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Statement by  
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Subcommittee on Financial Institutions and Consumer Credit  
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Madam Chairwoman, I appreciate the opportunity to provide the Federal Reserve's perspectives on the status of the Community Reinvestment Act (CRA), and our efforts to reform our system for assessing CRA performance. Although the agencies have submitted a joint statement, which I believe lays out in fair and comprehensive form the history and status of our CRA efforts, I would like to take some time to emphasize a few additional points.

First, let me say that the Federal Reserve Board fully supports this effort to reform our CRA regulations. It is, as a rule, advisable to take a close look at regulations periodically and CRA was overdue for such a look, even absent the President's prompting of July 15, 1993. During the past 20 months, I have been the Board's representative in the interagency process. This has involved not only formal meetings and hearings, but also informal trips around the country to see how CRA is actually working in practice. Our efforts to date have been an exhaustive -- and at times exhausting -- process of finding an appropriate balance among the sometimes conflicting objectives of CRA.

It is no secret that CRA reform has involved a longer process than any of us wanted. But I believe that the issue before us is too important to rush. The nature of the law itself and the resulting plethora of tough issues that confront the agencies have posed many challenges -- some foreseen, others not. I believe that the time we have spent on this project will, in the long run, prove to be time well spent. We do no one any favors if we institute a set of regulations which are unworkable

in the field or produce bizarre anomalies as they are applied to the many and diverse markets with which we are dealing. Further, we will not be aiding the process of extending credit in traditionally underserved markets if we adopt regulations that cannot stand the test of time and do not have broad support and acceptance by those involved in the process. In particular, we will be doing more harm than good if we treat CRA as anything other than a way of developing and extending profitable market opportunities for financial institutions.

In my statement for the Board, I would like to focus on several reasons why the process has been so difficult and taken so long. In so doing, I also would like to explore some of what I believe are the misunderstandings about CRA, including assertions that the CRA process as presently constituted has had so little impact and is so unworkable that it requires radical revamping. Finally, I would like to outline some of the key principles the Federal Reserve believes should be reflected in any CRA reform.

### CRA Difficulties

Some of the central issues with which the agencies are now dealing, in fact, have been well known from the beginning. In part, that's because those issues derive from the unusual content and structure of the law itself, and have plagued the CRA implementation process in varying degrees ever since the act was passed in 1977. There are, in short, inherent, unavoidable

contradictions in any scheme to administer CRA. Moreover, the agencies have been charged with developing that process with a minimum of Congressional guidance.

In the absence of very much legislative direction, the agencies have been asked to:

- o develop clearer, more objective criteria or standards for measuring CRA performance, but without forcing institutions to engage in governmentally mandated or sanctioned credit allocation activity or compromise the safety and soundness of insured institutions.
- o assemble sufficient information about the needs of communities and bank activities to enable the agencies and the public to determine whether performance standards have been met, while minimizing compliance burden on the institutions, and protecting the confidentiality of the financial situation of the bank's customers.
- o ensure consistency in CRA evaluations while maintaining enough flexibility and judgement to consider fairly vast differences among banks in size, capacity, business strategies, and product mix, and the diversity of communities in terms of their size, economic condition, programs and resources.

These goals are often contradictory. All of these core issues involve important matters of public policy, and difficult trade-offs. Let me briefly elaborate on the inherently contradictory nature of these objectives. Consistency and objectivity are laudable goals. But, to be implemented in a regulatory scheme, they require both a set of statistical data and a formulaic basis for evaluating those data. The more rigid the formulas which are applied, the greater the consistency, but the lower the variety of outcomes and allowance for local circumstances which is permitted.

Some may argue that a sufficiently detailed set of data and complex set of formulas will permit regulators to capture the variety of local circumstances which exists. Ultimately such quantifiable evaluations could be applied to individual loan decisions. Such an approach is now a risk in such areas as fair lending, for example. But, given the public nature of the CRA disclosure process, such detailed data collection and reporting involves a degree of intrusion into the affairs of a bank's customers that we have tended, in this country, to find objectionable. Carried to its logical conclusion, such a process would tend to replace examiner judgment and personal evaluations of character and creditworthiness with evaluations based solely on quantifiable criteria. In my view, while such an approach may seem superficially fairer than the current system, it might ultimately reduce economic opportunity and might prove

counterproductive in aiding traditionally underserved populations.

In addition, given the complexity and diversity of our financial system and the markets it serves, one may suspect whether any nationally imposed set of formulas on performance, no matter how sophisticated, could ever be made to work. As a result, subjectivity and some degree of inconsistency and attendant unfairness will be inherent in any CRA enforcement process we develop.

I believe that my colleagues and I have confronted these issues head-on and are evolving a set of rules that balances the maximum amount of flexibility in implementation with the spirit of objectivity and consistency in CRA enforcement which the President called for. However, getting to that point has not been easy.

#### Nature of the Law

As our joint statement indicates, CRA is indeed a highly unusual law. At first glance, CRA's mandate to us as a regulatory agency appears fairly simple. Under CRA, we have four primary duties: to encourage banks to help meet the credit needs of their communities, including low- and moderate-income areas; to assess bank records of performance through examinations; to produce publicly available evaluations of bank CRA performance; and to take their records of performance under CRA into account when evaluating proposals for expansion.

Note that all of these requirements are for regulatory action. Although CRA says that we are to encourage banks to help meet community credit needs, the act does not require any specific bank actions. The CRA reminds banks and thrifts about their charter obligations, but does not specifically define them in a way that would provide guidance on reinvestment questions. The act also says that banks should "help" meet community credit needs, but does not specify what kind of help, or how much help, is necessary or appropriate.

Further, in calling on the supervisory agencies to assess bank performance, the act does not tell us or the banks what good CRA performance is, or what types of specific measures the regulators might use to define good performance. The CRA also requires the agencies to consider an institution's CRA performance when reviewing its applications involving depository facilities, but leaves to the agencies the task of determining what the consequences of poor CRA performance will be and when and how those consequences should be applied.

Even on relatively simple, but important matters, such as what constitutes an institution's community, whether "services" should be included in the concept of helping meet credit needs, whether banks should be judged on credit extended to low- and moderate-income persons, or only to borrowers in low- and moderate-income neighborhoods, the act provides little help to regulators, bankers or community representatives.

In the absence of guidance on principles, standards, or definitions in the CRA, the agencies have been forced to attempt to add much more substance through regulation than is usual for the agencies, to an extent that may be unique for financial regulators. And as this committee knows, the public policy process requires consideration of highly divergent views and interests in an attempt to strike a compromise acceptable to affected parties. This is not a comfortable role for the agencies.

It is not my purpose to suggest that Congress should rewrite the law to clarify its intent. I am simply attempting to describe the circumstance in which we've found ourselves, and indicate that this too, has contributed to the difficulty of the reform process. Moreover, there are other factors that have complicated the task.

#### **Public Scrutiny and Involvement**

Although it is extremely vague, CRA is unusual in quite another way. Virtually every other banking law and regulation involves two primary parties--the agency and the bank. The CRA, however, compels the agencies to look beyond the bank itself and assess the role the bank plays in its community. While supervision of the safety and soundness of financial institutions involves us in a primarily two-way conversation with the bank about its policies, practices, and financial condition, CRA

brings a third-party to the table--the bank's community or the public at large.

As the members of this Committee are well aware, the "public" is a large and amorphous group of diverse interests. Often, the voice of the public is interpreted as belonging to the individual or group that can marshal the greatest communication skills. Thus, even a theoretical three-way conversation about CRA among the agencies, banks, and the public, is in practice hard to hold, and often can be quite contentious.

One of the reasons for the increasingly contentious nature of the discussion is that CRA has become much more prominent and important to the involved parties. Public disclosure of CRA evaluations, which began a few years ago as a result of amendments to the Act, has focused greater attention on this issue. More than ever, the CRA performance of financial institutions is being discussed in the press and media, and virtually every group or association with a constituency focused on housing and community development has demonstrated some interest in CRA over the last few years. On the local level, elected officials, trade unions, church groups, and civil rights groups have become active in CRA protests. In those instances where governmental dollars for economic development have dwindled, communities have often turned attention to the private sector and the prospect that CRA will be a strong encouragement to private financial institutions to assume a more direct role in revitalization.

Much of this public interest is based on a realistic understanding of what CRA says and how private financial institutions work. But some is not. Public pressure, at times, has brought needed correction to insensitive or recalcitrant institutions. At other times, the ability to threaten adverse publicity and delay has no doubt led to abuses in demands from particular special interest groups claiming to represent the public.

The CRA also has become increasingly important to the management of financial institutions. Many now recognize that in an era of growing competition, CRA performance may be critical to an institution's ability to adjust to the new banking environment. CRA-related activities can help develop new markets, potentially profitable business, and improve a bank's public image. Also, bankers, and even some bank analysts, now recognize that cleaning up the deficient CRA record of an institution, both before and after consummation of a merger or acquisition, can be a costly process.

Consequently, for both the public and financial institutions, concerns about CRA performance have intensified. This has produced a commonality of interest in clarifying standards. However, views about the appropriateness of the law, the attributes of good CRA performance and the effectiveness of the supervisory agencies have become increasingly divergent.

## Evolving Views

Some may think that the current reform effort is simply directed at correcting the administration of the law to return to what it should have been from the inception of CRA in 1977. But this may be too limited a view. In fact, given the increasing intensity of interest in CRA over the years from all sides, the expectations about the CRA performance of banks have evolved considerably.

In CRA's early years, a commonly held view was that CRA's essential purpose was geographic in nature: to help ensure that banks would not ignore the needs of low- and moderate-income areas in their communities. Today, however, there is a widely held view among community groups that banks can, and should, do more. This may involve aggressive outreach, the use of new marketing tools, and the evolution of new loan products designed to increase loan approvals to low- and moderate-income borrowers.

The current emphasis is not on simply assuring that segments of communities are not ignored, but on dynamic, affirmative efforts. As a result, even institutions that have demonstrably increased mortgage and other credit extensions in lower-income areas, and expanded their participation in community development, are not infrequently criticized for failure to do more. I might add that we regulators have, to a substantial degree, concurred with the evolution in thinking in this area. Our expectations of what banks should be expected to do to comply

with CRA are much more aggressive than they were ten or fifteen years ago.

### CRA Complaints

Not surprisingly, along with these rising expectations, many in the banking community have come to view agency CRA efforts as increasingly burdensome and unfair. These views have intensified even as the agencies have taken explicit steps to reduce burden, especially for small banks.

At the same time, community and consumer groups often view agency efforts as weak and have suggested a number of changes, including new disclosure provisions, to help ensure that banks and supervisory agencies approach their CRA responsibilities effectively. Further, community groups say the CRA ratings are much too high and they contend that the banking agencies are much too lenient. They point to the fact that over 90 percent of the institutions do get a satisfactory or better rating.

Both bankers and community representatives have alleged that the evaluations of the agencies are not equally comprehensive, and that the CRA ratings assigned are not always the same for banks that appear to have similar performance. And both bankers and community groups continue to charge that the agencies appear more interested in ensuring that institutions

have the appropriate CRA procedures and paperwork, than actual lending programs in their communities.

All of these frustrations are real, but as I've tried to indicate they are probably natural products of the CRA law itself as well as the 1990's view of CRA, which is quite different from its modest beginnings in 1977.

Although the complaints about CRA are real, to some extent I believe many are based on misunderstandings. First, I want to note here that the Board is not particularly disturbed by the ratings distribution for state member banks which are virtually identical to those of other regulators. Yes, over 90 percent do pass. But CRA ratings are not, and frankly for several reasons should not be, as some have suggested, the result of "grading on a curve."

I do not mean to say that the Board or the other agencies have been infallible in assigning ratings. But at the Board, we have put tremendous resources behind intensive examiner training on CRA, fair lending, and other related issues. A great deal of time and effort also have been spent, especially over the last three years, in reviewing CRA evaluations to ensure that they reflect what we believe are fair outcomes and are as comprehensive and consistent as we can make them.

Moreover, through our Community Affairs programs at Reserve banks, the Federal Reserve System has developed or sponsored over the last five years over 650 educational conferences, seminars and workshops for bankers and others on CRA

and the types of community development lending and investment programs available to help them respond to community credit needs. We believe these programs--attended by thousands of bankers--have had a positive effect.

Finally, we have been examining each state member bank for CRA performance once every 18 months to two years for over 16 years. The cumulative effect of our training, educational programs and examinations, I believe, makes it highly likely that most banks generally understand their CRA obligations and should know what needs to be done to achieve adequate performance.

And frankly, our goal--the goal of CRA, I believe--is to encourage all institutions to have, in substance, good, or outstanding CRA programs. Just as we would not entertain the notion that bank CAMEL ratings should somehow be proportional--meaning that at least a certain number of banks should, a priori, fail their safety and soundness examinations--we do not believe this should be assumed for bank CRA performance ratings. Just as we try to help banks with financial problems to solve them and return to safe and sound operations, we also have been helping banks with CRA problems to improve their programs. CRA evaluations are certainly not grading on a curve. We believe that all banks could be outstanding, if they chose to be.

The regulatory burden of CRA may have been overstated somewhat by the industry. Most of the more vigorous complaints about regulatory burden come from community bankers who understandably remain concerned and pressed by the cumulative

effects of all of the consumer laws and regulations passed over the last 25 years in addition to CRA. Cumulatively, these regulations have been costly to all institutions, and certainly have fallen disproportionately on smaller banks. Given CRA's vague prescriptions and the uncertainty of the examination process, CRA may have become a stalking horse for frustration with regulatory costs in general.

My point is that I think some caution is called for in assessing the extent of CRA's burden, and its purported enforcement.

#### CRA'S Impact

Despite CRA's lack of clarity and the criticisms of CRA from all quarters, I believe that CRA has had a significant impact on the availability of credit in low- and moderate-income areas. In fact, I fear that the focus on the imperfections of CRA--many of them probably unavoidable--has misdirected the public debate. Far too much emphasis has probably been placed on the problems of CRA, rather than its strengths. Here is a government program that has entailed little bureaucracy, great local autonomy, and virtually no federal tax dollars to administer. Yet its impact on communities can probably be measured in billions of dollars in community and economic development activity, benefitting the most distressed parts of communities.

CRA has helped stimulate loans for home mortgages, housing construction and rehabilitation, and small and minority business development in low- and moderate-income communities. Banks and thrifts have made tremendous strides to explore new loan underwriting standards to better accommodate the circumstances of lower-income borrowers without sacrificing safe and sound lending principles. The HMDA data for 1992 and 1993 show encouraging signs that the greatest percentage of growth in home mortgages is to low-income and minority borrowers.

More banks and thrifts are seeking and participating in public/private partnerships in both urban and rural communities than ever before. A growing number of bank-led community development corporations or multi-bank lending consortia are supporting home ownership, small business development and other projects benefitting low- and moderate-income areas. Moreover, all this has been accomplished with no significant adverse effect on safety and soundness. And though as I've said we support this reform effort, the record suggests that we want to be very cautious in avoiding unintended consequences from any proposed changes in CRA.

#### **Federal Reserve Principles for CRA Reform**

Finally, Madam Chairwoman, let me be clear about the Federal Reserve's position on a number of issues related to CRA and the reform process. First, as indicated, in our view, CRA has had a beneficial effect on many communities and institutions.

On balance, we believe that the law is worthy of being maintained, provided it is administered in a sensible fashion.

Second, one of the major risks in the reform process is that changes we may make to CRA's regulations could result in unintended and unwarranted credit allocation. I want to emphasize that the Board is very concerned about this prospect. Let me assure this committee that the Federal Reserve has no wish to produce a regulatory scheme that would result in governmentally imposed credit allocation driven from Washington. But despite our best intentions, this is an undeniable risk. One of the strengths of CRA that we should take special care to preserve is its flexibility and responsiveness to local conditions. Under any scheme, banks should still be able to determine how best to serve the needs of their communities. We must not substitute the judgment of the agencies for the judgement of the banks. I do not believe that any other alternative would be acceptable to the Board, and we will not endorse any reform approach--no matter how well intentioned--that violates this principle.

Third, we must be very cautious in attempting any revision of the regulations, given the uncertainties involved in how an entirely new set of regulations will actually affect bank behavior. I am particularly concerned about the unintended consequences of regulation which may actually harm existing minority owned or oriented financial institutions, or undermine the efforts of small community based banks or non-profit institutions, or cause banks to leave markets or avoid

experimentation due to a fear of increased risk. Wholesale or radical change invariably ends up as counterproductive.

Underserved markets do not need alternating periods of extreme policy activism followed by extreme neglect. They require steady, moderate, predictable, and workable efforts.

In that regard, I would emphasize that the Board historically has endeavored to steer a steady course on CRA, adopting modest changes in policy to respond reasonably to new conditions and expectations, but avoiding radical changes that could have unfortunate consequences. We believe that approach has been the correct one.

Fourth, any pursuit of more objectivity in the rating scheme must be tempered with a recognition of the potential adverse consequences of any mechanical system that doesn't allow considerable agency judgment. I think that was brought home clearly in the responses by many in the banking industry to the first reform proposal, which proposed a formulaic market share test as the primary element in a rating system. There were just too many unforeseen problems with the concept.

Fifth, any reform structure must recognize the uniqueness of small institutions and the disproportionate burden they bear from any regulation, CRA or otherwise. I believe that any final proposal will accommodate a streamlined examination for smaller banks, though it will not exempt them from their CRA obligations.

Sixth, any increased data reporting must be justified. It is important to bear in mind that the primary cost of detailed data reporting is not borne by the banks, but by their customers. The detailed reporting of individual loans now required under HMDA, for example, means that applicants' incomes and other sensitive pieces of information, are placed in the public domain. While Congress has determined that the benefits of such reporting outweigh the costs in that particular instance, the assumption that further detailed reporting is necessarily beneficial should be carefully scrutinized.

Seventh, while we can understand the desire to develop additional incentives for good CRA performance, discussion of a variety of safe harbor proposals over the years has generally provided protection to too many institutions whose performance may be barely satisfactory and too few when limited to only those rated "outstanding." One solution the Congress may want to consider is to establish a new rating category of "strong satisfactory" and focus some benefits to institutions at that level or higher.

Finally, we believe it especially important that the commitment to safety and soundness be maintained. Community reinvestment must be economically sound and ultimately engender adequate rates of profitability, if it is to be sustained. If CRA is to work over the long term, economic sense, not shifting views about CRA obligations, must be the driving force. Giving money away is not what CRA is or should be about, and while some

flexibility in loan terms may at times be appropriate, we do not support anything other than safe, sound and profitable lending.

### Conclusion

The CRA reform process has been very arduous and difficult, and certainly has taken longer than desired. But I believe that the Board, along with the other agencies, has made a good faith effort to adhere to the President's request. The Board has devoted a tremendous amount of time and energy, as have the Reserve Banks, to the reform process.

Our work is not done, however, and we welcome this committee's interest in this process. Our task is to develop a CRA regulation and evaluation process that is superior to the one now in place, but one that will not have adverse long-term consequences. I can assure you of the Federal Reserve's commitment to this goal.