Speeches and Congressional Testimony

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Consumer Bankers Association, on the benefits of financial literacy programs, Arlington, Virginia, April 8, 2002

Financial Literacy: A Key to New Banking Markets

It's a pleasure to join you at your annual Community Reinvestment Act conference—another opportunity for CBA to reaffirm its standing as one of the premier banking organizations in this country. A large share of the credit for your success goes to Joe Belew, who over the years has led with intelligence, conviction, and style.

One of the most important of your products is your survey of the industry's financial literacy efforts. When it was first released last summer, the survey confirmed what many of us already knew: that thousands of Americans have been smarter financial consumers—and more successful participants in the economy—because they attended educational programs developed, financed, and carried out by banks across the country.

This year's survey reflects an even more impressive variety of bank-sponsored programs: credit counseling, small business development, in-school tutoring, foreclosure prevention, and more. Of the banks surveyed—a group that represented almost 60 percent of the industry's total assets—nearly all said that they contributed to the war on financial illiteracy in some way, with more than half serving as primary sponsors of the programs in which they participated.

Clearly, bank-sponsored financial education programs have not only benefited the people who have enrolled in them, they've also earned respect and good will for the industry.

Yet when you think about it, the wonder is not that financial institutions have been so busy and active in promoting financial literacy, it's that there are still banks out there that aren't involved.

There are certainly plenty of reasons for public-spirited bankers to become involved in the effort to promote financial literacy. Evidence confirms that people who have been through well-designed and well-executed financial education programs are more likely to make sound economic choices for themselves and their families.

They're more likely to own their own homes and to keep them, with all of the social and economic advantages that go with homeownership. They're more likely to accumulate assets and less likely to be burdened by excessive debt. As Treasury Secretary Paul H. O'Neill recently said, "Ownership, independence, and access to wealth should not be the privilege of a few. They should be the hope of every American. Financial literacy is an essential tool to make that hope a reality."

Studies also tell us that financial education is an indispensable element of any strategy to combat the rise of predatory lending. I don't need to tell you that abusive lending has become a serious public policy concern—and a serious concern for the financial services industry.

Although those who engage in predatory practices are relatively few in number—and only rarely include regulated depository institutions—they've done real harm to the reputation of all financial institutions. It's therefore very much in the industry's interests to assist in efforts to oust the bad actors.

One of the best ways we've found to do that is through education, with programs that focus on the most common victims of predatory lending—particularly the poor, the elderly, and minority groups—programs that provide information on predatory practices and on non-predatory financial options. I was encouraged to see that more than half of the respondents in the current CBA survey reported addressing predatory lending issues in their financial literacy programs.

The predatory lending problem illustrates what I think is a point of surpassing importance: altruism that's reinforced by self-interest is most likely to produce results. And I believe that banks have a strong self-interest in promoting financial literacy.

High among the reasons why banks serve themselves when they serve others through participation in financial literacy efforts are regulatory considerations, and particularly CRA considerations.

We and other financial regulators give CRA credit for financial literacy programs in assessing your record of serving the needs of low- and moderate-income individuals. Banks' participation in these programs may receive consideration under the CRA regulations.

For example, the Interagency Q&As offer a long list of activities that would qualify for consideration under the CRA service test. The list includes such things as:

- providing technical assistance on financial matters to small businesses;
- providing credit counseling, home buyer and home maintenance counseling, financial planning or other financial services education to promote community development; and
- establishing school savings programs and developing or teaching financial education curricula for low- and moderate-income individuals.

Regarding the investment test, the Interagency Q&As note that when financial institutions make investments in or grants to non-profit organizations that provide counseling for credit, home-ownership, home maintenance, and other financial services education, such investments will qualify for CRA consideration.

Clearly, financial literacy activities can play a big part in any financial institution's overall CRA strategy. And we know that some of our largest institutions already play such a role.

But banks should not get involved in the financial literacy crusade merely as a matter of public spirit or regulatory obligation. They should do it because it makes good business sense—because a financially literate public is the natural market for bank products and services.

It's now well known that there's a large pool of unbanked Americans—people who may use the banking system for a casual transaction or two, or maybe not at all. By definition, they don't have a savings or checking account, and they rely on nonbank financial providers when they need to cash a check or buy a money order. According to some estimates, this group may constitute up to ten percent of all American households.

Then there are the underbanked, as I call them—millions of people who may have a bank account, but who rely to a greater or lesser extent on high-cost, short-term credit provided by nonbank lenders, often in the form of payday loans.

There are significant differences between these two groups. But they also have a lot in common. Both generally pay more than they should have to for financial services in a fully competitive market. Both would benefit from more comprehensive banking relationships. And for both, financial literacy programs may hold the key to getting there.

Let me emphasize again that for banks, this should be a matter of enlightened self-interest. This a lucrative market that we're talking about. Overall, those who serve the unbanked and the underbanked do exceedingly well at it. In 2000, Americans cashed 180 million checks at 11,000 check-cashing outlets, generating fees of $1.5 billion. And the payday loan industry has been booming. Today up to 10,000 outlets nationwide make payday loans—and earn fees that may total as much as $2.2 billion.

While many will say that fees for these services are unreasonably high, bankers in this country can't afford to ignore the number of consumers using these services. They clearly demonstrate a market opportunity.

Is it realistic to think that bankers can gain a bigger share of this promising market? Clearly, it won't be easy. The nonbank providers that currently control the market possess a number of advantages—not the least of which is public acceptance.

Check cashers and payday lenders have attracted customers for a reason—or for a host of reasons. They keep longer hours than banks. They tend to be more conveniently located. They speak their customers' languages. They don't ask for a lot of intrusive paperwork. They frequently offer more of the retail products and services these customers need than banks do—including money orders, wire transfers, and bill payments, as well as short-term, low-denomination loans.

They're set up to work fast—a fact of paramount importance to many payday borrowers, who are usually impatient for their money and won't wait days or weeks for a loan to be approved. In short, they're more user-friendly. And nonbank providers can often claim—correctly—that their services cost no more—and sometimes less—than the same services provided by banks—that is, when those services are even *available* at banks.

Yet banks have some significant competitive advantages that should position them to be far greater rivals than they are for these fringe providers. Banks alone have access to the payments system. They alone can hold transaction balances. They alone have deposit insurance coverage and access to the discount window. They alone are eligible to accept direct deposits. And they alone can offer banking services in conjunction with a variety of other services.

Add the many intangible benefits that banking relationships offer—institutional advice and support, opportunities to build formal credit histories, and so on—and you have a powerful set of reasons for banks to go after this business.

Of course, banks have enjoyed these advantages for years. Yet that hasn't prevented the estrangement of millions of Americans from the banking system. So the problem becomes one of ensuring that these advantages are understood by—and made accessible to—the individuals who would benefit from them.

The answer—or part of it—lies in something that *is* relatively new. I have long suggested that technology is an essential component of any viable strategy to extend the benefits of banking to the underbanked. I'm pleased to see that this view is beginning to take hold both among consumer advocates and among bankers themselves.

For example, last week a large national bank introduced a no-frills, "checkless" account that gives customers unlimited access to their funds through the bank's automated teller machine (ATM) network and eliminates the need to cash payroll checks.

This is one of those cases where government has led effectively by example. Consider the case of the ETA—the Electronic Transfer Account—that was developed by the Treasury Department when I was Under Secretary for Domestic Finance. ETAs are now being offered by hundreds of banks around the country—including the six largest—and have already drawn thousands of previously unbanked Americans into the banking system. More than 26,000 ETA accounts have been opened since the program began. To be sure, that's not an earth-shaking number. But it's a good start.

When we developed the ETA model, we had two principal goals in mind. First, it was designed to facilitate the transition—mandated by law—from paper to electronic delivery of federal payments. Obviously, people can't receive electronic payments unless they have a bank account to do so.

The transition to electronic direct deposit was expected to save the government tens of millions of dollars—as indeed it has done. Over the past decade, in fact, the government has saved more than $2 billion by converting from paper checks to electronic payments.

But we also hoped and expected that the ETA—a cheap, no-frills, utilitarian account—would serve as a model for financial institutions seeking to establish or expand a foothold in the unbanked market.

Taking advantage of their ability to batch remittances, some banks are beginning to develop electronic accounts that combine direct deposit with debit card access and bill payment options. Such accounts are proving attractive to individuals accustomed to spending several dollars per month for money orders or electronic bill payments. Because such accounts largely dispense with paper, they can be offered at low cost—lower in many cases than the customer would pay for the same set of services at a nonbank outlet.

But it's not only their competitive pricing that makes such accounts attractive to those who would otherwise be dealing with a nonbank. They provide a safe and cheap repository for funds. No more lost or stolen checks; no more hassles to cash a payment check; no more risk of carrying around a wad of cash and becoming a target for predators. The paycheck goes directly into the bank account, and with a debit card the customer can draw funds as she needs them, at an ATM or at point of sale. And if the bank has been innovative, the customer may even be able to make basic payments from the account by electronic transfer, either without cost or at a cost far less than a money order.

For the bank there are also important benefits: no processing of paper checks, no risk of overdrafts, the opportunity to establish new customer relationships that may be developed into something more.

For example, if such customers need small loans, for a car or appliance purchases—or even payday-type credit—a direct deposit account, which already enjoys cost advantages over a paper-based account, offers the possibility of prearranged electronic debits, significantly reducing not only the processing cost, but the bank's risk of default, as well. And they are favorably considered in a bank's CRA evaluation.

Banks are also taking the initiative to address the short-term borrowing needs of their customers, and here again, technology can be a big part of the solution.

In one noteworthy development, a prominent national bank has begun to offer a product that provides access to low-cost cash advances for direct deposit customers. Funds can be obtained directly from the bank's ATM network or by speaking to a telephone agent who will transfer the funds into the customer's account. The bank has also automated the underwriting process, cutting costs for both parties to the transaction and virtually eliminating the waiting period for established customers—a matter of considerable importance, as we've seen, for the emergency borrower.

Let me commend those of you who have added such innovative products to your offerings—and challenge those of you who haven't done so to think of even better ways of delivering these services.

But despite what Emerson said, it's not enough to build a better mousetrap; the world has to know about it before anyone will beat a path to your door. You have to give people a reason to break old patterns and habits; you have to let them know that they do have better options. And that brings me back to the importance of financial literacy.

A quick cautionary note is in order here. There can be a fine line between education and marketing, and it's a line that should be heeded in an educational setting. But this is an instance in which the facts—plain and uninflated—are on your side. Bank products and services—and the value of banking relationships—should sell themselves to informed consumers.

Coupled with innovative, technology-based approaches to product delivery, I believe that educational outreach holds tremendous potential for reducing the ranks of the underbanked. The potential rewards—for the economy and the banking system—certainly make the effort worthwhile.

It's not an effort we expect the industry to undertake on its own, of course. As with technology, we in government are leading by example, and we're working in partnership with others to promote the cause of financial literacy. I'm proud to report that the Treasury Department and its bureaus—especially the OCC—have been extremely active in this effort.

OCC has published resource guides and advisories to banks and others in search of ideas about where to obtain financial education and about how to help. We participate in the National Forum to Promote Low-Income Savings, an effort directed by the Consumer Federation of America to increase the savings rate in local communities. The OCC is one of only four federal agencies to have a formal partnership with the National Academy Foundation, a nonprofit organization dedicated to preparing young people for careers in the fields of finance, travel and tourism, and information technology.

And, of course, we work closely with banks, individually and through organizations like CBA, encouraging them to expand the scope and quality of their financial literacy activities.

Indeed, I believe it says something about our success in regard to numbers—numbers of banks participating and number of clients served, for example—that we're turning more to the question of program quality. Success in the financial literacy area cannot be measured simply in terms of raw statistics. We have to develop qualitative measures of our programs' effectiveness. We must set standards and measure outcomes where appropriate. I'm encouraged to see that many banks are engaging their community-based partners and other independent parties to evaluate the effectiveness of their programs.

Let me close by once again commending CBA and the banking industry for your important work in reaching out to the unbanked, the underbanked, and those in need of more and better information about their financial options. But we can't stop here, because the truth is that your work—our work—has just begun. There are millions more who remain outside the banking system—and outside the mainstream of our economy. We will never achieve our full potential as a nation as long as that's the case. And the banking industry will miss out on opportunities to serve, to grow, and to profit.

Reach out because it is the right thing to do; reach out because the American people need you. But do it most of all because it's good business. After all, doing good by doing well is the American way.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on ending inequitable treatment of national banks, Washington, D.C., April 23, 2002

Statement required by 12 USC 250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Sarbanes, Senator Gramm, and members of the committee, I am pleased to have this opportunity to present the views of the Office of the Comptroller of the Currency (OCC) on deposit insurance reform. As the current and most recent past chairmen of the Federal Deposit Insurance Corporation (FDIC) have noted—and as I strongly agree—the system of federal deposit insurance adopted by the Congress in the early 1930s has served this nation well for the greater part of a century. No massive overhaul of the system is required to ensure that it will continue to contribute to financial confidence and stability in the twenty-first century.

Nonetheless, the efforts so far undertaken to address the weaknesses in the system uncovered during the banking and thrift crises of the late 1980s and early 1990s have not been entirely adequate to the task. Indeed, the legislation adopted in response to those crises has actually constrained the FDIC from taking sensible and necessary actions. This is particularly the case with respect to the FDIC's ability to price deposit insurance in a way that reflects the risks posed by different depository institutions, and to the funds' ability to absorb material losses over the business cycle without causing sharp increases in premiums. Failure to address these issues in the current financial environment poses the danger that the next major domestic financial crisis will be exacerbated rather than ameliorated by the federal deposit insurance system.

Current legislative proposals in the House and Senate to reform deposit insurance address most, albeit not all, of the issues raised by the FDIC staff in its excellent and wide-ranging *Options Paper* released in August 2000. Among these issues are (1) how much discretion the FDIC should have to set premiums reflecting the risks posed by individual institutions to the insurance funds; (2) whether strict limits on the size of the insurance funds result in excessive volatility of deposit insurance premiums; (3) whether the deposit insurance coverage limit should be increased and/or indexed to changes in the price level; and (4) whether the Bank Insurance Fund (BIF) should be merged with the Savings Association Insurance Fund (SAIF).

In summary, the OCC recommends that (1) the FDIC be provided with the authority to implement a risk-based premium system for all banks; (2) the current fixed designated reserve ratio (DRR) be replaced with a range to allow the FDIC more flexibility in administering the deposit insurance premium structure; (3) coverage limits on deposits should not be increased; and (4) the BIF and SAIF should be merged.

We believe that deposit insurance reform also provides an opportunity to strengthen our supervisory structure by eliminating a distortion and unfairness in the current system of funding bank supervision. Currently, a portion of the earnings on the insurance funds, which state and national banks paid into, is diverted to fund the federal supervision of only one class of institutions, state banks supervised by the FDIC. The FDIC has elected not to pass those costs on to the banks they supervise. As a consequence, state nonmember banks pay only a small percentage of the costs of their supervision. In contrast, national banks pay over $400 million each year to cover the full costs of their supervision by the OCC. Ending this anomaly is not just a matter of fairness to national banks. It is a necessary component of allocating the costs and benefits of deposit insurance in an equitable and efficient manner among insured banks. For that reason, in addition to our views on the issues addressed by the legislative proposals to reform deposit insurance, my testimony today will include our suggestion for remedying the inequity that exists in the funding of supervision.

Eliminating Constraints on Risk-Based Pricing

The ability of the FDIC to set premiums for deposit insurance that reflect the risks posed by individual institutions to the insurance funds is one of the most important issues in the deposit insurance reform debate. The banking and thrift crises of the 1980s revealed the weaknesses of a flat-rate deposit insurance system in which the great majority of sound, prudently managed institutions subsidize the risks assumed by a few institutions. The Congress responded to this glaring deficiency by enacting the Federal Deposit Insurance

Corporation Improvement Act (FDICIA) of 1991, which required the FDIC to establish a risk-based system of deposit insurance premiums, thereby bringing the pricing of deposit insurance more in line with the practices of private insurance companies. The FDIC's initial efforts to implement such a system made meaningful, actuarially based distinctions among institutions based on the risk each institution posed to the insurance funds, but fell short of creating a well-differentiated structure.

Unfortunately, the Deposit Insurance Fund Act (DIFA) of 1996 diminished the FDIC's discretion to maintain, let alone improve, the risk-based structure of deposit insurance premiums. DIFA effectively prohibited the FDIC from charging a positive premium to any institution in the 1A category—that is, well-capitalized institutions with composite CAMELS ratings of 1 or 2—whenever the reserves of the deposit insurance funds are at or above the designated reserve ratio (DRR) of 1.25 percent of insured deposits. As a result, at December 31, 2001, 92.5 percent of all insured banks fell into that category, and therefore pay nothing for their deposit insurance—even though their risk of loss may be far above zero. Thus, today many institutions—some of which have never paid any deposit insurance premiums—receive a valuable government service free, and very well-managed institutions in effect subsidize riskier, less well-managed institutions. Moreover, quite apart from the risk that a specific bank might present, banks are not required to pay even a minimum "user" fee for the governmentally provided benefit represented by the deposit insurance system—a benefit without which, as a practical matter, no bank could engage in the business of taking deposits from the public.

Aside from the obvious inequity to institutions that contributed heavily to recapitalize the funds after the losses of the 1980s and 1990s, a system in which the vast majority of institutions pays no insurance premium forgoes one of the major benefits of a risk-based pricing system—creating an incentive for good management by rewarding institutions that pose a low risk to the insurance funds. A mandated zero premium precludes the FDIC from charging different premiums to banks with different risks within the 1A category, despite the fact that within the 1A category there are banks that pose very different risks to the funds.[1]

[1] In its August 2000, deposit insurance reform *Options Paper*, the FDIC reported that "the 5-year failure rate for CAMELS 2-rated institutions since 1984 was more than two-and-a-half times the failure rate for 1-rated institutions" (p. 13). As shown in chart 1 on page 12, the five-year failure rate for CAMELS 1-rated institutions (commercial and savings banks) was 0.7 percent, while that for CAMELS 2-rated institutions was 1.8 percent (www.fdic.gov/deposit/insurance/initiative/Options_080700m.pdf).

Whenever the reserve ratio of the BIF falls below 1.25 percent, however, FDICIA requires the FDIC to charge an assessment rate to all banks high enough to bring it back to the DRR within one year. If that is not feasible, the FDIC must impose an assessment rate of at least 23 basis points. This sharp rise in premiums, or "cliff effect," would hit banks the hardest when they are most vulnerable to earnings pressure. To avoid creating this procyclical volatility in deposit insurance premiums, it would be preferable to offset losses to the funds through more gradual changes in premiums based on the level of the insurance fund relative to the FDIC's assessment of current risk in the banking system. In short, we believe that as risks in the banking system change relative to the level of the insurance funds, the FDIC should have the authority to adjust premiums on all banks.

Increasing Coverage Limits

The question of deposit insurance coverage limits is a challenging one, in part because it is extremely easy for depositors to obtain full insurance of deposits in virtually unlimited amounts through multiple accounts. Along with most academic economists and other bank regulators, we are convinced that the sharp increase in the deposit insurance limit from $40,000 to $100,000 in 1980—at a time when the thrift industry was virtually insolvent—was a serious public policy mistake that increased moral hazard and contributed to the weakening of market discipline that exacerbated the banking and thrift crises of the 1980s and 1990s. By encouraging speculative behavior, it ultimately increased losses to the deposit insurance funds and taxpayers.

Proponents of an increase in coverage assert that it would ease liquidity pressures on small community banks and better enable small banks to compete with large institutions for deposits. None of these assertions, however, is supported by substantial evidence.

First, we see no compelling evidence that increased coverage levels would offer depositors substantial benefits. Anyone who wants to use insured bank deposits as a means of holding their wealth can do so today virtually without limits, subject only to the minor inconvenience of having to open accounts at multiple banks. Despite the ability of depositors to achieve almost unlimited coverage at banks, money market mutual funds, which have some of the same features as bank transactions accounts and generally offer higher returns than bank deposits, today hold over $2 trillion. Because these funds could easily be placed in insured accounts, these facts suggest that many depositors are not concerned about the additional risk involved in holding their liquid funds in uninsured form and that households are comfortable with the *status quo*.

Second, it is not at all clear that increasing deposit insurance coverage would result in an increase in the deposits of the banking system. One effect could be to cause a shift in deposits among banks. It is far from clear that any such redistribution of existing deposits would favor community banks. Depositors who multiply insurance coverage today by using multiple banks might consolidate their deposits in a single institution if coverage were raised, but there is no way of determining which institutions would be the ultimate beneficiaries when the switching process ended. Moreover, it is quite possible that larger, more aggressive institutions might use the expanded coverage to offer even more extensive governmentally protected investment vehicles to wealthy customers. That could cause an even greater shift of deposits away from community banks and increase the liquidity pressures felt by some.

For many of the same reasons that we object to an increase in the general insurance limit, we are also concerned about proposals to use the federal deposit insurance system to favor particular classes of depositors such as municipal depositors. For instance, at year-end 2001, commercial banks had $162 billion in municipal deposits. The FDIC estimated in 1999 that less than one-third of municipal deposits was insured. Applying that 1999 ratio to the 2001 total suggests that nearly $115 billion of municipal deposits at banks are uninsured. A significant increase in the insurance limit for municipal deposits, therefore, would undoubtedly raise the level of insured deposits and put pressure on the DRR. In addition, an increase in insured coverage could spur riskier lending because banks would no longer be required to collateralize the municipal deposits with low-risk securities.

Merger of the BIF and the SAIF

One of the least controversial issues of deposit insurance reform is the merger of the BIF and the SAIF. The financial conditions of thrifts and banks have converged in recent years, as have the reserve ratios of the two funds, removing one of the primary objections to a merger of the funds. As of the fourth quarter of 2001, the reserve ratio of the BIF was 1.26 percent, while that of the SAIF was 1.37 percent. The reserve ratio of a combined fund would have been 1.29 percent as of the same date. As is described in greater detail below, many institutions now hold some deposits insured by each fund. But under the current structure, BIF and SAIF deposit insurance premiums could differ significantly depending on the relative performance of the two funds, raising the possibility that institutions with similar risks could pay very different insurance premiums. This would unfairly penalize low-risk institutions insured by the fund charging the higher premiums.

Despite the tendency for the activities of the banking and thrift industries to converge in recent years, substantial differences remain in their portfolio composition. For example, residential mortgage loans constitute 51 percent of the assets of insured savings institutions but only 15 percent of the assets of insured commercial banks. Largely because of these differences, merger of the two funds would result in significant diversification of risks.

A related development affecting the potential for diversification is industry consolidation, which has led to an increased concentration of insured deposits in a relatively few institutions and increased the risks to the deposit insurance funds. According to the FDIC staff, the three largest SAIF-insured institutions held over 15 percent of SAIF-insured deposits in 2001, while the corresponding share of the top three BIF-insured banks was over 13 percent. Merging the funds would reduce these concentrations, and thereby the risk that the failure of a few large institutions could seriously impair the insurance fund.

Further, there is significant overlap in the types of institutions insured by the two funds. As of March 2001, 874 banks and thrifts were members of one fund but also held deposits insured by the other fund, and BIF-member institutions held 41 percent of SAIF-insured deposits. Finally, merger of the BIF and the SAIF would undoubtedly result in operational savings as the two funds were combined into one.

Increased Flexibility for the Deposit Insurance Funds

The OCC supports giving the FDIC the authority to establish a range for the DRR to replace the present arbitrary fixed DRR of 1.25 percent. The FDIC should have the authority to set the range based on its assessment of the overall level of risk in the banking system. We also believe that in establishing the range the FDIC should provide notice and an opportunity for the public to comment on the proposed range. Adoption of a range and elimination of the 23 basis point "cliff effect" would allow the FDIC more flexibility in administering the premium structure and would minimize the likelihood of sharp increases in premiums during economic downturns when banks can least afford them.

When the funds exceed the upper boundary of the DRR range set by the FDIC, the FDIC should be authorized to pay rebates or grant credits against future premiums. To ensure that rebates or credits to insured institutions are equitable, the FDIC should have the authority to assess the nature of the institutions' claims on the funds. Institutions that have paid little or no insurance premiums to the funds have far less of a claim on rebates or credits than those that contributed to building up the funds.

While such rebates or credits seem reasonable on their face, there are two obvious principles that should be observed in determining their size and allocation. First, a system of rebates and credits should not undermine the risk-based premium system. Institutions that paid high insurance premiums because they posed a higher risk to the funds should not receive larger rebates than less risky institutions of the same size. The fact that these high-risk institutions did not fail during that period does not alter the fact that they subjected the funds to greater than average risks.

The second principle is that the payment of rebates and credits should not have the unintended consequence of exacerbating the disparity in supervisory fees that now exists between state and nationally chartered banks. Today, the FDIC charges the insurance funds for its costs of supervising state-chartered institutions. National banks, in contrast, pay the full cost of their supervision despite the fact that they have contributed almost 55 percent of the amount in the BIF. For example, in 2001, in addition to $400 million in assessments that national banks paid to the OCC for their own supervision, national banks can be viewed as contributing 55 percent, or about $273 million, of the $525 million that the FDIC spent on state nonmember bank supervision. Failure to take this into account in fashioning a rebate program would be unconscionable.

Fee Disparity

State banks, on average, pay only modest assessments to state regulators, which represent about 20 percent of the total costs of state bank supervision. Far and away the largest component of state bank supervision is that provided by their federal regulators—the Federal Reserve, in the case of state banks that are members of the Federal Reserve, and the FDIC, in the case of nonmember state banks. In 2001, the Federal Reserve and FDIC together spent over $900 million on state bank supervision. None of this was recovered directly from the banks they supervise. The FDIC absorbs the cost of its supervisory and regulatory activities through charging the BIF and SAIF, while the Federal Reserve uses its interest earnings to absorb its supervisory and regulatory costs. Neither the Federal Reserve nor the FDIC assesses state banks for their costs in providing exactly the same supervisory functions as the OCC provides for—and assesses—national banks. As a result of this subsidy provided by the Federal Reserve and the FDIC, there is a continuing incentive for national banks to convert to state charters. Indeed, state supervisors aggressively proselytize for such conversions, heavily exploiting fee disparity as a major part of their sales pitch.

It should be emphasized that fee disparity has no relationship to the relative efficiency of national and state bank supervision. It is entirely a consequence of the fact that state banks are not charged for the major portion of their supervision costs—that provided by their federal regulators. Indeed, the OCC has a strong externally imposed incentive to run its operations efficiently, for if it fails to do so, and must turn to its banks to pick up additional costs, it runs the risk of causing increased conversions of banks from national charters to state charters. Still, the effectiveness of supervision can suffer, and serious inequities can result, when unavoidable pressures on supervisors' budgets are created. For example, during the wave of large bank failures in the late 1980s and 1990s—a period of stress in the banking system that had not been seen since the Great Depression—significant resource demands were placed on bank supervisors in responding to severe problems in the banking system. Yet just as these demands were being felt, the banking system was under severe earnings pressure.

At the OCC this meant significant increases in direct assessments on national banks—14 percent in 1989, another 11 percent in 1991, and 30 percent in 1992. While there were reductions in assessments in subsequent years, one conclusion is inescapable: the OCC assessment mechanism works procyclically in times of stress in the banking system. At the Federal Reserve and the FDIC, similar cost increases were easily absorbed—at the FDIC out of insurance funds and at the Federal Reserve out of revenues that otherwise would have been paid over to the Treasury Department. In other words, the OCC faces the threat of reduced supervisory resources at the very time they are most likely to be needed. National banks face a higher burden of supervisory costs at the very time they are facing a troubled economy. Just as the need to address the 23 basis point "cliff effect" has gained attention, so also should the procyclical distortions raised by the present system of funding supervision.

The question, of course, is what to do about this disparity. Proposals to level the playing field by requiring the

Federal Reserve and the FDIC to impose new fees on state banks have been dead on arrival in Congress. We believe it is necessary to come up with a new method of funding bank supervision—a method that will strengthen both the state and the federal supervisory processes and ensure that all supervisors have adequate, predictable resources available to carry out effective supervisory programs without imposing additional fees on state banks.

Solution

There are a number of alternative approaches to solving this problem that one might consider, and we believe that now is the ideal time to do so, as the whole topic of the role of deposit insurance is being reexamined. An idea that we think has considerable appeal would draw on the earnings of the FDIC's insurance funds to cover the costs of both state and national bank supervision. Today, with the level of the combined funds at about $42 billion and generating earnings of around $2.5 billion per year, there are considerably more funds available to defray the costs of FDIC, OCC, and state supervision than those agencies today spend in total. Working together, and using the present costs of supervision as a baseline, state and federal supervisors could develop a nondiscretionary allocation formula that would reflect not only the breadth of responsibilities of the agencies, but the condition, risk profile, size, and operating environment of the banks they supervise. All agencies would remain free to impose supplemental assessments if they chose, but competitive pressures would presumably work to keep these charges at a minimum.

This arrangement would offer some meaningful advantages. First, it would remedy the inequity to national banks that exists today, resulting from the fact that the FDIC funds the supervision of only one class of banks, state nonmember banks, out of the earnings of the deposit insurance funds, to which all banks have contributed. As I mentioned earlier, we estimate that national banks have accounted for more than half of the contributions to the Bank Insurance Fund.

Another major advantage to a system under which the OCC and the state supervisory agencies would be funded out of the earnings on the insurance funds is that it would reinvigorate the dual banking system. It would create a regulatory system under which banks choose their charters on the basis of factors such as regulatory philosophy, access, and the perceived quality of supervision. The result would be competition based on characteristics of supervisors that are relevant to maintaining a safe and sound banking system.

Conclusion

The OCC supports a merger of the BIF and the SAIF and proposals to eliminate the current constraints on deposit insurance premiums. We favor elimination of the current fixed DRR (designated reserve ratio) and its replacement with a range that would allow the FDIC more flexibility in administering the deposit insurance premium structure. We oppose an increase in deposit insurance coverage limits at this time. Finally, as the entire role of deposit insurance is being subjected to scrutiny by policymakers and legislators, it is an opportune time to address the distortions and unfairness in the current system of funding bank supervision that I have highlighted in my testimony today.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the 38th Annual Conference on Bank Structure and Competition, on the growing consensus that fee disparity problem must be fixed, Chicago, Illinois, May 9, 2002

The independence of bank supervision is not likely to find its way on to the list of America's great contributions to popular government. But given what we increasingly know about the vital role that independent supervision plays in maintaining financial stability, it may be time for a new list. The importance of supervisory independence—and what we must do to *keep* U.S. supervision effective and independent—are the subjects I'd like to discuss with you this afternoon.

Certainly the subject has a long history. In 1829, when New York State legislators created the nation's first truly professional bank supervisory agency, they took steps to ensure that it would be able to operate free of political influences and pressures. So did the legislators who created the national banking system in the 1860s. They created the Office of the Comptroller of the Currency as a "separate bureau" within the Treasury Department. They provided the Comptroller with a five-year term and protections against premature removal from office. The first bill that passed Congress forbade the Comptroller's removal except with the approval of the Senate—an extraordinary requirement. But in amended legislation, that "advice and consent" requirement was dropped—not because of second thoughts about the importance of protecting the Comptroller's independence, but in recognition of the practical difficulty of reassembling a recessed Senate—in those days, the Senate was not in virtually continuous session, as it is today—to deal with a Comptroller whose conduct merited removal. Indeed, the Senate recognized "the force of the argument that [the Comptroller] ought to be in a great degree independent."

Congress even contemplated moving the OCC to New York or Philadelphia, so the Comptroller would not have to contend with the bleating and pleading of the lobbyist crowd. And the founders of the national banking system expressed their commitment to supervisory independence when they chose to fund the examination of national banks from fees and assessments on the banks themselves, rather than entangling the OCC's performance of bank supervision in the political give-and-take of the federal budget and appropriations process.

The legislative debate on the National Bank Act of 1864 may have been brief, but supervisory independence—and how best to safeguard it—was central to it. And the authors of that legislation took great pride in the success they believed they had achieved in promoting it.

It's important to note, moreover, that the independence of supervision is not simply an interesting bit of historical trivia. It has been reinforced repeatedly by Congress, even up to recent years. Within the past decade, for example, Congress has passed additional measures forbidding the Treasury Department from intervening in any matter or proceeding before the OCC, or from delaying or preventing the issuance of any rule or regulation by the OCC, and it has expressly permitted the agency to submit legislative recommendations and testimony to Congress without prior approval or review in the Executive Branch.

It's also important to note that this is not an issue of purely domestic relevance. Experience in other countries, where the tradition of supervisory independence may be weak or nonexistent, reminds us that there's a steep price to be paid when supervisors are unable or unwilling to conduct their business independently.

Indeed, the absence of supervisory independence has been implicated in almost every national financial crisis the world has recently seen. In Argentina, South Korea, Thailand, Japan, Turkey, and Indonesia, bank supervisors were unable to operate with the independence their responsibilities demanded. In each case, supervisors became instruments of government or central bank policies that subordinated the safety and soundness of financial institutions to other goals. In each case, banks were permitted—or even encouraged—to make loans in defiance of good credit practices in order to promote certain policy objectives, such as protecting inefficient industries. Moreover, in each case, the result was the same: supervision was discredited; the condition of the banking system deteriorated; the national economy suffered; and the process of recovery was seriously impeded by a crippled banking system. Some countries are still struggling with the consequences of such ill-advised supervisory policies.

These experiences help explain why, when the Basel Committee on Banking Supervision adopted its core principles for effective supervision in 1997, "operational independence and adequate resources" headed the list. And the experiences of other countries remind us of the importance of vigilance in defending supervisory independence here at home.

Supervisory independence in this country has also seen its share of challenges. During the Great Depression of the 1930s, for example, there was strong sentiment that federal bank supervisors should align themselves behind the monetary and macroeconomic policies of the Treasury Department and the Federal Reserve. Many people thought that the Comptroller of the Currency should encourage national banks to make loans to good borrowers and bad borrowers alike, and to look the other way as credit quality deteriorated. This view was frequently expressed in terms of countercyclicality—that bank examiners ought to promote the cause of growth and easy credit when the economy was in a slump and enforce credit restraint when the economy was in danger of overheating.

Fortunately, the firewalls erected by Congress in the 1860s and buttressed over the years thereafter held strong during the banking crisis of the Great Depression. The OCC was able to continue supervising national banks objectively and independently, and the banking system subsequently regained its strength.

That experience was not lost on a generation of bank supervisors, who came away convinced that combining monetary policy and supervision would undermine both. For people like J.L. Robertson, who served as a bank supervisor for 30 years, first as a deputy comptroller of the currency and then as a governor of the Federal Reserve System, it became an article of faith that "bank examiners should never be obliged to switch from rose-colored glasses to black ones, and bank and forth again, in an effort to implement the monetary policy of the moment."

However, the notion that federal bank examiners might be pressed into service of some larger political or economic agenda lived on—and it lives on today, after a fashion. For evidence one need look no further than the introduction to our own conference program, where, sure enough, you'll find the question whether "regulation and supervision [should] attempt to smooth the business cycle" on the list of current supervisory issues.

I believe it's a matter of considerable significance, however, that while we may still debate the idea of using bank supervision as a macroeconomic tool in forums like this one, the question has essentially been laid to rest in government circles. Indeed, it has never come up in any official discussion in which I have participated, either as Under Secretary of the Treasury for Domestic Finance or as Comptroller of the Currency. The statutory constraints that limit the ability of Treasury to become involved in matters at the OCC have been well understood and scrupulously respected during my experience in the Department. As a practical matter, I believe, the principle of operational independence for bank supervisors in this country is no longer open to question.

There's another dimension of supervisory independence—independence from the institutions we supervise. In this regard, the chartering and regulatory choices available to U.S. banks—the dual banking system and the tripartite division of federal regulatory responsibility—create certain tensions. The problem was highlighted over 30 years ago by Federal Reserve Chairman Arthur Burns, who decried what he saw as a dangerous "competition in laxity," not only between state and national bank supervisors, but among the various federal regulators as well, each having an incentive to pursue supervisory and regulatory strategies that would attract constituents to their particular jurisdictions.

In the game of regulatory competition, a gain to one supervisor usually means a loss to another, with varying consequences. While it is true, for example, that a wholesale exodus of banks away from the national charter could decimate the OCC, a threat equally if not more imposing might face the Federal Reserve System if there were to be a wholesale exodus away from state member status. In such an event the Federal Reserve Banks—already facing competitive pressures in other aspects of their operations—could face the need to downsize significantly their role in supervision. Not only would this have implications for the Fed's monetary policy and discount window functions, but, as the Reserve Banks were forced to shrink and become less substantial participants in the financial system, it would have implications for an important foundation stone of the Fed's independence.

We have been willing for many years, in the name of federalism, to accept whatever implications the mere existence of the dual banking system might have for supervisory independence, and I am a supporter of the dual system. But there is an aspect of the dual system—the way in which the costs of supervision are allocated—that presents an even greater threat to the independence of bank supervisors than dual banking in and of itself—a threat that has disproportionately serious implications for the OCC.

No one would ever accuse the United States of not taking literally the Basel principle that bank supervisors should have adequate resources at their disposal. In 2001, the total of supervisory expenditures in this country amounted to nearly two *billion* dollars—a substantial sum by any standard. That covers the supervisory expenses of the OCC (for national banks), the Federal Reserve (for bank holding companies and state member banks), and FDIC (for state nonmembers), as well as the expenses of the 50 state banking authorities.

It's how we raise and allocate that vast sum that introduces irrationality into our system, that potentially undermines its safety and soundness, and that destabilizes our dual banking system. There's nothing terribly complicated about it. National banks must bear the entire cost of their supervision, in the form of assessments paid to the OCC. State banks, by contrast, receive the federal portion of their supervision—far and away the largest component of state bank supervision—at no cost.

To be sure, state banks pay relatively modest fees to their state supervisors, reflecting the comparatively modest role that many states play in the supervision of federally insured state banks, compared to the pervasive roles played by the Fed and the FDIC. As a consequence, national banks pay on average two and a quarter times more in supervisory fees than do state banks. While national banks fully shoulder their costs of supervision, state banks pay only about 22 percent of the costs of their supervision.

That's not all. National banks actually subsidize the supervision of their state-chartered competitors. The FDIC draws on the insurance fund to cover the expenses of supervising state nonmember banks, yet 55 percent of the balance in the fund reflects insurance premiums paid by national banks. Thus, 55 percent of the subsidy that the FDIC affords state banks by absorbing their cost of supervision is, in effect, provided by national banks. A similar subsidy is delivered by the Federal Reserve to state member banks, since the costs of Fed supervision are not passed on to the banks they supervise. In this case, however, it is taxpayers that bear the cost of the subsidy, since the funds that the Federal Reserve draws on to absorb the costs of supervision would otherwise be returned to the Treasury.

Operating in tandem, the freedom that banks have to choose a state or national charter and to choose their federal regulator, *and* the disparity in the allocation of the costs of supervision caused by the federal subsidization of state banks, create a system in which financial institutions have a potential influence in their relationships with their supervisors.

This influence can be exercised overtly or tacitly—and, I hasten to say, it is not an influence that may be directed only at the OCC. Fee disparity simply becomes a cost factor for banks to weigh in the balance. If a bank feels "oppressed" by the OCC to the point that the combined cost of the higher fees and the supervisory "oppression" outweigh the advantages of the national charter, the bank has an incentive to convert. By the same token, if a state bank feels "oppressed," either because state law or its federal regulator limits its flexibility to conduct its business in the manner it desires, the incremental cost of higher assessments might be outweighed by the appeal of the national charter.

Fee disparity can have a particularly insidious impact on the OCC, however, because, unlike our self-funded sister agencies, we must tax our bankers to maintain our agency. Thus, to the extent fee disparity encourages conversions to state charter, there is a direct impact on the OCC's budget. In times of severe stress in the economy, this impact could have serious consequences. As a deteriorating economy translated into increased problems for banks, supervisors would be confronted with the need to expand their resources to cope with worsening conditions. At the OCC this would likely create a need for increased assessments—with a commensurate increase in the financial burden on national banks. Those national banks in the best condition, facing the prospect of larger assessments needed to deal with problem institutions, would thus have a strong incentive to convert to the subsidized state charter, leaving a diminishing number of national banks to bear the costs of an increasing OCC workload. And of course such conversions do not change at all the systemic costs of supervision, since the agencies assuming jurisdiction must pick up the costs of expanding their own supervisory resources to deal with the converted banks. Conversions thus simply transfer those costs from the national banks to either taxpayers generally or to all insured banks. The implications for the independence of the OCC in such a scenario are self-evident, I believe.

I'm encouraged to see that there's a growing understanding of these issues, and a consensus that the problems I've been discussing are problems that must be fixed. The question, of course, is how we should do that. Any solution we propose must meet several basic criteria. First and foremost, it should protect and preserve the independence of bank supervisors. It must also make our system of supervisory funding fairer, more secure, and more predictable. National banks should not be forced to subsidize their state-chartered competitors and taxpayers should not be expected to defray the cost of supervising one favored class of banks, as is now the case with state member banks that receive free supervision from the Federal Reserve.

Both state supervisors and the OCC must be freed from the uncertainty that currently surrounds their funding. At present, we are subject not only to fluctuations in the economy, but to changes in the structure of the banking system. Declining on-balance sheet assets mean declining revenues. And industry consolidation means an increasing reliance on a shrinking number of institutions. In half the states, a single bank accounts for 25 percent or more of the asset base on which state supervisors assess fees. The loss of such a large bank, through either failure or conversion, could have a crippling effect on a state supervisor's ability to provide quality supervision. Of course, the OCC could find itself in the same fix.

One suggestion made recently was that the OCC's funding concerns should be addressed through the use of appropriated funds. But if this means subjecting the supervision of national banks to the budget and appropriations process, it would clearly be a step in the wrong direction.

As I described earlier, since the very inception of the national banking system Congress has scrupulously insulated bank supervision from the political process—just as it has the formulation and execution of monetary policy. Injecting political considerations into supervision through the appropriations process would clearly run the risk of bringing to bear pressures that could undermine the objectivity and integrity of the critically important work that supervisors perform, and would make the direction and strength of supervision subject to the varying priorities of partisan politics. That would be no more desirable in the area of bank supervision than in respect of monetary policy.

Certainly, if there were any serious case for subjecting bank supervision to the kind of political oversight involved in the budget and appropriations process—and I see none whatsoever—it would be impossible to rationalize treating *only* national banks in this fashion, while leaving federal supervision of state banks to be self-funded through the use of the Federal Reserve's earnings and the FDIC insurance fund, with no outside oversight whatsoever.

Of course, the funding of supervision could be rationalized in the context of legislation reforming the entire structure of federal supervision of financial institutions—a challenge that has repeatedly been taken up over the past three or four decades. Experience in the United Kingdom and other countries that have altered their supervisory structures suggests that serious structural change is not an impossible goal. Nonetheless, past efforts in the United States have foundered for at least four reasons:

- First, the states have always felt that if there were a monolithic federal regulator for all banks, the attractiveness of the state charter would diminish. Now state banks can choose between the Fed and the FDIC as their federal regulator, or they can choose to go to a national charter. Those options would be lost under any proposal that sought to unify supervision.

- Second, a key element of past proposals has generally been to take the Fed out of bank supervision. This aspect of restructuring has had to confront two major objections: the explicit objection that removing the Fed from supervision would deprive it of a "window into the banking system," and thus impair its effectiveness in implementing monetary policy; and the implicit objection that taking the Fed out of supervision would decimate the Reserve Banks and thus undermine an important pillar of the Fed's independence.

- Third, there has never been any appreciable public constituency for such change. The banking industry and other interest groups have learned to live with—and take advantage of—the existing system, and they have not been anxious to change things. One does not even hear a clamor from public interest or consumer groups for such change.

- Finally, as illogical as it might be, the present system works pretty well, and enhanced cooperation and coordination in recent years has made it work even better.

While the challenge of addressing the funding problem in the context of regulatory restructuring is a formidable one, there are alternative approaches that should be considered—measured steps targeted to the problem that would avoid the difficulties presented by more far-reaching proposals to dismantle and reassemble the current supervisory structure.

I have proposed that we replace the system under which the OCC and state supervisors fund themselves through direct assessments, with a system that would draw on the earnings of the insurance fund. Such an approach would have multiple advantages:

- First, it would be supremely logical. After all, protection of the insurance fund is a major purpose of bank supervision. Charging the costs of supervision to the fund would place supervision on a sounder and fairer footing, relieving national banks of the unique and discriminatory burden of directly funding the costs of their own supervision—and of the grossly unfair burden of subsidizing the cost of supervision of their state bank competitors.

- Second, it would promote the equitable and efficient allocation of the costs and benefits of deposit insurance, and ensure that all supervisors have the resources necessary to provide effective bank supervision, regardless of changes in the economy or the structure of the banking system.

- Finally, it would revitalize the dual banking system by eliminating the distorting effects of a selective subsidy, while retaining the element of charter choice that has long been its hallmark.

Under our proposal, federal and state agencies would jointly formulate an allocation formula initially calibrated to provide the OCC and state agencies with resources equivalent to their current levels. This "baseline" allocation would be adjusted annually under the formula to take account of changes in the composition and condition of each agency's constituent banks, so that allocations from the fund would be automatic and nondiscretionary. The great benefit of this proposal is that it would significantly reduce, if not eliminate, reliance on the federal subsidy to state banks as a major determinant of charter choice. Banks would then make charter decisions based on such considerations as the quality of supervision and the suitability of the charter for their business objectives—a far healthier environment for the dual banking system than at present. It would provide the basis for restoration of salutary competition among the regulators—a "competition in excellence," that would restore the focus to the qualitative aspects of charter choice, rather than competition based on subsidized pricing.

There are some who believe that the national charter is so far superior to the state charter that an equitable allocation of the costs of supervision would result in a massive outflow of banks from state systems, and on this ground they oppose our suggested solution. But while I bow to no one in my enthusiasm for the national charter, the state charter has significant attributes of its own. Many states have been very innovative in granting powers to their banks that national banks do not yet have, and many states have adopted "wild card" laws that allow their banks to exercise many powers permissible for national banks. No comparable "reverse wild card" law affords reciprocal benefits for national banks. In the area of interstate branching, state supervisors have been very resourceful in reducing the burdens of duplicative regulation on banks operating in multiple states, and Congress has enacted "equalization" provisions giving state banks with interstate branches many of the benefits that national banks have in that connection.

Whatever one's view might be of the relative merits of the two charters, however, I think it's fair to say that the state charter is not in such a state of decrepitude that it needs almost a billion dollars a year in federal subsidies to shore it up—particularly subsidies that are delivered not pursuant to congressional mandate, but through the discretionary decisions of those federal regulators who have a self-interest in maintaining these banks as their constituents. If, indeed, an elimination of these subsidies would result in a major outflow of state banks to the national charter, we should all be alarmed, and we should focus on more fundamental concerns about state systems. Similarly, maintenance of a subsidy that is intended to protect the role of the Federal Reserve Banks in supervision diverts attention from what may be more significant structural issues in the Federal Reserve System. If there *is* reason to have such concerns, we should address them more forthrightly, and we should not obscure them with subsidy practices that have the purpose or effect of maintaining a particular regulatory share of market.

But I do not for a minute think that elimination of the subsidy would cause an exodus of state banks. Supervisory costs are naturally a concern for all banks, but I don't believe that major banking organizations make their charter choice simply on the basis of supervisory fees. I see no reason, to put a somewhat finer point on it, why the Federal Reserve should be concerned that its perfectly legitimate interest in being meaningfully involved with the banking system would be undermined if the discriminatory cost burden now borne by national banks were eliminated.

When we began to talk about the fee disparity issue in public nearly two years ago, it was the target of a fair amount of derision. Predictably, those who derided it most were many of the same people who were benefiting most from the subsidies I've been discussing.

Now I think it's widely acknowledged that we do need to revisit the way we fund bank supervision. But the changes needn't—and shouldn't—be radical ones. Ungainly though it is, our system of supervision has been too successful to scuttle. Indeed, our goal should be to strengthen our supervisory system by preserving and enhancing independence.

I believe that the proposal I have sketched today meets that standard. I commend it to your attention—and look forward to continuing the dialogue well under way with everyone who has a stake in the issue.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Local Initiatives Support Corporation annual staff conference, on the beneficial relationships between banks and community development corporations, Cleveland, Ohio, April 10, 2002

Thank you very much for inviting me to address Local Initiatives Support Corporation's (LISC's) national staff conference. I am honored to be here and I am delighted to have the opportunity to talk about the important role of community development corporations today, particularly the mutually beneficial relationships being forged between banks and community development corporations (CDCs). LISC has been instrumental in structuring many of these relationships, which hold great promise for economic revitalization of communities across the country. And I particularly want to congratulate all of you here today for the enormously important—and sometimes unrecognized—work that each of you do to foster community revitalization. You give hope to individuals who have been left on the shore of our economic mainstream.

Also, before I begin, I want to again thank Michael Rubinger, Buzz Roberts, and Oramenta Newsome for organizing a fascinating community development tour for Comptroller of the Currency Jerry Hawke, myself, and other OCC staff in Washington, D.C., in October 2000. On many occasions after that, we have reflected on, and spoken about, what we learned during that tour.

I don't have to tell you that LISC has long been a leader in the community development field. If only for its national scope and for the resources it brings to bear, LISC exerts much influence over the efforts of numerous community development corporations—CDCs—operating at the local level. But even more than these formidable assets, LISC's professional standards, expertise, and its day-to-day operating policies and practices are examples that local CDCs emulate and rely upon.

I thought it would be timely to discuss three topics with you today. First, since I am, after all, a *bank* regulator, I will review some perspectives on the mutually beneficial relationships that *banks* have developed with CDCs. Second, I will discuss some of the challenges we see CDCs facing in their relationships with banks, especially with regard to performance measures for the industry. Finally, I'll offer some thoughts about the new initiatives that CDCs and banks may be able to develop, such as through the New Markets Tax Credit Program.

Bank and CDC Partnerships

Over the past several years, we have seen a significant increase in the level of bank involvement with CDCs. The National Community Capital Association reports that bank investments as a proportion of CDFI-borrowed capital dollars more than doubled from 12 percent to 25 percent between 1994 and 2000. We at the OCC have seen large increases in bank investments under our Part 24 community development investment authority, which allows national banks to make equity investments in CDCs, community development projects, and other public welfare activities. National banks made more than $5 billion of Part 24 investments since 1995, almost 10 times more than the amount invested during the previous 30 years since Part 24 was established.

Much of this growth has occurred through bank investments in Low Income Housing Tax Credit projects with nonprofit sponsors, such as those planned and assisted by many of you here today. LISC has an impressive track record in this area, having raised some $3 billion in Housing Tax Credit investments—over three quarters of which has come from banks.

Banks have found that these types of investments and their relationships with CDCs can dramatically further their own ability to provide a presence in targeted segments of their markets, especially segments in which banks are underrepresented. Working with CDCs, banks find lending opportunities in these areas and bring needed capital to small business expansion, affordable housing development, and social services facilities. CDCs can help evaluate the repayment ability of the borrowers and also leverage bank investments with public and philanthropic funding in order to assemble the funding mix needed for these projects. Because of their mission, CDCs provide the resources and personnel to do the necessary work to make these projects work. In fact, CDCs often bring "the deal" to the bank.

In 2000, the OCC issued the results of a survey aimed at determining the practices that contribute to banks' community development success in the housing and small business sectors. We found that community development efforts are most likely to succeed when they are supported by multi-pronged partnerships of local governments, community organizations, philanthropic and religious groups, businesses, and other relevant stakeholders in the community.

Driving factors for bank participation exist when a CDC partner does an effective job of screening deals to bring good ones to the table, and when the CDC works with potential borrowers to devise business plans and credit proposals that meet banks' underwriting requirements. This helps banks reduce transaction costs and allows the bank to deploy its own personnel and resources in the most effective manner.

Our study also found that CDCs often play a key role, not only as project managers, but also as intermediaries and facilitators, making them valuable partners for banks. For example, many CDCs provide basic financial literacy education that can help the unbanked build relationships with traditional financial institutions. CDCs have been particularly effective at tailoring these educational programs to the needs and interests of specific groups within their communities. CDCs also provide pre- and post-purchase counseling for homebuyers. This counseling may be the best way to minimize default risk, or, quite simply, keep people in their homes. CDCs provide similar counseling to entrepreneurs who have taken out loans to start or expand a small business.

In addition to the project management role which CDCs play in many affordable housing developments financed by Low-Income Housing Tax Credits, CDCs increasingly also provide a range of social services for residents including day care, after-school programs, and job training resources. These services help enable residents of these developments to find an affordable place to live and provide support mechanisms to help them find ways to increase their income. This can increase the likelihood for success of affordable multifamily developments in certain markets.

Of course, the ability of CDCs to pull together complex financing packages, with funding from a number of third-party sources, is legendary. This skill is especially appreciated by small and mid-size banks that may have less experience with the complexities of community development financing. And even the largest banks recognize the benefit of the specialized expertise that CDCs can bring to structuring the multi-part financing packages that some projects require. As a result of this technical financing knowledge, CDCs can find new opportunities for banks to participate in projects, either as lenders or investors, that banks would not have been able to arrange on their own. By designing innovative financing structures, CDCs are able to involve banks in funding projects such as shopping centers, charter schools, small business incubators, or commercial office space. Banks are able to participate in capacities that make sense for them from a business and community reinvestment perspective, local community development needs are served, and, by improving the local environment and economy, banks may gain new customers and new markets.

Challenges in a Changing Economic Landscape

Yet, today the community development industry faces important challenges that arise from changes in the broader environment in which they operate. Among these changes are the shrinking and consolidation of the banking industry. Many CDCs have come to depend a great deal on banks for operating funding as well as for loans and investments, but its seems inevitable that in the future CDCs will have fewer banks to rely on for funding. Moreover, in economic downturns, as profit margins are squeezed, at least some of those remaining banks will be forced to trim their community development grant budgets. These factors bear directly on the future health of the CDC industry.

On the other hand, the federal government is changing its funding strategies in ways that favor continuing support for CDCs. Federal set-asides for nonprofits in HOME (HOME Investment Partnerships Program) funding and Low-Income Housing Tax Credits, for example, provide critical operating and project support to CDCs. And the New Markets Tax Credit is likely to spur the development of more Community Development Entities. Indeed, the authorizing legislation calls for their creation. But none of these federal programs is designed to be the sole source of funding for CDCs. All leverage private money, which frequently comes from banks. This leads to some thoughts on factors that banks are likely to view as significant as they evaluate potential CDC relationships.

Evaluating CDCs

In a landscape where there may be fewer private sector investors to turn to, the CDCs with the soundest fundamental elements are the ones most likely to survive and to continue developing fruitful community development partnerships. Quantifying the soundness of a particular CDC is already an exercise many banks undertake when evaluating their CDC partnerships. As the supervisor of national banks that lend to and invest in these entities, we have an interest in mechanisms and initiatives that enhance the performance of CDCs and enable banks to evaluate CDCs' performance.

The primary mission of my agency, the OCC, is to ensure a safe, sound, and competitive banking system that supports the *citizens, communities, and economy* of the United States. There are many facets of what bank supervision encompasses, but at its core, effective oversight of banks has to rely in large measure on the ability of banks themselves to establish effective systems for monitoring the risks and returns associated with their various lines of business. For example, we mandate that banks develop systems to monitor the quality of their loans. So, regardless of the line of business—from traditional lending to the most sophisticated capital markets activities—we make it clear to the banks we supervise that they must have systems and controls in place, appropriate to the size and complexity of their business, that enable them to monitor, measure and manage their activities.

The ground rules are no different for banks' partnerships with CDCs. Banks need information to be able to monitor, measure, and manage their loans to and investments in CDCs. Loans should be repaid, investments should generate returns, and grants should improve conditions in the markets in which the bank operates. We ask our banks to perform due diligence on all their investments, including ones in CDCs, because we want our banks to achieve successful results in their community development activities, just as in their other endeavors.

Banks can assess potential partnerships with CDCs more easily when the CDCs themselves have already instituted performance standards and measures. I recognize that measuring results is a challenge in many industries, and this is particularly true for CDCs. The traditional measures of dollars invested and units of housing built provide some sense of a CDC's capacity, but further measures are needed for investors to assess, for example, how well CDCs manage themselves and how their work affects the quality of life in their communities. Banks need to know that sound fundamentals back their business decisions—and investments in CDCs are not an exception to that rule. When you consider that a Housing Tax Credit investment normally remains on the bank's books for 15 years, banks need to be confident that their CDC partners have the staying power to manage the asset through to maturity.

It is those CDCs who have sound fundamental operating procedures, who have proven themselves to be insightful managers of their internal organizations as well as their external products and services, that will be sought out by banks. So, what are some of the "sound fundamental elements" that intermediaries such as LISC can help promote?

- ***Demonstrable results***. Measurable outcomes and careful tracking allow CDC boards and management to make decisions about which programs to pursue and what changes to make, and it allows them to assess the success of the CDC's overall efforts. These same measures help successful CDCs communicate their accomplishments to their financial institution partners, funders, policymakers, and to the public at large. This is *particularly* important to banks and thrifts, which must demonstrate to their regulators how CDC activities they have financed serve the needs of communities within their assessment areas under CRA. CDCs that are able to assemble geographic, income, and demographic data regarding the beneficiaries of their activities can provide bank partners with the information that bank regulators need to review as part of CRA compliance examinations. To the extent that this helps banks document their CRA performance, the more likely that CDCs that can provide such information will be sought after by additional banking industry partners.

- ***Sound financial management***. On the most basic level, CDCs must have accurate and timely financial information and effective financial management systems that will allow boards of directors and management to make sound, well-informed decisions. CDCs manage important, often scarce, resources in low-income communities. Careful stewardship of these resources is a public trust.

- ***Talented staff.*** The effectiveness of CDCs depends in great part on their staffs. Many talented people who come to the community development field do so because they are committed to the mission of CDCs. Planning for the succession of these talented and accomplished people ought to be high on the priority lists of CDCs and their boards of directors.

- ***Watchful, thoughtful boards of directors.*** Whether it be a bank or CDC, organizations involved with the complexities of community and real estate development need boards of directors embodying a diversity of talent and points of view—and enough relevant expertise to effectively serve their function as overseers of the organization's management. And while continuity among board members provides needed stability to such an organization, continuity must be leavened with periodic infusions of new blood to bring in new energy and new ideas.

- ***Operational integrity.*** CDC managers and directors owe duties of care and loyalty to the organization they serve—just as do managers and directors of banks. This means they must undertake their functions with care and diligence and execute their duties with undivided loyalty to the interests of their organization. In practice, CDCs should have written policies, which are carefully monitored, covering potential trouble areas such as conflicts of interest, board member compensation, and hiring or contracting with relatives. These policies help to ensure that the organization is not inappropriately used by the employees or directors as a source of private gain. Failure to comply with duties of care and loyalty can result in unfavorable consequences ranging from negative news reports, to financial penalties under recently enacted tax laws, and could even jeopardize an organization's federal tax exemption. The good name and reputation of any nonprofit organization is a priceless asset, on which its future may hinge. It should be safeguarded with the same vigor as the organization's financial assets.

A challenge facing the CDC industry is for more CDCs to systematically incorporate the fundamentals I have just described in their planning and operations. In this regard, the work of the National Community Development Initiative (NCDI) to promote capacity building and accountability within the CDC industry has advanced the industry significantly. As you know, NCDI combines the funding of corporations, foundations, and the Department of Housing and Urban Development and channels these monies to LISC and the Enterprise Foundation to leverage CDC activities at the local level. LISC makes these funds available through its Operating Support Collaboratives, which provide financial support for capacity building, strategy development, technical assistance, and training. The Operating Support Collaboratives also help the CDCs identify organizational strengths and weaknesses, and the receipt of these monies are usually made contingent upon the CDC's achievement of mutually agreed-upon performance objectives.

In 1998, the Urban Institute studied the activities of CDCs in the 23 cities participating in the NCDI and found CDC capacity growing strongly by a number of measures. Capacity is important to investors because it enables CDCs to have a greater impact, thereby generating greater return on their investments. The number of CDCs capable of producing more than 10 housing units per year grew from 104 in 1991 to 184 in 1997. The study also found that the NCDI helped produce a 45 percent increase in the number of "top tier" CDCs with consistent production records, strong internal management, and diverse funding sources.

The Urban Institute cited the clear articulation of performance standards as a key driver of the NCDI's success. Naturally, performance standards backed by a track record of results create a degree of comfort for banking partners and their regulators. NCDI and LISC's Operating Support Collaboratives do not automatically fund every CDC nor allow the funding to be seen as an entitlement. Funding is not renewed to organizations that do not show progress in meeting standards, and disbursement of funds can be held until CDCs are able to show progress in key areas. Because of the program's effectiveness, LISC and Enterprise have been able to raise more than $350 million from foundations, banks, corporations, and the federal government under the National Community Development Initiative over the past 11 years.

I understand that through LISC's capacity-building work with the Operating Support Collaboratives, you have developed a new CDC performance assessment tool—*Cap*Map—a capacity mapping approach that is being rolled-out at this conference. *Cap*Map has been designed to help CDCs create and track measures of success and also plan for growth based on their operating capabilities. I am particularly intrigued by the prospects for this tool that would allow for a more consistent set of criteria to be used in assessing capacity of CDCs across the country on critical success factors. *Cap*Map will be a true success if it can help a CDC more clearly chart its current stage of organizational capacity and what milestones it must achieve to realistically undertake further growth.

New Initiatives

So what does the future hold for the continued relationships between banks and CDCs? I am probably preaching to the choir when I say that I believe the next frontier lies in the extension of the successful partnerships we have seen in using housing tax credits to ones that will use the New Markets Tax Credit. You can successfully build homes and apartments in distressed communities, but if you are not able to change the surrounding neighborhood, your efforts will have fallen short.

As the Low Income Housing Tax Credit addressed the equity gap needed to develop affordable housing, we hope the New Markets Tax Credit will encourage capital to flow to businesses and other ventures in low-income areas. The New Markets Tax Credit will provide $15 billion over the next six years to promote investment in low-income areas, by allocating tax credits in support of for-profit enterprise development in low-income communities. Over the life of a seven-year investment, investors will be able to realize a tax credit equal to 39 percent of the amount that they have invested. To be eligible for an allocation of tax credits, an entity must obtain certification as a Community Development Entity (CDE) from the Department of the Treasury's CDFI Fund. The certification process entails providing a clear explanation of its business plan for making investments in targeted communities. By increasing their capital base, this tax credit will enable CDEs to lend and invest more, to attract additional outside capital, and to bring even more private-sector engagement to their market-priming activities.

The CDFI Fund has reported that it hopes to determine the awarding of allocations by the close of this calendar year. From our initial discussions with banks, many intend to be investors in New Markets Tax Credits. I hope to see LISC and its affiliates as active users of this new investment tool.

Conclusion

Today I've discussed the types of productive partnerships that CDCs and banks have established, shared some thoughts on challenges facing the CDC industry in order to continue its effectiveness in the years ahead, and I've described the potential that the New Markets Tax Credits provide. While most of the work that will determine continued success will occur at the individual CDC level, intermediaries such as LISC are playing a crucial role in maximizing the impact of bank/CDC partnerships in our communities. Your work is important not only through funding CDCs, but also by your efforts providing information and promoting best practices that are building a solid base for success for CDCs in the future.

Thank you, and I truly look forward to seeing more of the fruits of your good work.