Remarks by

Lawrence B. Lindsey

before the

Board of Governors of the Federal Reserve System

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on the subject of

The Interagency Proposal to Reform the Community Reinvestment Act

September 26, 1994

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Thank you, Mr. Chairman. Last July 15, the President asked the four banking regulatory agencies to revise the Community Reinvestment Act regulations to make them more objective, more focussed on performance, and more oriented to extending loans to low and moderate income neighborhoods. Last December the agencies released a notice of proposed rule making which represented our first draft of these revised guidelines. More than 2000 individuals and organizations commented on those rules. In the last few months we have been hard at work attempting to craft regulations which met the concerns of those who commented on the December regulations. Today I am asking the Board to consider putting out for public comment the fruits of those efforts -- a revised proposal for the Community Reinvestment Act regulations.

I believe that we all owe an enormous debt of gratitude to the staff for their many long hours on this effort. In particular I would like to thank Glenn Loney of the Consumer and Community Affairs Division, and Bob Frierson of the Legal Division for their efforts. The professionalism and dedication with which they approached this task is truly commendable.

In addition, I believe that the public at large has been well served, not only by our own staff, but also by the staff at the other regulatory agencies. Further, I would be remiss if I

did not mention the contributions of the other principals - Gene Ludwig, Skip Hove and Jonathan Fiechter. Their leadership on this project was crucial to its completion. We didn't always agree on everything. And sometimes these discussions got rather lengthy. But through it all, everyone involved maintained a degree of professionalism of which we, as Americans, can be quite proud.

I believe that the proposal we have produced meets the President's objectives. It creates a more objective basis for analyzing bank compliance with CRA. That basis is more focussed on actual loan performance and more on loans to low and moderate income areas than are the current guidelines. At the same time, we have preserved to a maximum extent the strength of the current system by allowing examiners flexibility in assessing bank performance in light of local conditions as well as the capacity and constraints of the institution involved.

In December, I urged that we go out for comment on a set of proposals which I believed also met the President's objectives. But at that time I expressed some concern about whether or not they were sufficiently flexible to actually be workable in practice. In general, the respondents told us that the more formulaic approach in the December proposal was too rigid and therefore the proposal was not workable. The revisions contained in this proposal take those issues into account.

With the exception of one issue which I will turn to later, I am substantially more confident about the workability and

general merits of today's proposal. Still, the value of a public comment period is enormous. As regulators, we end up acting as legislature, judge, and jury in the application of these rules. At the very least we should be modest in our expectation that we have gotten everything right and should expect candid public comment on our performance.

I am particularly interested in public comment on one portion of this document which is new: the collection of race and gender information on small business lending. Indeed, in our December proposal we stated that we were going to avoid asking for such data in this regulatory revision. Before expressing my concerns about this one portion of the proposal, however, I would like to turn to Glenn Loney for a discussion of the bulk of the issues involved.

Mr. Chairman, as I mentioned earlier, there is one section of this proposal about which I have particular concerns. This proposal contemplates asking many business borrowers to identify the race and gender of their owners. There is no question about the good intentions motivating this idea. The goal of increased business opportunity for all Americans is a laudable one. Indeed, it is one which I have argued for in a wide variety of other contexts at this Board table.

Frankly, I will stand second to none of my regulatory colleagues in consistently supporting regulatory positions which increase economic opportunity. Indeed, I have even been accused of engaging in "politically correct theatrics" in the American Banker on CRA enforcement issues[1]. But actually providing economic opportunity to everyone trying to take their first step on the ladder of economic opportunity is much broader than CRA. As the record shows, I have opposed rigid appraisal rules, been against imposing strict downpayment requirements, and have favored a more flexible regulatory attitude toward the use of cash; policies motivated by a desire to increase opportunity for all Americans. Frankly speaking, any one of those issues has more practical effect on the ability of someone to start his or her own business, than will the new paperwork requirement being contemplated here.

Under this proposal, businesses asking for loans of $1

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[1] Jim McTague, "You Too, Can Learn To Love The Lender Bias Crackdown, American Banker, June 21, 1993.

million or less will be asked to identify, by percent, the composition of their ownership by race and by gender. Publicly traded firms will be exempt. I would note that this proposal runs contrary to 20 years of Board policy on this matter. Ever since the passage of the Equal Credit Opportunity Act, our emphasis has been on requiring banks to ignore irrelevant characteristics such as race, religion, gender, and marital status. What we have always sought was a race-blind policy.

Ideally, a change in policy of this magnitude is best left to the Congress, not to some relatively small coterie of regulators. This is not some minor technical amendment to an arcane subject. At its heart, we are determining whether or not government is now going to be identifying, and requiring other non-government institutions to identify corporate and other business entities by the race of their owners. I cannot imagine an issue that is better left to the legislature. In addition to this fundamental concern, I have a number of technical regulatory concerns as well with emphasis on the more practical aspects of this proposed regulation.

Proposal Bears No Relation to CRA Regulation

The race and gender coding requirement is included in the draft CRA regulation, but is not linked to other aspects of the regulation in any way. In other words, nowhere in this regulation is there any rule which links the race and gender information which we are requiring banks to request to the CRA rating of the institution. Nor, to my knowledge, do any of the

draft examiner guidelines of any of the agencies make any suggestion as to how this data is to be used. At the very least, in my view, it is questionable regulatory policy to propose a data collection requirement without having any explicit use for the data in the regulation.

Let me stress that even absent this data collection effort, this proposal takes a very aggressive stance against the practice of redlining. The new CRA proposal includes the geocoding of business loans -- that is, identifying the number and volume of loans by census track. This geocoding information is explicitly linked to the rules which guide examiners in assessing a bank's CRA performance. The contrast to the explicit and clearly defined purpose for collecting geographic information, and the complete absence of such justification for race and gender data is striking. Citizens will correctly be puzzled about just what our purpose here is.

Definition of Race Unclear

One of the reasons for the absence of guidance with regard to how to use this data is that asking for racial definitions entails a veritable Pandora's box of legal, moral, and social questions. We as bank regulators may be ill equipped to answer many of them. Paramount among these is the definition of race or ethnicity.

The evidence I have collected in researching this subject, which I would be very happy to share with you, is that there can be no objective definition of racial groups. As a result,

Canada dropped questions about race from its Census in 1951[2]. The American Civil Liberties Union worked to get race eliminated from the U.S. Census of 1960[3].

The ACLU may or may not have an entirely different position today. My point does not lie in what position one takes on the issue of racial categorization. My point is that there exists in this country a fundamental problem in the process of racial categorization and this process is at the heart of this proposal. The official questioning of this whole racial approach includes senior officials in the Clinton Administration. Sally Katzen, the director of the Office of Information and Regulatory Affairs (OIRA) at OMB says, "When OMB got into the business of establishing categories it was purely statistical, not programmatic -- purely for the purposes of data gathering, not for defining or protecting different categories."[4]

Despite this official confusion, we are asking a lot of the small business community, which must identify the racial characteristics of its ownership. I have asked our General Counsel what the maximum penalty for providing incorrect data might be. I was quite surprised. It is 30 years in prison and a $1 million fine for knowingly providing false information for the purpose of influencing action on a loan application filed with a

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[2] Lawrence Wright, "One Drop Of Blood", The New Yorker, July 25, 1994, pp. 50.

[3] Ibid.

[4] Ibid., pp. 54.

federally insured depository institution. Some might legitimately question whether it is appropriate to potentially put small business owners at this kind of risk simply in order to collect statistics.

The problems presented here are real. In particular, I believe that the public comment period would be helpful in enlightening us about both the process of defining race and the long term effects of doing so as well as a general sense about whether this type of data collection, as defined, will help to achieve our goal of increasing economic opportunity for all Americans.

Further, it would be helpful to receive comment on other aspects of this proposal. First, is it appropriate that Mom&Pop enterprises be scored as male or non-female owned businesses? Under the regulations as drafted, a business must be more than 50 percent owned by women to be a women-owned business. Thus, a traditional Mom&Pop would be considered as being all Pop's under this rule. I can assure you that if my wife and I went into business together she would find this a somewhat less than ideal ruling.

Second, is ownership the right basis for racial and gender evaluation, or would some broader notion such as stakeholdership be more appropriate?

Third, how should foreign nationals be treated? For example, should a citizen of an Asian country be scored as an Asian/Pacific Islander and his or her loan be counted as

"minority"? What about a wealthy citizen of a Latin American country making an investment in this country. Should they be counted as Hispanic and the loan counted as "minority"?

Fourth, what racial and ethnic categories should we include on the form? Current discussion focusses on including Middle Eastern, Hawaiian, and multicultural identifications on the list.

Fifth, the Equal Credit Opportunity Act gives equal standing to religion, age, national origin, and marital status as protected classes, along with gender and race. Should similar scoring be requested for these categories? I might note, Mr. Chairman, that during our interagency discussions, the plausibility that discrimination is occurring on these grounds was considered by those advancing this proposal as no less likely than for race or gender. If, therefore, it is concluded that such scoring is essential for us to enforce ECOA on the basis of gender and race, I can see no logical argument for us not requiring scoring on these other grounds as well.

Quality and Usefulness of Data Collected

An analysis of business loans by the race and gender of the owners is only as good as the data which goes into the analysis. I have great concerns about the proposal as outlined due to what I feel may be data limitations. As drafted, providing race and/or gender coding of one's business is not mandatory. The bank can neither demand it nor be held responsible for the quality of the response. It is entirely optional. This fact will undoubtedly reduce both the quality and the volume of data.

Therefore, I think it would be most helpful to hear from the public on the efficacy of introducing a data collection effort that may produce scattered, inconclusive data.

Indeed, even if such data limitations are ignored, the likelihood of having the qualitative ability to use the data for statistical purposes is highly suspect. I asked staff from our Division of Research and Statistics about whether a computer based analysis to detect discrimination in small business lending, similar to what was done in Boston, would be possible. Their answer, "the successful completion of such a study would appear to be problematic at best. Small business lending is highly idiosyncratic, often reflecting the outcome of lengthy negotiations. Lenders frequently do not use formal application forms in small business lending (sometimes only completing such forms when a decision has already been made to approve an application), the credit underwriting factors reviewed vary widely and many small business loans are based on assessment of character (a factor not amenable to statistical evaluation). These considerations suggest statistical evaluations of small business loan underwriting decisions would be extremely difficult and may be seriously compromised by missing information".

Privacy

Mr. Chairman, my final concern involves the protection of the privacy of the millions of small business owners in this country who apply for bank loans. During the development of this regulation I frequently raised the privacy issue and have pushed

the current regulation as far as is practicable in the direction of privacy protection. But, both my instincts and our experience to date with such data suggest that the privacy protections we now have in place are probably ephemeral.

We are asking financial institutions to assemble, on a loan by loan basis, extremely sensitive information about companies for regulatory purposes. Counsel has assured me that we have the right under the Freedom of Information Act to deny the public the access to that data. However, we have no obligation to do so. Furthermore, we may be required to release this detailed data as we were in the case of the HMDA data. The alleged privacy protections we are proposing therefore rest on nothing more than the long term political will of this agency and the other bank regulatory agencies to resist pressure for more information. Experience suggests that this is a thin reed indeed on which to rest.

First, consider our experience with HMDA. Beginning in 1977 banks were required to disclose the number and dollar amount of loans by census tract. In 1989, race, income, and gender information about the applicants was added, along with disposition of the application and, optionally, reasons for denial. Obviously, this required reporting to the agency was done on a loan-by-loan basis. Then in 1992, Congress amended HMDA to require that individual loan application registers be made available to the public.

If you are a nosey mother-in-law, an ex-spouse seeking an

alimony adjustment, or a private investigator, you can find out someone's income with only a moderate amount of difficulty. There are about 4000 people in a typical census tract, roughly 1000 homes. Something on the order of 100 of these turn over in any year, 25 in any quarter. You know the sales price of the home and the property transfer date because that is a matter of public record as is the name of the lender. Performing a match to discover any individual's income and race is not all that difficult. If anyone has any doubt that this is done, let me assure you that such use of the IRS tax file -- which is a nationally based stratified random sample -- has very much been an issue because of past abuses.

In the case of small businesses, we are asking for loan information, which may be crucial to the lifeblood of the company. Not only the usual suspects, but also potential competitors, employees, and buyout specialists are now in the market for information. Furthermore, there are far fewer small businesses in the typical census tract than there are homes, on the order of a dozen or less. Identification therefore becomes much easier.

Amazingly, when the interagency staff drew up its initial proposal in this area, privacy concerns had not even entered their thought process. An early draft of this proposal, responding to comments on the December proposal, was going to have HMDA type reporting of small business loans. There, for all the world to see, by census tract, was every small business loan

made. This result was not because our staffs at the regulatory agencies are particularly nosey, or malicious, but because these are not issues about which we have much institutional experience or concern. The natural reaction in this whole area is to provide more information to the public, and will be for the foreseeable future.

When such a change is made, you will be able to read all about it in the Federal Register. The usual groups who care about such matters -- community groups and banking organizations -- won't much care. The real people who are affected, the small business owners of America, don't have time to read the Federal Register, and probably don't know how to protest such a development even if they heard about it.

Therefore, both our HMDA experience with Congress and my experience in drafting this regulation lead me to conclude that it is virtually certain that adoption of this rule will ultimately lead to public exposure of significant detail of all small business lending. We live in an era in which the public's right to know is almost inevitably taken on face value. I would therefore like the public comment period to include a question on how we, as regulators today, can prevent the erosion of people's privacy in the future in light of the inevitable political pressure for ever more data on this issue.

In sum, Mr. Chairman, I have a number of concerns about this step we are about to take. I believe that it is both unfortunate and unnecessary that this proposal for race and gender coding of

loans has become wrapped up in a CRA reform that I otherwise view as a very positive step.

I would be happy to address your questions on this matter, or on the CRA reform in general.