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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Credit and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives

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[Handwritten initials]

Mr. Chairman, I appreciate the opportunity to appear before this subcommittee to discuss Community Reinvestment Act (CRA) reform. The Community Reinvestment Act is intended to ensure that every community has access to adequate credit to help meet its needs. We at the Federal Reserve Board believe that the law has produced substantial benefits. However, the CRA has not -- nor should it be expected to have -- cured all the problems that plague our cities.

As you know, the federal financial institution regulatory agencies are actively engaged in an effort to reform CRA by amending our regulations. This effort is the result of the President's request to make CRA more objective, the ratings more uniform and the paperwork less burdensome. This effort is a challenging one; it involves a substantial commitment by the agencies and encompasses many difficult issues. We are very conscious of the fact that what we do could significantly affect financial institutions and the public alike and that care must be exercised when undertaking such an important project. As we are midway in the process and still receiving comments from the public, our report to you necessarily will be somewhat preliminary.

History of CRA and the Current Reform Effort

Before discussing the proposal to reform CRA, I'd like to briefly review the law and a little of its history, since that history is very relevant to the reform project. The Community

Reinvestment Act calls for the financial regulatory agencies to use their examination authority to encourage institutions to help meet the credit needs of their communities, including low- and moderate-income areas, consistent with safe and sound business practices. The agencies are required to assess the community lending records of the institutions they supervise as part of their examinations and to take into account those records in considering applications. The law, however, gives no other indication how the agencies are to accomplish these tasks, and does not define key concepts, such as how an institution's community is defined or what constitutes satisfactory performance. A considerable responsibility, therefore, was placed by Congress on the agencies.

The regulations adopted in 1978 by the financial regulatory agencies focused, at least in part, on factors related to the process used by institutions to determine the credit needs of their community and how they responded to those needs. To avoid credit allocation, and to allow for the maximum amount of creativity by institutions in meeting the varying credit needs of their localities, these regulations did not attempt to prescribe any particular level of lending. Instead, the evaluation of a financial institution's performance has been based on the application of twelve assessment factors, including how community credit needs are ascertained, the geographic distribution of loans, the record of opening and closing branches and providing services, participation in local community development projects,

and the financial and legal capability of the institution. In determining how well an institution ascertains the credit needs of its community, examiners have taken into account such matters as the institution's community outreach and credit marketing.

In the course of our review of CRA, we have heard from many consumer and community groups about how valuable the law has been in getting credit extended in low- and moderate-income areas. Some groups put the success of CRA at \$30 billion, which they estimate to be the level of CRA commitments for new credit. I suspect the total impact of CRA considerably exceeds the \$30 billion estimate. And, to date, this has occurred with a comparatively light hand from Washington. Indeed, one of the strengths of the present system is that it allows great flexibility in fashioning programs to meet the different and changing credit needs of this country's diverse communities.

Despite the significant benefits that communities have seen from CRA, the approach taken in the regulations, and the agencies' implementation of that approach, has generated a good deal of criticism. Financial institutions have frequently complained that they are burdened from imprecise rules and inconsistent evaluations on the one hand, and overly prescriptive documentation requirements on the other hand. Small institutions, in particular, complain about the costs of compliance and contend the law is unnecessary because they must serve their entire community to succeed. Further, it appears to some that there is little incentive for institutions to try to

achieve an outstanding rating, especially when applications filed by institutions with outstanding CRA ratings may still be protested by the public.

Community representatives have complained that the regulators emphasize documentation of CRA activities in their examinations of financial institutions, instead of actually measuring the degree to which they are meeting community credit needs. They point to the fact that almost 90 percent of institutions receive "passing" ratings, and the fact that the agencies rarely deny applications for CRA reasons alone, as evidence that regulatory enforcement of the law has been weak. They also wish to have a more formal role in the evaluation process.

While we have tried to respond to these various concerns through modifying our process and providing official guidance, it has become clear that CRA enforcement needs a broad-based review to see whether improvements are in order and if so, what they should be. Consequently, the President requested the Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision to reexamine the regulations. The President asked the agencies to improve them by addressing several areas of concern. The objectives outlined by the President, which we also believe are important to the ultimate reform of CRA, include:

- replacing paperwork and process-related requirements with clear objective criteria that measure actual performance; and
- working together to improve uniformity in evaluations and instituting more effective sanctions for consistently poor CRA performance.

The ultimate goal, according to the President's request, is to "replace paperwork and uncertainty with greater performance, clarity and objectivity." We are in full accord with this objective.

The agencies held a series of seven public hearings throughout the country to gather information on the best way to amend our CRA regulations and enhance our enforcement. Over 250 witnesses testified, many raising common concerns. We were strongly encouraged to revise our regulations so that CRA performance would be evaluated in as objective a manner as possible and to give better guidance on how different types and levels of performance will be rated.

While witnesses stressed that CRA should continue to focus on lending, many also recommended that greater weight be given to investments (such as in community development projects) and the provision of banking services (such as through locating branches and providing low-cost accounts or noncustomer check cashing). Many witnesses requested that institutions be required to collect more data on the geographic distribution of loans in

order that they may be better able to evaluate an institution's CRA performance.

Representatives of smaller institutions, on the other hand, generally criticized the burden and expense they bear from existing documentation requirements. Other witnesses recommended that institutions be allowed to develop their own CRA plans against which their performance would be rated, with these plans reviewed by the agencies. Finally, most witnesses, other than those from financial institutions, opposed providing a safe harbor from CRA protests to institutions rated satisfactory or outstanding.

Following these meetings, we developed the proposed changes to our CRA regulations in conjunction with the other agencies and published them on December 21, 1993. Comment on the proposal has been requested by March 24. We have extended our comment period to that date to accommodate the numerous requests for time to do a complete analysis of what is a very complex proposal. We do not know how many comments will ultimately be received and whether fundamental changes in our proposed approach will be called for. Although I cannot state when a final rule will be adopted, we do intend to move the process along as quickly as is appropriate. And, I want to emphasize that I would not expect any final rule to become mandatory until after an adequate lead time -- particularly if the proposed data collection requirements, or something similar, are retained.

Most important, I am committed to making sure that our final rule will work. We will do no one any favors by promulgating a rule that is operationally untenable. During this comment period, I am paying particular attention to questions or complaints about the details of implementation and of unintended consequences from how the proposal will work in practice.

Balancing Competing Objectives

With this proposal, we have attempted to achieve the difficult and important goal of balancing the competing concerns of providing greater specificity on what is expected on the one hand without dictating credit decisions on the other. The proposal attempts to clarify our expectations for CRA performance by (1) creating a new, more numerically driven system for assessing CRA performance in three critical elements: first and foremost, lending, and secondarily, services and investments; (2) requiring the collection of data on the number, amount, and geographic location of small business, small farm, and some consumer loans to use in the assessments; (3) providing for streamlined review of small institutions; (4) permitting institutions to submit their CRA plan in advance to their regulator for approval and public comment as an alternative to being evaluated under the general assessment scheme; and (5) specifying the regulatory sanctions that are possible from noncompliance with the regulations.

In part, the balance we seek to achieve in the proposal is intended to respond to those most concerned by CRA -- banks and representatives of communities. Despite their different perspectives on CRA reform, I think that in many respects the interests of banks and community representatives are consistent rather than at odds. Both want local lending institutions to be strong and viable so that they will have the capacity to effectively serve their communities over the long term. Both want to assure that the projects that are funded make economic sense for lender and borrower alike. Both also have a common interest in a CRA evaluation system that is fair and consistent, and that avoids unnecessary paperwork. To be sure, community groups may favor more data collection, greater public participation and more stringent accountability than lenders, but on balance, I believe there is greater commonality of interest among the groups in the goals of reform than is often assumed.

Having said that, however, I am sure there are some specific points in the proposal where views may differ -- for example, on the appropriate cut-off level for the more streamlined review procedures for "small banks." Points of difference like this seem unavoidable in a proposal as comprehensive and complicated as ours and the public comment should help us resolve some of the disagreements about the right approach. I can assure you that we have struggled throughout this process to achieve an appropriate balance to the competing

interests where it does exist; how well we have done this will be judged in the public comment process.

Issues Raised by the Proposal

Given Comptroller Ludwig's description of the proposal for the subcommittee, I will not also review the details. As is well known, however, although the Board joined with the other agencies in seeking public comment on the proposal, Board members have a variety of concerns about the proposal. For example:

- The proposal is intended to provide greater certainty to institutions in the type of evaluation they might expect to receive, primarily based on their performance relative to others. Yet, measuring an institution's performance against other lenders in the service area at year-end means that the standard will necessarily be fluid from year to year.

Moreover, the terms used to describe different levels of performance include "roughly comparable," "significant amount," and similar words that are anything but precise. These general standards have been proposed, in part, to avoid giving specific numbers which would risk resulting in the specific allocation of the amount, type, or terms of credit institutions must provide.

Institutions will have to speculate about the activities of their competitors, and examiners will be forced to interpret these terms on a case-by-case basis, when evaluating individual institutions. Thus, an institution may have some of

the same uncertainty about how its performance will be evaluated that it has now. To some extent we will always be plagued by the dilemma of how to provide better guidance and certainty in the CRA area without reducing needed flexibility. But we expect these issues to be resolved over time although ultimately the experience may prove frustrating to both financial institutions and community groups.

- There may be problems associated with the "market share" test. One such problem may result from the fact that the market share for other than mortgage loans will be computed only in comparison to other depository institutions who must report data. Leaving out small depositories (generally under \$250 million in assets) and nondepositories, the percentage of those who are subject to CRA and included in the market share comparison will be low. In some localities, a very few or even a single institution may be included in the "market." This could cause practical problems and anomalous results.

- The new requirement for summary reporting of the number, amount and geographic distribution of small business, mortgage and some consumer loans is a significant one. It is important to the goal of making the CRA process more quantifiable; yet it could be costly. For covered commercial banks, the annual cost for the small business portion of the data collection alone has been estimated by our staff to approach \$21 million. In all, about 3,400 institutions will be required to gather new data.

Because of these concerns, we have also asked for a discussion of burdens and benefits of this requirement in the public comments.

- The appropriateness of the streamlined review procedure for small institutions under \$250 million in assets will surely be questioned in the comments -- as well as the impact of the presumption that such small institutions have a "reasonable" loan-to-deposit ratio if it is 60 percent. We have heard from the small banks who have commented on the proposal thus far that this is an unrealistically high loan-to-deposit ratio for them, especially for good quality loans, and we have some concerns that small institutions who want to benefit from the streamlined CRA review might be forced to imprudently change their lending standards in order to meet this presumption.

- There are other potentially controversial aspects to our proposal, such as whether the alternative evaluation for banks with preapproved plans is workable, whether the role of the public and community groups in development of the plans is adequate, and whether we, in fact, should be treating institutions receiving low ratings as being in violation of the regulation and subject to our enforcement authority. These important issues will also receive considerable attention by us and, I hope, by the public.

Discussion of Specific Issues Raised in Letter of Invitation

In addition to many of the issues I have already addressed in my statement, I would like to respond to some of the questions raised in your letter of invitation:

- The Appeals process: Financial institutions have always been able to request supervisory personnel at Reserve Banks to review the ratings issued by examiners--whether involving CRA or other supervisory issues--but we do not consider this a formal appeals process. We anticipate that our informal system for appeals would complement the opportunities for input in CRA evaluations. The proposal would permit institutions to rebut presumptive ratings under the lending, service and investment tests. But the proposal also provides that the agencies would announce upcoming examinations in order to get public comment on an institution's performance. These comments, and those in the institution's public file, would be taken into account in our assessment of their performance.

- Frequency of examinations for institutions rated "outstanding": The proposal does not address examination frequency. Our current policy, however, does allow evaluations to be conducted less frequently for outstanding-rated institutions. Presently, state member banks rated outstanding, with at least satisfactory ratings in consumer compliance in general, are examined once every eighteen to twenty-four months, compared to the six- to twelve-month examination frequency for

poor performers. At this point, I would assume that we would maintain our current policy even with regulatory changes.

- Effect of investment credits and indirect lending on ratings: Under the proposal, investment activity by retail banks could help to increase their base rating in the lending test, up to two levels if the investment performance is outstanding. Investments will be the sole criteria for measuring the performance of wholesale and limited-purpose banks, however. Indirect lending activity may be taken into account under either the lending or investment tests. These aspects of the proposal are controversial, and of particular concern to community groups. We will be evaluating their comments very carefully as we consider what the appropriate treatment of investments and indirect lending should be.

- Effect of ratings and public involvement on applications: CRA ratings, as well as public comments on applications, can and do influence significantly the Board's consideration of an institution's application. This has been made clear in earlier CRA policy statements. The proposal is more explicit than our current regulation about the effect different ratings will have on the Board's consideration of an application. For example, under the proposal, an "outstanding" would be looked on very favorably and a "substantial noncompliance" rating generally would result in the denial of the application. We are aware of the concern of community groups that there may be an implicit "safe harbor" in the proposal. A

"safe harbor" was not intended, and to the extent that there is any misunderstanding, it will be clarified in the final version.

Conclusion

Through our internal review of CRA and the public hearings on CRA reform, we have been afforded a unique opportunity to step back and take a fresh look at the enforcement of one of the most important, yet controversial, laws affecting financial institutions. In proposing our comprehensive regulatory reform of CRA, we have been highly aggressive in approach. Our efforts are bound to generate a good deal of debate and concern -- for example, that we are demanding too much or not enough, that we have been too specific or too vague, and that we have been too sensitive to small banks' concerns about paperwork burden or not sensitive enough.

As I said during the Board's public deliberations on the proposed amendments to our CRA regulation, although I take a natural pride of authorship given the time I have invested with my colleagues, I am not unalterably wedded to this specific proposal. If the public comment points out serious flaws, particularly in the areas of operations or implementation, or if better ideas emerge, I am perfectly willing to recommend to my fellow regulators and members of the Board of Governors that we return to the drawing board. We should not hesitate to do so if that is the way to ensure that we have done the best job

possible. To give the public anything less than the best is a goal that no one involved in this process would condone.