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CRA'S UNCERTAINTIES: ARE THEY ITS WEAKNESS OR ITS STRENGTH?

Remarks by

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The Community Reinvestment Act continues to be the source of considerable "heat" and the focus of a number of controversies. The banking community sees itself beset by a law it views as unnecessary, vague, and difficult to comply with. Community and consumer groups often view the act as one with few teeth and see the dentists -- meaning "the supervisory agencies" -- as afraid to use their drills. Regulators are caught in the middle. And, of course, on Capitol Hill there are an increasing number of proposals to "fix" the CRA.

In part, many of the controversies surrounding CRA are due to its lack of specificity. It doesn't tell bankers what they must do to comply. It doesn't define good CRA performance. It doesn't tell anyone -- bankers, the community, or the regulators -- how much is enough.

Today, I want to address the origins and substance of some of the current controversies surrounding CRA. To understand some of the current controversies, I want to look at the current CRA environment.

Second and more important, I want to try to address head-on some of the key issues generated by this environment and share some thoughts on what can be done about them.

To a large extent, many of the controversies surrounding CRA are a direct result of the changing environment.

There is a much brighter spotlight on CRA than in the past. Why? It's probably a combination of things.

First, public awareness about CRA continues to grow.

Congressional interest in CRA has grown dramatically over the past few years. Congress has re-educated itself (with the help of consumer and community groups) on what was amended as part of FIRREA -- and a number of new CRA amendments are currently on the table.

Public disclosure of CRA evaluations, which began last year, has focused greater attention on CRA. More than ever CRA performance is being discussed in the press and media and has gained the attention of state and local public officials.

In addition to consumer and community organizations, who were the primary supporters and users of CRA during its first decade, a growing number of other groups have taken direct interest in the CRA performance of financial institutions.

For example: State and local governments, seeking focused private sector financing to replace reduced federal support, have looked to financial institutions as sources. With their CRA obligations and local presence, banks have become natural targets of efforts to develop public/private partnerships.

The National League of Cities has developed a CRA guidebook for its members and held a number of CRA seminars around the country for local officials. And, a number of cities and states have passed local versions of the CRA or "linked deposit" laws which require deposits of public funds only in institutions with "satisfactory" or better CRA records.

At the federal level, HUD, SBA, and other agencies have been studying CRA and have expressed interest in developing programs around it.

In addition, virtually every group or association with a national constituency focused on housing and community development has demonstrated <u>some</u> interest in CRA over the last few years.

Finally, elected officials, trade unions, church groups, and traditional civil rights groups (such as the NAACP) have become active in CRA protests.

In addition to the increased <u>public</u> awareness, CRA has become increasingly important to the management of financial institutions. The brighter spotlight on CRA is shining internally in the offices of CEO's and in board rooms as well as on lending officers and compliance officers.

They are now recognizing that in an era of growing competition, CRA performance may be an important criterion in evaluating an institutions' willingness to adjust to a new banking environment, especially those created by mergers and interstate banking.

A growing number of bankers are seeing that CRA is part and parcel of good business practices that help banks compete -- like staying in touch with a bank's market, identifying community credit needs, and developing products to help meet those needs. These are just good business practices and they generate profitable business.

Bankers are also recognizing that in competing for customers it is necessary to meet local credit needs. Public disclosure has made many bank customers increasingly sensitive to how well local institutions are serving their communities.

Another factor is the trend toward consolidation of the industry, including the new "mega-mergers." These continue to turn bank management's attention to CRA. Bankers and even more bank analysts now recognize that in merger and acquisition situations there may be real costs associated with cleaning up deficient CRA records both before and after consummation of mergers and acquisitions.

Given all of this confusion, how well is CRA working? The answer to this question is that it depends on where you sit. Since I <u>currently</u> sit on the regulatory side, let me share that view with you.

The Federal Reserve assessment of how well CRA is working is, over all, a positive one. Certainly the brighter spotlight on CRA has affected performance for the better.

But, first, the "macro" view. Although I am not an economist, as you know, I've sort of been hanging around with quite a few economists lately and have picked up a few good terms. Based on the intent of the law and the sum of our evaluations over the past year, our <u>macro</u> view is this:

For financial institutions in general, we have seen a noticeable increase in the quality of their CRA performance; the regulatory agencies have noticed, <u>over all</u>, a much more positive approach to the community outreach and program development activities related to CRA.

Across the country, banks are entering a growing number of housing community and economic development partnerships to meet community credit needs. Many of them are highly innovative. Whether they involve community development corporations, loan consortia or participation in new state and local government programs and innovative secondary market approaches, the level of creativity and activity is, in many cases, impressive.

And senior bank management, over all, appears to be playing a larger role in ensuring that their institutions maintain outreach and marketing programs, designed to reach their entire communities.

We believe these efforts are reflected in the distribution of CRA ratings for examinations completed over the past year. As of September 17, 1991, the Federal Reserve System has completed 694 CRA evaluations and 11 percent were rated "outstanding," 80 percent "satisfactory," 8 percent "needs to improve," and 1 percent, "substantial noncompliance."

For regulators, the first year of public disclosure has gone smoothly. Much of the initial anxiety for bankers and regulators has dissipated. The new public CRA evaluation system appears to be working well, and we are determined to make the quality of evaluations uniform across all of the supervisory agencies. The agencies constantly update their training of examiners who conduct CRA assessments and continue to review together the results and trends.

Next week, in fact, the Federal Reserve System will be conducting another week-long training course, exclusively on CRA, for some of our newer examiners. Over the last three years, virtually all of our consumer compliance examiners have taken this course. That is in addition to their regular training in compliance, which, of course, covers CRA.

But, if we see highly positive trends on the macro side, the micro view still reveals some problems. The grades alone tell you that a small percentage of institutions continue to have problems meeting their CRA obligations.

While things have certainly improved over the past few years, there continue to be a number of issues, uncertainties, and controversies about CRA. I want to spend some time addressing some of them directly.

Bankers and community groups frequently charge that the agencies appear more interested in institutions' appropriate CRA procedures and documentation than real lending programs in their communities. We are said to favor process over product, paperwork over loans.

This is a misconception. And it may be that we, the regulators, are to blame for it. In response to the clamor by bankers and others for more guidance on what was required regarding CRA performance, we issued in 1989 the Joint Policy Statement of the Federal Financial Supervisory Agencies Regarding the Community Reinvestment Act. This policy statement does stress process. The major reason is that the agencies simply cannot issue clear guidelines on the specific number, types, and dollar amounts of loans that are expected. That would constitute credit allocation, an issue which I will touch on later.

Let me say, however, that in conducting CRA examinations we do not focus on process to the exclusion of lending. Both remain important, and one without the other will not suffice.

An effective CRA program is in a real sense, a process. It is a process which is outlined in the CRA assessment factors. Financial institutions are required to determine credit needs, develop products to help meet those needs, and market those products equitably through the communities they serve. And senior management is expected to play a major role in developing the CRA program, directing improvements as needed, and reporting the results to directors.

We believe that institutions which do not have a well-thought-out, active CRA process may be ignoring responsive lending in their communities.

Process, however, is not a substitute for loans. It is complementary. Most larger institutions, especially those with large branch networks, cannot possibly know what the credit needs are in their diverse communities, unless they have an effective process in place to find out. Similarly, they cannot know whether they are meeting credit needs unless they have a process in place that would provide them with the pertinent information.

Of course, for smaller institutions the process is much simpler but not less relevant.

Clearly, the loan products for housing, small businesses, public facilities, and other community development projects are an extremely important part of CRA performance, perhaps the most critical part for some institutions. But to make those loans, banks need to reach out, identify community needs, assess existing resources, build partnerships with agencies and community groups, and do effective marketing.

For many banks, that's the process by which they conduct business. But CRA requires special focus on that process and a judgment whether it is effective.

As I noted, the process vs. product issue is directly related to the whole question of "how much is enough." How much community lending, how much participation in community development, how much outreach, marketing, etc. is enough? Some bankers continue to plead with the agencies and lately with

Congress to tell them. "Just tell us what to do, and how much is necessary," some say, "and we'll do it."

That is impossible and undesirable for several reasons. First, every bank is different. Each has its own market focus, structure, lending territory and line-up of products unique to itself. Even banks of similar sizes in the same community can be drastically different.

Second, every community is different. Although many have common needs, the relative weight is rarely the same. Virtually all communities have a different mix of businesses, housing types, and infrastructure. And, of course, local political goals and the community resources devoted to them are very different from one locale to another.

Finally, in the context of these differences, regulators cannot possibly know, a priori, what the needs in each and every community are and what the best way of meeting those needs would be.

Even if they did there would be an implication of credit allocation which is something the Congress explicitly rejected when it passed CRA. It also would be incredibly bad public policy on the part of bank regulatory agencies to second guess normal market forces.

In general, my response to bankers who continue to raise the question about how much is enough is often another question for them. "Enough for what?" Enough to get through a CRA examination? Enough to satisfy community activists? Enough to keep local government officials and the press off your back? It's really none of these.

The answer is that there is <u>no</u> permanent, concrete quantity. <u>The bank</u> must assess community needs by reaching out and doing the research needed to make that assessment. It is <u>the bank</u> that should decide which needs it will address and how. And it is <u>the bank</u> that decides how much is enough. The examiner's role is to determine how reasonable the bank's process is and whether it has made sufficient efforts given its size, market reach, and resources.

Given the distribution of ratings I noted earlier, I continue to believe that most banks are doing a good job answering the question for themselves.

That raises another issue from folks often sitting on the other size of the table -- the community groups. They maintain that the distribution of ratings is unrealistic. The grades are much too high, they say, and they charge that the banking agencies are much too lenient.

Should 88-90 percent "pass"? Well, as I indicated before, I believe that, on the whole, most banks are doing a good job, even though I don't believe that they should be content with a "satisfactory."

Frankly, it is a judgment call, one made for each institution on a case-by-case basis. Those who challenge the ratings should be prepared to show in each individual case why and how the rating assigned is unreasonable.

Don't get me wrong. The agencies are not infallible. But we have put a lot of time and effort into the evaluation system. A lot of time and effort has gone into training examiners, reviewing their evaluations, and determining what we believe are fair outcomes.

On top of that, the Federal Reserve and the other agencies are devoting considerable resources to helping educate bankers about CRA and about some of the types of programs available to help meet community needs. This conference is just one example of many.

Frankly, our goal -- the goal of CRA, I believe -- is to encourage all institutions to have, in substance, <u>outstanding</u> programs. This is not grading on a curve. We believe that all <u>could be</u> and should want to be outstanding.

Another continuing controversy in CRA is one that affects both the examination and applications processes. It is the question of forward commitments vs. historic performance.

Some banks make commitments or announce new programs just before a scheduled CRA examination is to take place. Although such commitments or programs are often well conceived and responsive to key community needs, examiners often have a difficult time determining their effectiveness if no marketing has been done or no loans have yet been made. The Federal Reserve is committed to placing more emphasis on historic performance than on future promises.

Similarly, the issue of bank commitments for future action is often raised during the application process. In the past, the Federal Reserve sometimes accepted bank commitments. We believed that this would be a method to encourage banks to improve their CRA performance.

We became increasingly uncomfortable with this procedure, however, when bankers began to view these commitments as a form of credit allocation. There was also criticism from community groups that commitments made at application time were being used by banks as a way to defer responsibilities under CRA, until such time as an application was pending.

Given these considerations, the Joint Policy Statement was designed to reduce any confusion about commitments. Despite the fact that the agencies' Joint Policy Statement on CRA appears to be clear about commitments, several issues remain.

The Policy Statement says that institutions should have the necessary policies in place and "working well" before they file applications. Commitments for future action, made around the time of the application, which are not yet "working well," can be considered if they are filling an identified gap in an otherwise satisfactory record.

One aspect of this issue is how long a program must be in place to be considered "working well." That's a difficult one to answer for all of the agencies. There are no clear-cut criteria and developing precise standard would be extremely difficult, inappropriate, and counter-productive.

But, although each application has unique circumstances, we do have some general expectations here. Activities that appear to be quick-fix, last-minute afterthoughts, or programs that just throw money at a problem -- "tell me how much and I'll write a check" -- generally would not be accepted as "working well." What we do expect to see are programs that have been well thought out, that are sustainable over time with a commitment of bank resources, and that have demonstrated some results. Again, the appropriate emphasis is on historic performance, not on future promises.

Finally, let me address one more recurring issue -- the supposed conflict between community development lending and commercial examination standards. The dilemma is that regulators require certain standards for real estate loans while encouraging affordable housing loans under CRA that may not appear to meet those standards. It has been suggested that many institutions have had to curtail lending for affordable housing or community development because of limits imposed by commercial examiners or by the banks' own internal credit review functions.

We continue to believe, however, that CRA is not inconsistent with safe and sound lending. We have not asked, and will not expect, a bank to make unsound loans to meet CRA responsibilities. And, at the Fed, it is not our policy to ask or direct commercial examiners to review or criticize community development loans.

The agencies recognize that there are many ways to make safe and sound community development loans. We continue to provide our examiners with information about the techniques many of you in this audience use -- alternative sources of repayment, including third-party guarantees, special reserves, and other innovative uses of public and private funds.

There may be a number of reasons why some institutions have temporarily reduced all of their lending, perhaps including affordable housing lending. I doubt, however, that it is simply a response to what may appear to be tougher regulatory treatment of real estate loans.

For example, risk-based capital guidelines are forcing some institutions to choose between reducing assets or raising capital in a tough capital market. Some institutions have chosen to let a portion of existing assets run off and are making new loans only of the highest quality. This may be at least one factor that is contributing to the so-called "credit crunch"; it's not just simply because of tougher examinations. And demand, or the lack of it, may be another factor.

The marketplace is part of the problem for all institutions. Unfortunately, despite the potentially strong market need for affordable housing, some institutions are gun-shy about any form of real estate loan.

Some banks have lumped affordable housing together with commercial real estate projects, even though the two markets have little in common. There is strong demand for affordable housing. But, intelligent and prudent lending in that special market requires special approaches. In like fashion, examiners must look at these loans under a different lens.

There may be some cases where either examiners or bank credit review officers misunderstand the nature and quality of special reserves and nontraditional sources of repayment sometimes found in community development loan packages. But I believe that these misunderstandings can be dealt with on a reasonable basis, and this is one focus of on-going examiner education programs.

Over all, we do not believe that safety and soundness examinations, or regulatory standards for real estate loans, should inhibit community development lending. But we are willing to work with banks in specific situations in which they believe that to be the case.

Change in the banking industry is occurring at a rapid pace, and changes will continue to affect CRA. There is one thing certain about change. It will continue to create more uncertainties, more issues about how CRA should be administered.

The consolidation of the industry, the potential for interstate branching, and the development of mega-mergers, will all raise new questions. How will an interstate bank, with branches across the country, be examined for CRA? How will the HMDA data from these huge, multi-state institutions be evaluated? To what extent should the new multi-billion dollar "megacommitments" now being made by merger partners be considered during the applications process?

These and other issues will be raised in the future,but if we see them coming, we can put in place the processes to handle them in a fashion which is consistent with CRA compliance and yet fair to banks.

In conclusion, CRA is not a perfect law, perfectly administered. There are many uncertainties inherent in CRA. The agencies have attempted to clarify some through the joint policy statement and their decisions in CRA-protested cases. Other issues are dealt with on a case-by-case basis during CRA examinations.

But the reality is that some of these issues don't lend themselves to simple, direct or finite answers.

In that regard, CRA must be viewed as a dynamic process. There is no beginning point or ending point for an ongoing bank's CRA program. As community needs or a bank's structure or market strategy change, so must its CRA program.

In that regard, the uncertainties of CRA may in fact be its strength. It forces us all to continuously review changes in the environment and take action based on that review.

That conclusion assures us that we will be dealing with many new issues in the future.

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