CFE Cities for Financial Empowerment

Testimony
Cities for Financial Empowerment Coalition

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Public Hearing on the Community Reinvestment Act Regulations

August 30, 2010

Introduction

Thank you for holding this series of hearings on reforming the Community Reinvestment Act (CRA). The Cities for Financial Empowerment (CFE) Coalition commends the Agencies' commitment to assessing ways to improve the effectiveness of CRA in encouraging banks to meet the financial services needs of those with low and moderate incomes.

Background on CFE

The Cities for Financial Empowerment (CFE) Coalition is a network of cities committed to advancing innovative financial empowerment initiatives locally and nationally. Expanding the vision of how municipal government can serve its citizens and create pathways for financial stability, CFE leverages power and politics in the service of at-risk communities. It provides a platform for cities to work and learn collectively, forging partnerships with public, private, and non-profit sectors. CFE members include co-chairs New York and San Francisco, and Chicago, Hawai'i, Los Angeles, Miami, Newark, Providence, San Antonio, Savannah, and Seattle.

CFE cities across the country are designing and implementing innovative policy solutions to help people who are disenfranchised from the mainstream banking system gain access to affordable financial services through both specialized account-based bank access programs and "Bank On" campaigns. By focusing on connecting families with low and moderate incomes to banking, opportunities for asset building and financial education, as well as maximizing consumer protections, these municipal efforts are reaching millions.

Recommendations

Enacted in 1977, the landmark Community Reinvestment Act (CRA) has been one of the most important vehicles for channeling investment into low-income communities and helping to reverse the discriminatory practice of redlining.

Without question, CRA has brought about major improvements in the provision of financial services to the underserved, helping to address the credit needs of low-to-moderate income (LMI) communities and reduce redlining in these communities. For example, the United States Department of Treasury has reported that CRA-covered lenders and their affiliates increased home mortgage loans to low- and moderate-income borrowers over the period from 1993 to

1998 at more than twice the rate of increase for other borrowers—39 percent for LMI borrowers as compared with 17 percent for other borrowers.[1] Also, according to a study released by the Joint Center for Housing Studies at Harvard University, CRA-regulated entities originated significantly more loans to people and communities with lower incomes than they would have if CRA did not exist.[2] Moreover, numerous studies have shown that CRA-covered lenders were significantly less likely than lenders not covered by CRA to make the types of high-cost or subprime loans to borrowers with low income that contributed to the recent foreclosure and economic crises.[3]

CRA can be improved in many ways, however, and the hearings you held over the last several weeks provide an opportunity to weigh in on changes that can have a positive impact on making CRA more valuable to consumers and understandable to financial institutions. CFE is pleased to respond to the Agencies' requests for recommendations. There are many opportunities to expand and strengthen the CRA, including, for example, additional incentives for responsible small-dollar lending and evaluating banks on their offering of prepaid debit cards with appropriate terms. However, we focus our testimony primarily on one area—how CRA can expand access to safe, affordable financial products and services to meet community needs. In our view, this is the key area in which CRA can make enormous strides in the near future.

In addition, we are pleased to respond to the Agencies' questions regarding the role of ratings and incentives in the evaluation of CRA performance and the role that institutional and geographic coverage should play in defining CRA coverage.

I. **Ensure the service and community development tests effectively assess the extent to which banks serve the comprehensive financial services needs of communities**

The evidence is overwhelming that low-to-moderate income communities continue to need safe and affordable banking products. The numbers truly illustrate the scope of this problem. In a study released earlier this year, the FDIC found about eight percent of U.S. households—approximately nine million households—have no bank account at all.[4] Being unbanked results in substantial costs to consumers, draining funds from families with low incomes and stifling the economic development of their communities. For example, a full-time worker without a checking account could save as much as $40,000 during his or her career by relying on a lower-cost checking account instead of check-cashing services.[5] In addition to paying more for basic transaction and credit financial services, relying on fringe services is a strong predictor of overall financial instability.[6]

Financial institutions, by and large, have yet to focus on the service needs of low-income unbanked and underbanked consumers. In 2008, the FDIC found that less than 18 percent of banks identify expanding services to unbanked or underbanked individuals as a priority in their

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[1] Litan, Robert E., et. al., "The Community Reinvestment Act After Financial Modernization: A Baseline Report," U.S. Department of Treasury, April 2000.
[2] Apgar, William, et. al., "The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System," The Joint Center for Housing Studies at Harvard University, March 2002.
[3] See, e.g., Canner, Glenn and Neil Bhutta, "Staff Analysis of the Relationship between the CRA and the Subprime Crisis," Board of Governors of the Federal Reserve System, November 21, 2008.
[4] "National Survey of Unbanked and Underbanked Households," Federal Deposit Insurance Corporation, December 2009.
[5] Fellowes, Matt and Mia Mabanta, "Banking on Wealth: America's New Retail Banking Infrastructure and Its Wealth-Building Potential," Brookings, January 2008.
[6] FDIC National Survey of Unbanked and Underbanked Households, December 2009. Available at http://www.fdic.gov/householdsurvey/Full_Report.pdf.

business strategy.[7] Over three quarters of banks in the study had not conducted research on this potential opportunity in their CRA assessment areas.[8]

CRA has the potential, however, to change the calculus for financial institutions and address clear market failures in the transactional banking arena. Simply put, CRA regulations should comprehensively address banks' performance in meeting the need for safe, affordable financial products and services in LMI communities. Based on the initiatives to provide access to banking undertaken in CFE cities around the country, we offer the following specific recommendations to accomplish this goal, as well as to enhance the precision and effectiveness of CRA ratings and incentives.

A. For large banks, service test rules should be amended to prioritize evaluation of products and services more heavily than branch locations.

Focus on retail banking products

The "service test" is one part of the large bank exam. Among other things, the service test pertains to the provision of financial services in CRA assessment areas. Current CRA rules can be improved by focusing the service test more tightly on the core services of financial institutions. Given that large banks make up the greatest share of the retail banking market—holding roughly 85 percent of depository institution assets overall[9]—the service test is an important area of the CRA rules to strengthen and clarify to maximize the impact of improvements.

The Agencies currently do not place enough emphasis on the development, promotion, and actual sale of safe and affordable banking services to community residents. Furthermore, regulators inadvertently may be inflating the value of certain service test activities by giving credit for marginally useful community development activities such as board participation, volunteer activities and a vague, catch-all category of financial education. A study released by the Brookings Institution in 2002 found that when banks performed so poorly on the lending and investment tests that they were in danger of receiving a "Needs to Improve" rating overall, their service test scores were much higher than would otherwise be expected.[10]

The breadth of activities covered under the service test, combined with a lack of a clear emphasis on the actual financial services provided, undermines the test's utility. This lack of clarity on the CRA service test has also proven to be problematic for financial institutions as widely varying interpretations of this test have driven many to devote disproportionate resources to activities outside of the banks' core business interests and their core areas of expertise. Instead, banks should be focusing on what they do best—delivering financial services. In other words, the service test should not just evaluate whether financial institutions are good corporate citizens; it should evaluate whether, in the course of their core business activities, they serve the actual financial needs of a broad spectrum of consumers. Aligning the CRA's service test more closely with the core operations of the financial institutions will make it far more effective for consumers and cost-efficient to the financial institution.

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[7] "Banks' Efforts to Serve the Unbanked and Underbanked," Federal Deposit Insurance Corporation, December 2008.
[8] Ibid., FDIC, December 2008.
[9] New York City Department of Consumer Affairs' analysis of FDIC's Statistics on Depositary Institutions, December 31, 2009.
[10] Stegman, Michael A., Kelly Thompson Cochran, and Robert Faris, "Creating a Scorecard for the CRA Service Test: Strengthening Basic Banking Services under the Community Reinvestment Act," The Brookings Institution, March 2002.

Clearly define eligible products and services
Central to assessing banks' performance in comprehensively meeting community needs is ensuring they are offering the types of financial products and services aimed at serving consumers with low and moderate incomes in a manner that safely encourages asset building and financial stability. To evaluate banks effectively, a framework for the specifications of such products must be uniformly defined and applied consistently across regulators and examiners.

To accomplish this, the Agencies should develop standards for what qualifies as a safe, affordable product or service that would be eligible for CRA credit. The FDIC's recently proposed checking and savings account templates serve as excellent models for clear, yet flexible definitions of appropriate and safe financial products.

Systematically evaluate the promotion and uptake of products
While the delivery of safe and affordable products clearly falls within the scope of the service test, there needs to be greater guidance given to financial institutions on how to track and report the development, promotion and uptake of these products. While physical presence and delivery channels can be important, banks also should be assessed on product and service activities.

In addition, CRA rules should clearly focus on actual promotion and sales—not simply the technical availability—of safe and affordable bank accounts. Examiners should use qualitative and quantitative data to determine whether such products are in fact meeting the needs of those with low-to-moderate incomes, using defined metrics to assess the extent to which financial institutions market the product to consumers and the extent of consumer uptake. Clarity of metrics will ensure that the service test is applied consistently and effectively, and actually should make compliance easier for banks. Developing suitable products is the first step, but community needs are not met until the right consumers are connected to the right products.

Regulators can and should give credit for steps taken to reduce barriers to serving the unbanked and underbanked, such as locating branches in communities that are truly underserved, broadening acceptable forms of identification for account opening, increasing bilingual bank staff and increasing hours of operation. Greater and more appropriate weight should be given to banks' marketing and actual sales of clearly defined products and services that safely and effectively meet community needs.

B. For intermediate small banks, the community development test should be expanded to incorporate the same access to banking components of the service test.

Intermediate small banks are not subject to the service test, but intermediate small banks can and should be evaluated on their performance regarding access to safe, affordable banking,[11] consistent with our recommendations above, through the "community development test" to which they are subject.

The Agencies' regulatory changes in 2005 that created the community development test, combining elements of the service and investment tests, sought to reduce the regulatory burden of intermediate small banks.[12] However, there is ample room in the community development test

[11] While not specifically covered by our recommendations, the Agencies should consider appropriate ways to give small banks credit on their CRA exams for the marketing and uptake of safe, affordable financial products to low-to-moderate income consumers, as well.
[12] See Community Reinvestment Act Regulations, Federal Register, Vol. 70, No. 147, August 2, 2005, P. 44256.

to incorporate meaningful and effective evaluations of bank performance in regard to banking products and services offered, and such data could be collected without substantially increasing the regulatory burden on intermediate small banks. In fact, a report released last year by the Woodstock Institute found that, "…despite oft stated concerns about increased regulatory burden, banks already collect key transactional and account data for marketing and other purposes and that these data could easily be collected and used to implement the Community Reinvestment Act (CRA) service test more effectively."[13]

We recommend that the community development test for intermediate small banks be expanded to include the core access to safe banking elements of the service test recommended above, including quantitative measures of branch presence and comprehensive, systematic evaluation of banks' offering, marketing and selling safe, affordable products.

II. Restructure CRA ratings to incentivize high performance

A. Increase differentiation of CRA ratings based on performance

As "grade inflation" has become increasingly pervasive, the significance of CRA ratings in distinguishing truly exceptional financial institutions and calling out those that perform poorly has diminished. Analysis by the National Community Reinvestment Coalition (NCRC) illustrates the striking changes in CRA ratings over time. In 1990, when ratings first were made publicly available, nearly 10 percent of examinations resulted in either a "Needs to Improve" or "Substantial Noncompliance" rating; by 2009, this number shrunk to less than two percent.[14] Overall, from 1990 through 2009, 15.8 percent of banks received "Outstanding" ratings, and 80.2 percent received "Satisfactory".[15]

The Agencies should develop a revised CRA grading scale that more meaningfully differentiates financial institutions on their performance in meeting the needs of the communities in which they do business. This could include, for example, introducing overall ratings of "Low Satisfactory" and "High Satisfactory", rather than having only one overall rating of "Satisfactory"; or increasing the number of points on the CRA grading scale, as has been recommended by NCRC. In addition, banks should only receive an "Outstanding" rating if they receive "Outstanding" for each of their component tests, rather than allowing performance in one test to compensate for another test.

B. Increase incentives for high performance and disincentives for lower performance

Currently, there are inadequate incentives for banks to make sufficient investments to reach an "Outstanding" level of performance. Likewise, penalties for not meeting CRA standards do not sufficiently prevent repeated poor performance. The consequences of a poor rating do not amount to much more than a brief public relations "hit", if anything. The primary enforcement mechanism, denying merger applications based on poor CRA ratings, has been used in only very rare instances. For example, between 1989 and 2007, only eight of the 13,500 applications for the formation, acquisition, or merger of bank holding companies or state-member banks reviewed by the Federal Reserve Board were denied due to unsatisfactory consumer protection

[13] "Benchmarking Branch Outcomes: Using Available Data to Analyze and Improve the Delivery of Retail Bank Services to Low-Wealth Communities," Woodstock Institute, May 2009.
[14] Taylor, John, Testimony Before the House Financial Service Committee, Financial Institution and Consumer Credit Subcommittee, Hearing on "Perspectives and Proposals on the Community Reinvestment Act," National Community Reinvestment Coalition, April 15, 2010.
[15] Ibid., John Taylor, NCRC

or community needs issues.[16] Given the vast consolidation in the market that has already taken place, this little-used "stick" is likely to be even less meaningful in the future.[17]

In revising the CRA regulations, we recommend that the Agencies develop an array of "carrots" to strongly encourage institutions to strive for outstanding performance. Incentives for achieving high ratings could include charging tiered assessments and examination fees based on CRA ratings. Additionally, institutions that have developed and implemented innovative products or services and received an "Outstanding" rating might be eligible for a CRA Innovation Award or a CRA Achievement Award, which could provide valuable publicity and marketing opportunities.

As for more effective "sticks" to punish poor performance, an accelerated exam schedule for recidivist poor performers could serve as a strong disincentive. Agencies should also consider directly levying fines on financial institutions that repeatedly fail to attain a "Satisfactory" rating or higher. In addition to serving as a public penalty for poor performance, the accumulated funds from such fines could be used to establish a cash award program to reward banks.

Another approach to raising the importance of CRA ratings is to educate consumers about what such ratings actually mean to them. Regulators should launch a public awareness campaign to provide greater recognition to the banks that meet the high standards necessary to receive an "Outstanding" rating. Regulators should also consider requiring banks to prominently disclose their CRA ratings in marketing materials. A broadly recognizable CRA rating would be a powerful example of how regulators can meet the objective of encouraging banks to serve the comprehensive financial services needs of communities.

C. Increase reporting and data transparency

Publicly available Home Mortgage Disclosure Act (HMDA) data has been an extremely powerful tool used by advocates, researchers, and activist investors, among others, to hold financial institutions accountable for their lending performance. In amending the CRA regulations, we recommend that the Agencies build on this time-tested, valuable resource by requiring similar data reporting for all consumer credit and transactional products. Such data should be publicly available and easily accessible to researchers. To be most valuable for initiatives aimed at increasing access to safe banking, information regarding the types of products and services being sold by financial institutions, terms and fees associated with such products, and demographic and geographic profiles of customers could all be included in required reports.

III. <u>Evaluate banks on the full context of their operations</u>

A. Revise assessment areas to include all areas where financial institutions do business, not just where they have branch presence.

The Agencies should revise the methodology for determining CRA assessment areas to more comprehensively assess all of a bank's lending activity, including all relevant activities by non-depository affiliates. The current method of defining CRA assessment areas based on

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[16] Braunstein, Sandra, Testimony Before the House Committee on Oversight and Government Reform, Subcommittee on Domestic Policy, Hearing on "Bank mergers, Community Reinvestment Act enforcement, subprime mortgage lending, and foreclosures," Federal Reserve Board of Governors, May 21, 2007.

[17] For example, the number of commercial banks with assets of $50 million or less has dropped by more than 3,600 since 1994, to 1,198. At the same time, deposits held by the five largest banks increased to 37% of all deposits, as of June 2009, triple the top five's share 15 years prior. Barr, Collin, "Small banks, big problems," Fortune, December 29, 2009. Available at http://money.cnn.com/2009/12/22/news/economy/banks.fortune/index.htm

geographies where banks have physical presence does not sufficiently account for changes in the marketplace that have led many banks to extend their business activity significantly beyond brick and mortar locations. For example, lenders now have the ability to originate loans over the internet or through vast networks of brokers and loan offices in addition to their retail branches.

While the problem with this definition of assessment area based on physical presence is particularly relevant to the mortgage market, where non-depository affiliates and mortgage brokers have become a major conduit for such lending, it is also applicable to other areas in the consumer lending market, such as banks funding refund anticipation loans or auto loans.

Including non-depository affiliates of financial institutions on CRA exams is another important area for improving CRA regulations. The current rule gives banks the discretion whether to include the activity of affiliates, which neglects a large and growing share of the financial sector. According to OCC Chairman Dugan, "many financial services, such as mortgages and other consumer loans, may be offered by affiliates or subsidiaries within the [bank] holding company structure rather than through the lead insured institution."[18] For example, currently, the share of all home purchase loans made by banks operating in their CRA assessment areas has dropped to about 25 percent.[19] The current regulations permit inconsistent treatment by banks of affiliate activities and this results, in some cases, in systematic exclusion of discriminatory or predatory practices. As Treasury's Assistant Secretary for Financial Institutions Michael Barr has noted, "…participation by banks or thrifts in arrangements with affiliates or other parties that do not provide adequate consumer protection, or raise compliance, operational, or other risks, should receive negative consideration."[20]

Being covered by CRA can have a real impact on the suitability of products offered. Research has revealed that institutions regulated by the CRA performed differently inside and outside of their assessment areas, showing, for example, that a much larger percentage of higher-cost loans are made by CRA-regulated institutions lending outside of their CRA assessment areas, compared to loans made when lending within their assessment areas.[21]

We recommend that the Agencies update the CRA regulations to ensure that an institution's assessment area includes any areas where it makes a significant number of loans or has a substantial share of customers, regardless of whether or not it has physical presence in that area. Since loans made outside of a depository institution's assessment area are much more likely to be higher cost, revisions of assessment areas must go beyond physical presence to include all geographies where banks and their non-depository subsidiaries do business.

Conclusion

Thank you for convening these hearings and for giving stakeholders, including cities, across the country, the opportunity to share recommendations with you to strengthen the Community

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[18] See Dugan, John C., Comptroller of the Currency, Remarks Before the International Economic Development Council, April 20, 2010. Available at http://www.occ.treas.gov/ftp/release/2010-47a.pdf

[19] Essene, Ren and William C. Apgar, "The 30th Anniversary of the CRA: Restructuring the CRA to Address the Mortgage Finance Revolution," *Revisiting the CRA: Perspectives on the Future of the CRA*, Federal Reserve Banks of Boston and San Francisco, 2009.

[20] Barr, Michael, "Community Reinvestment Emerging from the Housing Crisis," *Revisiting the CRA: Perspectives on the Future of the CRA*, Federal Reserve Banks of Boston and San Francisco, 2009.

[21] "Paying More for the American Dream III: Promoting Responsible Lending to Lower-Income Communities and Communities of Color," Joint Report by California Reinvestment Coalition, Community Reinvestment Association of North Carolina, Empire Justice Center, Massachusetts Affordable Housing Alliance, Neighborhood Economic Development Advocacy Project, Ohio Fair Lending Coalition and Woodstock Institute, April 2009.

Reinvestment Act regulations, based on extensive and intensive local experience. We urge you to adopt these proposals to leverage CRA even more effectively to encourage financial institutions to engage in sustainable business practices that support the efforts of our eleven diverse cities to connect our residents to safe, affordable banking products and services.

Respectfully,

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