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BANKING AND BANK REGULATION
IN THE AGE OF SOCIAL ACTION

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before the

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I am very pleased to have this opportunity to speak with my many good friends in the Kentucky Bankers Association and to give you some idea of the view from an office in Washington. Today I will talk about the new "Social-Action" component in banking -- what it means for you as bank directors and what it means for us as bank regulators. I will begin with some general observations, will turn specifically to the Truth-in-Lending and the Community Reinvestment Acts, and will conclude with a few suggestions for banks and their regulators.

Let me read two rather startling quotes. The first one is this:

> Areas surrounding a location [should be] investigated to determine whether incompatible racial and social groups are present, for the purpose of making a prediction regarding the probability of the location's being invaded by such groups. If a neighborhood is to retain stability, it is necessary that properties continue to be occupied by the same social and racial classes. A change in social or racial occupancy generally contributes to instability and a decline in values.

The second quote reads:

> There are circumstances under which a bank in its consideration of a real estate loan application may consider the race of a potential borrower or the racial composition of a neighborhood. There exists the possibility that the financing of a real estate purchase for a member of a minority group might have a serious effect upon values in a neighborhood. If the bank already had a substantial number and dollar volume of mortgage loans in the neighborhood, it would necessarily consider the effect upon these assets. The bank management's important responsibility for safe investment of its depositors' funds may include the consideration of such aspects of any loan....

If I were to ask you to identify the origin of these remarks, you might guess that the first quotation was found by one of our examiners in the loan policy manual of a recalcitrant bank which had not yet accepted the legitimacy of the civil rights laws and that the second quotation was contained in a letter from the bank's president defending the policy. You might guess that -- but you would be wrong. The first quote is from the 1938 FHA Underwriting Manual and the second is a 1961 statement by the then Chairman of the FDIC. My reasons for bringing these statements to your attention are two-fold: to make the point that neither banks nor other businesses have been the principal practitioners of racial and other discrimination in our society --

the patterns have been pervasive and the government itself has been one of the chief offenders -- and to illustrate how dramatically and swiftly the mores of our society are changing.

During the past decade there have been two related social movements which should be of considerable interest to you as bank directors: The Civil Rights Movement and the Consumer Movement. During this period we have seen enacted several major civil rights laws including the Fair Housing Law, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Community Reinvestment Act. In the consumer area we have been given the Truth-in-Lending Act, the Real Estate Settlement Procedures Act, the Fair Credit Billing Act, the Consumer Leasing Act, the Fair Credit Reporting Act, and the Fair Debt Collection Practices Act.

The Civil Rights and the Consumer Affairs Movements, and the laws and regulations dealing with them, are distinct. They address very different problems and, for the most part, employ different approaches. The civil rights laws are aimed at eradicating discrimination in various forms -- discrimination based on race, color, sex, age, marital status, religion, and national origin. The consumer laws are designed to make our increasingly complicated society more equitable and more understandable to the average person.

But these movements are also related in that they are both part of a broader trend toward higher ethical standards. This trend may be attributable to vastly improved educational, communications, and transportation systems. Whatever the reasons, the public is considerably more sophisticated and expects much more from its institutions -- its business, labor, political, educational, and other institutions. The public has demanded that we take more care to protect our environment, that we improve the safety of our products, that we work toward a more open society in which every American has an opportunity to participate, that we clean up our political system to eliminate abusive practices and reduce the influence of special interest groups, and that our business and political institutions provide more information so the public can make more intelligent decisions and can more readily detect abuses. In my opinion, there can be no serious debate that each of these goals is highly desirable. No other Nation in history has so thoroughly attempted to build a society so open, so equitable, and so responsive to so many people.

This is not to say that we have completed our task. The fact that the unemployment rate among black teenagers has been hovering around 40 percent for the past 3 years is one of the most conspicuous reminders that much remains to be done. Nor is it to say that what we have achieved has come easily, nor that it has been accomplished in the best possible manner, nor at the lowest possible cost to society. We have dealt with some complex situations and we have understandably made some mistakes. But many of the "flaws" in our "cures" could have been avoided: (1) if business leaders had been more sensitive to the public's mood and had reacted in a more constructive manner, (2) if public interest groups had better appreciated what the free enterprise system could have accomplished if given the proper incentives instead of being saddled by burdensome and costly regulations, and (3) if government had better understood the needs and problems of both sides and had exhibited more leadership.

Truth-in-lending provides a case study of what can occur when business and public interest groups allow themselves to become polarized and the government provides leadership which can fairly be characterized as "uninspired." Lenders in general -- not just banks, I should emphasize -- failed to tell the public what the public wanted to know. The public suspected -- rightly enough -- that the true cost of a loan was considerably higher than it appeared to be.

The private sector could have dealt with the problem voluntarily. Truth-in-lending proposals were in the Congressional hopper for nearly a decade before finally being enacted; no one can claim to have been taken off guard. Bankers could have reacted by setting their own standards of disclosure, which would have given consumers the same kind of "bottom-line" information that bankers insist on for themselves. They could even have turned a program of this kind to their own advantage in their advertising. Banks have always enjoyed a special standing in the public eye. By adopting a policy of full disclosure, they would only have added to their reputation for fair dealing. Unfortunately, the banks not only failed to develop a program of voluntary compliance, they resisted legislation until they were finally forced to accept a bill in which they had little input.

The Truth-in-Lending Law gave to the Federal Reserve Board the responsibility for framing regulations, and all three Federal banking agencies were given enforcement powers with respect to the banks under their supervision. A complicated set of regulations was drawn by the Federal Reserve which attempted to interpret a complex law and to resolve sharp philosophical differences between creditors and consumers. What has happened since is a nightmare. In response to inquiries and pressures from both creditors and consumers, and motivated by a genuine desire to be helpful, the Federal Reserve has issued over 1,400 interpretations of its regulations. It has become virtually impossible to draft a disclosure statement which does not contain a technical violation. The smaller banks have been inundated with so many regulations they cannot even read, much less comply with, all of them. Thousands of lawsuits have been precipitaed. In many instances these amount to no more than defensive actions on the part of debtors attempting to delay or avoid paying debts about which there are no legitimate disputes. In most instances the suits result in court interpretations of Truth-in Lending which must be considered by creditors attempting to comply with the law and by examiners attempting to enforce it.

Speaking candidly, in my opinion all three Federal banking agencies have been relatively ineffective in handling Truth-in-Lending. Examiners have not been given adequate training to enable them to spot violations and to offer constructive advice to bankers attempting to comply. Bankers have not been given sufficient encouragement -- through educational programs and vigorous enforcement efforts -- to comply with the law.

Truth-in-Lending has become a mare's nest. In my opinion, the bankers themselves must share responsibility for the present situation and must work for reform. We regulators, too, must acknowledge our mistakes and attempt to correct them. Public interest groups must recognize that no one benefits from a law which is so expensive and so difficult to enforce. The time has come for us to abandon our contentious positions. Let us recognize each other's legitimate concerns and interests and work together toward a more acceptable solution. I believe that Truth-in-Lending can be greatly simplified and, at the same time, better achieve its objectives. In its present form it clearly costs consumers more money than it saves. Worse, it does precious little to assist the consumer in comparison shopping.

It is my hope that banks and bank regulators will learn from their mistakes in connection with Truth-in-Lending and will handle the Community Reinvestment Act more intelligently. Traditionally, the overwhelming public policy concern has been the safety of your depositors' funds. Assets were reviewed with this objective in mind. How the assets were invested was of no real concern -- so long as the investments were safe and sound.

This approach toward bank regulation is changing very rapidly. The public is no longer content simply to see that its deposits are safe -- although that remains an extremely important concern. Today the public is very much interested in knowing how and where its funds are invested, not just for the purpose of determining the safety of deposits but for the purpose of determining how well you are meeting the legitimate credit needs of your community. Access to credit has become extremely important in our modern society and more and more people are demanding greater access.

The banking industry has gone a long way in the past quarter century toward meeting these increased demands, particularly in the consumer and real estate loan markets, but the industry is being called upon to go much further.

Our financial intermediaries must become more sensitive to the public's mood in this regard. A report prepared by the New York State Banking Department, which was presented to the New York Legislature last May, indicated that ten Brooklyn savings banks held the vast bulk of their mortgage portfolios in upstate and out-of-area loans -- they made only about 10 percent of their loans inside Brooklyn. The public views the hundreds of millions of dollars lost by banks over the past few years in speculative, out-of-area real estate ventures and understandably questions whether it would not have been more appropriate, and less costly, to invest those funds in the local community.

Congress responded to these circumstances and to the public's concern by passing the Community Reinvestment Act. The Act calls on financial institutions to make an affirmative effort to channel funds into their communities -- whenever possible, consistent with safety and soundness factors -- and to make a special effort to meet the needs of lower-income customers, including small businesses and farmers. The regulators are to determine how well each bank is complying with these goals and are to take this record into account when the bank applies for permission to branch, merge, or expand in other ways.

The three Federal banking agencies and the Federal Home Loan Bank Board recently issued for public comment a uniform regulation implementing the Community Reinvestment Act. Our proposed rules are straightforward and easy to understand. We call on each institution to delineate its own community, in line with special local considerations, and to describe the services that it intends to offer in the community. We also call on each bank to publish a Community Reinvestment Act Statement that makes the bank's program a matter of public record. When we examine the institution, we will review the program it has adopted and its performance. The bank is required to retain for 2 years the public comments that it receives and these will be reviewed in connection with the examination.

One of the chief advantages of this approach is that it keeps down the cost of compliance and preserves the greatest flexibility for institutions. Most banks have already drafted their own loan policies for internal purposes which they can adapt to meet the CRA requirements. The approach also allows banks flexibility in identifying their communities so long as there is no gerrymandering to exclude low-income areas. We recognize that a bank can serve many communities simultaneously, and that it may be appropriate for a bank to adopt separate Statements for different communities in some cases.

Another advantage of this approach is that it takes into account the differences among banks. Bigger banks with more complicated operations and a wider range of services will have more to explain about what they offer to the communities they serve. Smaller banks are likely to serve a more homogeneous group of customers with more uniform needs. It is our hope that in every case the banks will make their CRA Statements concise and readily understandable.

Perhaps most significantly, the proposed regulations will compel banks to focus their attention on the needs of their communities and will hold their judgment up to public scrutiny. Banks and community groups sometimes see things from such different perspectives that it can become very difficult for the two sides to communicate with each other, and sometimes market forces alone are not enough to bring them together. For example, if a bank gets a reputation for redlining a certain area -- even if the bank does not deserve it -- people may not come to the bank to ask for loans and the result will be the same. Then, later on, community representatives might accuse the bank of redlining -- and be able to support the charge with statistics -- while the bank might claim that there is no demand for loans. The salient point is that in such a case both sides would feel justified -- the problem would lie in the breakdown in communications. We hope that the Community Reinvestment Act Statements will help bankers to establish the basis for a continuing dialogue with various sectors of their communities.

The Community Reinvestment Act requires bankers and their regulators to perform a delicate balancing act. Both clearly have an obligation to conserve assets and to protect the interests of depositors, other creditors, and shareholders. At the same time, in accepting the monies of the public, banks assume a responsibility for considering the public interest when investing those funds. This concept is not new. For years we at the bank regulatory agencies have been required to consider the "convenience and needs" of the communities in reviewing insurance, branch, merger, and other applications. The focus is new. We are now required to give more consideration than we previously gave to the convenience and needs of borrowers, particularly in credit-starved markets, as opposed to giving such heavy emphasis to the convenience and needs of depositors. Our task, and yours, is to design a practical solution which recognizes that both depositors and the community-at-large have legitimate claims on the assets of a bank.

I am opposed to mandatory credit allocation. In my opinion this approach ignores the claims of depositors and is doomed to failure because it substitutes a person's or a group's judgment for that of the marketplace. It has been demonstrated over and over again that, given the proper incentives, the private sector works far more effectively than the Government itself works, whether through direct operation and control or through the imposition of regulations or penalties.

Despite any claims to the contrary that you might hear, the Community Reinvestment Act is not a form of mandatory credit allocation. The Act encourages banks to meet credit needs in their local communities. It does not require them to make unsound loans. Experience has shown that legitimate and sound credit needs have sometimes not been met, primarily due to massive breakdowns in communications, attitudinal problems, and serious misperceptions. I hope that the Community Reinvestment Act will provide the impetus for the correction of these problems. If it does not, stronger measures could follow. I repeat what I said earlier: "It is my hope that banks and bank regulatory agencies will learn from their mistakes in connection with Truth-in-Lending and will handle the Community Reinvestment Act more intelligently."

Before closing today, I would like to focus more specifically on some important practical questions that I would be asking if I were in your shoes as a bank director. The way these questions are answered will vary depending on the size and complexity of your bank and its community. Taken together, I hope that they give you some flavor of what we will be looking for in our future examinations of your bank:

1. What is your bank's community, what are the financial needs of that community, and how is your bank responding to those needs?

2. Do your bank's advertising and public relations programs present a positive image of the bank in the community as an Equal Opportunity Lender? Does your bank take affirmative actions to seek out lending opportunities to small farms and businesses and to lower-income individuals?

3. Has your bank designated an adequately trained compliance officer to oversee employee training, to keep top management informed, and to resolve consumer complaints?

4. Does your bank have a code of social responsibility and ethics?

5. Does top management take a direct interest in consumer affairs and civil rights issues, and does the board of directors receive periodic reports of the bank's efforts in these areas?

6. Has your bank established an adequate audit program which will uncover violations?

7. When violations are discovered, whether through a customer complaint, an audit program, or a compliance examination, does your bank's management act proptly to remedy the situation and to prevent its recurrence?

8. Does your bank have a manual setting forth objective, nondiscriminatory loan policies and standards? Do the bank's underwriting standards unreasonably exclude lower-income borrowers, small businesses, or farmers?

9. Does your bank participate in the regulatory and legislative process to stay abreast of and help shape new laws and regulations?

10. Does your bank's top management meet regularly with community and public interest groups to keep open the lines of communication and to remain sensitive to changing needs and perceptions?

11. Does your bank have an adequate affirmative action plan for the employment and advancement of minorities and women?

I have one more item that I want to lay on the table before responding to your questions. I have done a good deal of talking about your new responsibilities in the age of "Social Action." We regulators must also accept certain additional responsibilities. Now I know that there is alway something a bit disconcerting about a regulator -- even one you know -- who talks about new responsibilities. It's bad enough when regulators talk about new duties for you. It's even worse when they bring up new duties for themselves. The regulators always lament the need to take them on, but somehow wind up with them anyway and then build an empire to carry them out. No doubt it's a corollary of Parkinson's Law.

In any event, it is clear to me that we regulators have been charged with, and must willingly accept, some new duties. At a minimum we must:

1. Engage in a continuing dialogue with bankers, trade groups, public interest groups, and Members of Congress and their staffs for the edification of all concerned and to help us keep pace with shifting attitudes and developing problems;

2. Make our regulatory decisions only after receiving sufficient input from the private sector (both trade and public interest groups), weighing the cost-effectiveness of our proposals, and considering less-burdensome, alternative approaches;

3. Draw our regulations as narrowly as possible and make them as simple and readily understandable as possible;

4. Train our personnel so that they can detect violations, deal intelligently with problems and complaints, and be helpful to bankers seeking to improve their compliance efforts;

5. Through the use of manuals, seminars, and other techniques, make clear to bankers exactly what their responsibilities are and what we expect of them; and

6. Be fair, firm, and consistent in applying sanctions whenever unsound banking practices or violations of law are uncovered.

As I said earlier, the time has come for all of us to stop behaving as adversaries. Bankers must recognize that consumer advocates and civil rights groups have legitimate concerns. Conversely, the people who focus their attention on social issues -- including the regulators -- must understand and accept the economic pressures with which business must deal. Everyone suffers when our economy falters -- those who are just beginning to climb the economic ladder suffer most of all. If we can cooperate as reasonable men and women and make every effort to satisfy one another's objectives while we are satisfying our own, we can continue on the path toward a more open and productive society.

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