

Remarks on CRA Reform Proposal

By

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Board of Governors of the Federal Reserve System

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## Proposed CRA Reform

Thank you, Mr. Chairman. This afternoon the Board is considering what may be the most far reaching change in bank regulation outside of the safety and soundness area that has ever come before the Board. In the past few years the Board has been extremely reluctant to adopt aggressive regulatory measures. There is no question that what is under consideration represents a highly aggressive regulatory stance. So, I believe that it is imperative to review why this regulation is under consideration today.

For the last 15 years the Community Reinvestment Act has been jointly administered by the various bank regulatory agencies in a manner which tended to focus on process -- efforts by banks to engage in outreach to their communities, marketing efforts, and full and complete appreciation of CRA at the highest levels of bank management. The reason for this approach has been to avoid becoming enmeshed in credit allocation. The Board has long believed, in my view correctly, that markets not government should allocate the nation's resources.

I have frequently noted that this historic approach, while far from perfect, has been remarkably successful in encouraging banks to make commitments to traditionally underserved areas. Community activists have estimated that more than \$30 billion has been formally committed by banking institutions as a result of the Community Reinvestment Act. And for such a large program, it

involves relatively few government bureaucrats, little administrative cost to the taxpayer, and a relatively light hand of government regarding the use of the funds. I have stated publicly both in speeches and in Congressional testimony that I believed that a continuation of this approach was appropriate.

However, there appears to be an almost unanimous judgment among those groups most affected by CRA that it is working poorly. Consumer and community groups argue that disinvestment is still continuing and that enforcement appears lax or non-existent. The apparent subjectivity of the ratings procedure has been particularly criticized. It may be difficult to believe, but some community spokespersons have actually told me that they were under the impression that our examiners sat down with bank Boards of Directors to negotiate the bank's grade. This and similarly inaccurate perceptions are widespread. And I believe that it is fair to say that among community groups, neither the ratings nor our enforcement efforts enjoy much credibility.

Financial institutions have also been critical of the existing Community Reinvestment Act. CRA is regularly cited as the most burdensome of all the regulations we impose. Banks are also critical of the ambiguities that result from our focus on process. Numerous bankers have told me, "Just tell us what to do and we'll do it." Regulatory burden seems particularly excessive and unnecessary at small banks, where serving ones community is an imperative. But large regional banks are also seeking burden

reduction in the form of greater clarity. Bankers have also joined community groups in complaining about ratings. Banks which have made significant CRA efforts, but not quite sufficient to be viewed as "Outstanding" by examiners, consider it unfair to be lumped in a "Satisfactory" category along with banks which have made marginally acceptable efforts in this area.

This cacophony of unhappiness has had its effect on our elected representatives. Hearings on how to improve CRA have been held and legislation introduced. A common reading of Congressional opinion is that we are doing an inadequate enforcement job; that results have been spotty and needs great; and that our greatest effect has been to create needless paperwork for the nation's banks.

Thus, in spite of what we might judge to be, on balance, a successful record, our view is clearly in the minority. It should therefore come as no surprise that the President asked the four regulatory agencies to undertake a reform of CRA. On July 15, he asked us to develop new regulations which would be more objective, based on performance, and which would increase investment in underserved areas while still reducing the paperwork burden. In addition, we needed to keep in mind that heavy handed credit allocation by government would be bad for banking, bad for the economy, and ultimately bad for the communities which most need credit.

If our assignment was not difficult enough, the President gave us a January 1 deadline. Back in graduate school they

taught us about constrained optimization. A key lesson was that if you impose enough constraints or requirements on an objective, it can easily become infeasible because no solution exists. There were many occasions in the last 5 months when I thought that was the case for our assignment.

However, I believe that we have produced a solution which meets all of the President's objectives. Furthermore, we have done so without a heavy handed credit allocation scheme. I do not claim that our solution is perfect, only that it is feasible. I recognize that our professional staff has serious concerns about it, many of which were addressed in the memo you have. The staff will discuss their concerns shortly. But first, I would like to lay out some of the positive elements of this proposal.

First, this proposal will begin the process of restoring credibility to our CRA enforcement process. Quantifiable criteria will be reported which will form the basis of our examiners' evaluations. Those criteria will include the number and dollar volume of loans made in low and moderate income census tracks and the proportion of the bank's branches and ATMs which are accessible to those neighborhoods. The staff will note that examiner judgment still exists. Of course it does. That judgment is necessary if we are to avoid formal one-size-fits-all credit rules for our highly diverse economy. But the degree of transparency and objectivity which exists in this proposal greatly exceeds the status quo. This greater objectivity will enhance faith in our regulatory process among those who now have

the greatest skepticism.

Second, for a substantial majority of the nation's banks, the potential exists for a dramatic reduction in the paperwork burden that CRA imposes. Our regulation makes clear that CRA applies to all institutions. But, for small community banks which are clearly overburdened by the status quo, this proposal is certainly an enormous improvement.

Third, many of the institutions which are not traditional retail banks will have clear CRA guidelines where none now exist. Special purpose banks such as credit card banks are often caught in a Catch-22 under current law. This regulation provides a feasible means for all banks to comply with CRA without requiring any institution to enter a line of business it does not choose to.

Fourth, large banking institutions which have sought greater clarity and well defined sets of rules which they can implement within their organizational structure now have them. The proposal also lays out formal procedures for aggregating the performance of institutions which serve many distinct markets.

Finally, greater credit and other banking services will flow to traditionally underserved communities. While I am not one who believes that banks have been the major cause of disinvestment and decline in our inner cities, I do believe that the existence of banking services is crucial to halting and reversing that trend. The physical and financial presence of banking institutions is part of the infrastructure that any community

needs to prosper.

Let us not pretend that CRA is the core solution to urban ills. It is not. Addressing the many public sector failings ranging from inadequate public safety to stultifying tax, regulatory and zoning policies will prove much more important. But we are not here, and it is not within our power, to redress these public sector failures. We are faced with redressing a market failure. I believe that the document now before you represents a comprehensive way of addressing that market failure. The public should have the opportunity to give its views on our proposal.

Finally, let me add that implementing a proposal this aggressive and this radical will not be easy. The potential for regulatory excess exists. It will be essential in the next couple of years for those of us in senior policy positions to very carefully monitor those who implement these policies in practice. The costs of change are real. Among them are the uncertainties that new regulations bring. But those costs are not beyond our control. We can and must do all we can in the implementation stage of this regulation to keep those costs under control. Fair, objective, and carefully monitored enforcement is the most effective means we have of reducing regulatory burden.

Griff Garwood will now speak for the Division of Consumer and Community Affairs.