' use of award dollars.

4. Our report does not comment on the BEA program's funding relative to other related programs within Treasury. We provide information on the program's funding for descriptive purposes only and make no assertions concerning its priority within Treasury.

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the contact named above, Wesley Phillips (Assistant Director), Emilie Cassou, David Dornisch, Ronald Ito, Austin Kelly, Elizabeth Olivarez, David Pittman, Linda Rego, and James Vitarello made key contributions to this report.

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