FEDERAL RESERVE BANK OF SAN FRANCISCO

OFFICE OF THE PRESIDENT

The Federal Reserve and the CRA: A Commitment to Community Investment

Robert T. Parry

President

Federal Reserve Bank of San Francisco

Conference on Community Investment

Tacoma

May 10, 1988

One of the goals of this conference on community investment is to promote greater understanding among community groups, bankers and savings institution executives, and federal regulators. I hope that my remarks today will enhance your understanding of the Federal Reserve's involvement in urban and neighborhood issues. I also look forward to your questions and comments to give us in the Fed and the Federal Home Loan Bank a greater understanding of your concerns.

I would like to address three topics this morning. First, I will describe the Community Reinvestment Act, its goals, and its mandate to regulators. Second, I'd like to describe the Federal Reserve's CRA compliance program. The goal of this initiative is to encourage banks to develop a long-term commitment to serving the needs of their entire communities. Finally, I will discuss some of the trends I see emerging in financial markets generally and in community investment particularly.

The Community Reinvestment Act

As you know, the Community Reinvestment Act was passed in 1977 to encourage financial institutions to consider the needs of their entire local communities, including low- and moderate-income neighborhoods. The Act set up a framework for making community investment an abiding commitment of financial institutions. Bankers, savings institution executives, and community leaders are encouraged to work together towards this goal.

The Act wisely, I believe, shunned government-imposed credit allocation as a means of stimulating community based lending. Credit allocation would have been a great mistake because it would have increased the cost of providing financial services to all, including low- and moderate-income neighborhoods.

Instead, federal financial regulators are involved in three ways: first, they require financial institutions to define the community they are committed to serving; this encourages institutions to recognize the credit demands of the entire local community; second, the federal regulators assess the community investment track record of the institutions they supervise; and third, they consider that track record in the process of approving or denying lenders' requests for permission to merge or engage in new lines of business.

The Federal Reserve's Program

The Federal Reserve's CRA program has three components that correspond to the three mandates of the legislation itself. These are the compliance examination program, the applications process, and the Community Affairs Program. I will describe each component briefly.

1. *The Compliance Examination Program*

The compliance examination program is the cornerstone of the Fed's CRA program. We introduced this examination program in 1977 to provide specialized oversight in the areas of consumer protection laws and the CRA. Our compliance examiners are trained specifically to conduct reviews and produce reports that deal exclusively with consumer compliance and CRA issues.

The criteria that guide our examiners reflect the Fed's view that CRA issues ought to be an integral part of a bank's operational policy and decision-making. Our first consideration is whether the institution's definition of its community is responsible and reasonable. We also look at the efforts the institution has made to assess its community's needs and then to market its services to the whole community. Other considerations include the bank's record in opening and closing offices, and its participation in community development projects and government sponsored loan programs. Finally, we look at the level of involvement of the bank's board of directors in the formulation and implementation of CRA policies.

2. *The Applications Process*

The second component of the Fed's CRA program is the applications process. To open a new branch or merge with another bank, state-member banks and holding companies must receive prior approval from the Fed. We base our decision whether to approve such applications on a number of criteria, including the safety and soundness of the bank or banks involved, the impact on competition for banking services, the needs and convenience of the community, the bank's managerial talent, and the bank's CRA record.

Three of these criteria have a bearing on the goal of encouraging community investment. First, and most obvious, is the bank's CRA record. A banking organization with a poor CRA record will receive close scrutiny in the applications process. We will evaluate the statistical evidence regarding the institution's geographic lending patterns. In some cases we may condition approval on commitments to correct inadequacies in the institution's community investment record.

Closely related to the bank's CRA record is our assessment of the needs and convenience aspects of the application. One way an applicant serves the needs and convenience of the community is to provide banking services to low- and moderate-income neighborhoods.

The third consideration in the applications process that has a bearing on community investment, perhaps surprisingly, is the impact of the proposed activity on competition within the banking and thrift industries. In a competitive environment, financial institutions simply cannot afford to ignore profitable lending opportunities, no matter where those opportunities might be located. Relatively few CRA-based protests have arisen in the Twelfth Federal Reserve district, because the banking industry in the West has a long tradition of being competitive and retailoriented. The states in this district have fostered competition by allowing relatively unrestricted branching and free entry.

An integral part of the applications process is, in fact, the opportunity we provide to interested individuals and groups to comment on an applicant's CRA performance. When a protest arises, we seek to provide a forum in which the applicant and those protesting the application can resolve their differences.

It is not our intention, however, to take on the role of crafting or enforcing agreements between community groups and the applicant, many of which may involve specific lending commitments. The CRA does not require -- and specifically avoids -- government-mandated credit allocation. Rather, our mandate is to take protests under consideration in making our own independent assessment of the applicant's CRA track record. To do otherwise would compromise the integrity of the CRA process.

Our primary concern when applications are protested is the same concern that undergirds our examination program and our applications process generally: namely, that the institutions we supervise demonstrate an abiding commitment to serving the entire community's needs. At times, the specific agreement between the applicant and those involved in the protest, though important, may not address this goal. That is why we conduct our own investigations into the applicant's CRA performance and why we may require improvements even apart from agreements reached between the applicant and those involved in the protest.

3. *The Community Affairs Program*

The Fed established a Community Affairs Program in 1980 as a third component of its CRA program. In 1981, the San Francisco Reserve Bank appointed a Community Affairs Officer to encourage community investment in our district. Under his direction, our program provides a liaison between community groups and lenders, assisting lenders in assessing community credit needs and enabling lenders and community groups to take advantage of private and public sector programs that support community development lending. Through this program, for example, we have co-sponsored a number of forums with Neighborhood Housing Services organizations and the Bay Area Council. Conferences like this one also come under the auspices of our Community Affairs Program and that of the Federal Home Loan Bank of Seattle.

I am pleased to see that our Community Affairs Program is helping to foster a spirit of cooperation among regulators, lenders, and community groups in this district. Cooperation is essential if the goals of CRA are to be met in a period of rapid economic and technological change. Let me briefly describe these changes and how they are affecting community investment.

Emerging Trends

Amid the welter of change in the U.S. financial system in the last decade, one development stands out: banks and other financial institutions no longer are tied to their local markets for investing or funding. The deregulation of deposit rates has enabled financial institutions to draw funds from anywhere in the country simply by advertising slightly higher rates than their competitors. Likewise, interstate and international banking has opened up lending opportunities in places far removed from banks' local markets. Finally, "securitization" has given banks the opportunity both to originate loans and sell them to investors anywhere in the country and conversely, to purchase loans originated anywhere in the country.

In part because of these changing economic realities, we are seeing a significant increase in the number of CRA-related protests. Nationwide, the total number of protested applications processed by the Federal Reserve jumped to 74 in the last three years, nearly double the total for the preceding seven years. In the San Francisco district, the total jumped to nine for the last two years, compared to only one prior to 1986.

Nonetheless, I am troubled by the tendency of some observers to measure the performance of the CRA process by the number of applications the regulators approve or deny. Most applications are, in fact, approved, and this reflects the fact that most banks in most banking markets do serve their designated communities. The intent of the CRA was to encourage financial institutions to serve the needs of their communities even better. This is accomplished through regulators' clear signal to banks that we evaluate applicants' requests in light of their CRA performance, even to the point of requiring major improvements. This, I believe, we are doing well.

The Future of Community Investment

The success of the Federal Reserve's efforts to promote community investment ultimately requires that all those involved in community and neighborhood issues be aware of and responsive to the changing realities of the marketplace. The world is a different place than it was 11 years ago when CRA was enacted. This does not mean that the concerns reflected in that law have less force today; rather, we must respond flexibly to the Act's mandates. In this regard, I see much that is encouraging.

The economic developments that are loosening financial institutions' ties to their local markets also are being pressed into service for the benefit of community investment objectives. Take securitization, for example. The highly successful Neighborhood Housing Services of America organization, or NHSA, purchases community development loans originated by the 280 local NHS programs throughout the country. It then pools and sells these loans to insurance companies and other intermediaries.

Another example of securitization is the recently-formed Local Initiatives Managed Assets Corporation, or LIMAC, which is based in New York. This organization proposes to purchase community development loans and sell bonds backed by those loans to investors. In time, this sort of operation could become the basis for a nationwide secondary market for community investment lending, in much the same way that Fannie Mae and Freddie Mac have been the backbone of the national secondary market for mortgages. Such a development could vastly improve the availability of funds for community investment, since banks would be able to sell the loans they originate, thereby leveraging funds for community investment.

I also am encouraged to see lenders in the Twelfth Federal Reserve district increasingly taking the initiative to develop specialized community investment programs. For example, a number of lenders in California, together with the San Francisco Development Fund, are in the process of forming the California Community Reinvestment Corporation, which will serve as a nonprofit mortgage banking corporation that provides loans for low income housing. A similar effort is on the drawing board here in the Pacific Northwest, as well. We at the Fed and at the Home Loan Bank applaud these initiatives.

These initiatives lead me to believe that community investment will continue to move forward in the future, contrary to the opinions of some of the doomsayers. The changed economic realities of the last decade actually present less danger than opportunity in this regard. I've already mentioned how securitization can be used through organizations like NHSA and LIMAC to make funds available for community investment.

Even the the trend towards interstate banking will open up opportunities. Interstate acquisitions, for example, afford the opportunity for closer scrutiny of the "acquiror's" and the "acquiree's" CRA records. With this in mind, banks wishing to build nationwide branch networks are becoming more concerned about maintaining and building good records.

In conclusion, the Federal Reserve remains committed to fostering community investment. The economic developments and community investment initiatives I've highlighted today should make our task easier in the future.