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STATEMENT OF

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on

UPHOLDING THE SPIRIT OF CRA: DO CRA RATINGS ACCURATELY REFLECT BANK PRACTICES?

before the

DOMESTIC POLICY SUBCOMMITTEE

of the

OVERSIGHT AND GOVERNMENT REFORM COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

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Chairman Kucinich, Ranking Member Issa and members of the Committee, I appreciate the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the enforcement of the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA) and how the FDIC considers compliance with these laws, often known as the "fair lending" laws, in assigning Community Reinvestment Act (CRA) ratings.

CRA was signed into law thirty years ago on October 12, 1977.[1] The purpose of CRA is to encourage banks to serve the credit needs of their entire communities, including low and moderate income neighborhoods. At the time CRA was enacted, there was a severe shortage of credit available to low and moderate income neighborhoods and concern about racial redlining and discrimination. While CRA and the federal fair lending laws have had significant positive impact, there remains much work to be done. My testimony will describe the fair lending review conducted as part of consumer compliance examinations, the separate CRA performance evaluation process, and the FDIC's supervisory and enforcement actions to enforce these laws. Finally, I will explain the effect of fair lending violations on the CRA ratings we assign.

FDIC's Fair Lending Examination Program

The FDIC is committed to protecting consumers and ensuring that the institutions under our supervision adhere to the letter and spirit of the fair lending laws. When the FDIC finds practices that violate these laws, we take action to ensure that the practices cease and that harm to consumers is remedied, using a range of supervisory and enforcement tools.

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[1] *See* 12 U.S.C. § 2901 et seq.

Applicable laws

The fair lending laws applicable to FDIC-supervised institutions -- ECOA and FHA-- are somewhat different in scope and applicability.[2] While ECOA applies to all credit transactions, FHA applies to housing-related credit. ECOA and FHA both prohibit creditors from discriminating against any applicant in any stage of a credit transaction on the basis of race, color, religion, national origin, or sex. In addition, FHA prohibits discrimination on the basis of familial status and handicap, while ECOA includes prohibitions against discrimination based on age, marital status, public assistance income, and the exercise of rights under the Consumer Credit Protection Act. ECOA also requires that a creditor take or refrain from taking certain actions regarding what information can be sought in an application process, what notices are mandated to be provided to an applicant, and when a spouse can be required to co-sign a loan.

Fair lending reviews

FDIC conducts a fair lending review as part of every regularly scheduled consumer compliance examination of the institutions we supervise.[3] Our examiners also have the authority -- outside of a regularly scheduled examination -- to visit any FDIC-supervised institution to investigate a concern that has been brought to our attention.[4]

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[2] *See* 15 U.S.C. § 1691et seq., and 42 U.S.C. § 3605 et seq.

[3] Consumer compliance examination intervals depend on an institution's size and most recent examination ratings. *See* examination frequency table incorporated in the FDIC Compliance Examination Handbook at: http://www.fdic.gov/regulations/compliance/handbook/html/chapt02.html#Examination

[4] For example, the FDIC conducts a fair lending review when it receives a consumer complaint of discrimination.

To conduct a fair lending review, examiners follow the Interagency Fair Lending Examination Procedures.[5] These procedures were developed by the federal financial institution regulatory agencies in consultation with the Departments of Justice (DOJ) and Housing and Urban Development (HUD). Pursuant to the procedures, examiners begin by reviewing a bank's lending operations to determine the areas at most risk for discrimination. Examiners next analyze the bank's reasons for approving and denying loans, and, as part of this analysis, conduct interviews of bank personnel to determine the bank's underwriting and pricing criteria, both as written and as actually implemented. Examiners also conduct individual loan file reviews -- focusing on targeted loan products -- to obtain and confirm the underwriting and pricing criteria. If a file comparison shows differences in treatment, the examiner determines whether these differences are based on a prohibited factor.

Review of Home Mortgage Disclosure Act (HMDA) data also is an important component of fair lending reviews, and provides examiners with valuable information about a bank's home mortgage operations. In addition to considering loan application information, FDIC examiners review HMDA pricing data as a part of each fair lending examination of banks required to report the data.[6] Where the data show a larger pricing disparity for minorities or women in one or more product areas than is evident for other FDIC-supervised institutions, examiners scrutinize the institution's lending more closely.

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[5] These procedures have been incorporated in the FDIC Compliance Examination Handbook, which is published on the Internet at: http://www.fdic.gov/regulations/compliance/handbook/html/chapt04.html.

[6] HMDA does not require all institutions to report HMDA data. However, all institutions are required under ECOA to retain information regarding an applicant's race, sex, age, ethnicity, and marital status, for dwelling secured transactions. *See* 12 C.F.R. §§ 202.12 and 202.13(a). This information retention requirement is particularly significant for the FDIC because it supervises many small banks not subject to HMDA reporting requirements, so the ECOA data is available to examiners who retrieve the information from loan files during fair lending reviews.

When examiners identify a potential fair lending violation, they consult with FDIC fair lending and legal staff at the regional office. If FDIC regional staff concurs with the finding of a likely violation, a formal letter is sent to the bank apprising its management of the finding and the bank is provided an opportunity to respond. In the event the institution's response does not provide credible nondiscriminatory reasons that refute the evidence of discrimination, the FDIC cites the violation in the examination report and seeks corrective action. As required by ECOA,[7] a referral is made to DOJ with a recommendation that an appropriate civil action be instituted where the fair lending violation appears to involve a pattern or practice.

Regardless of whether a fair lending violation constitutes a pattern or practice that must be referred to DOJ, the FDIC requires that corrective action be taken for all violations. Isolated, technical violations of ECOA that do not involve discrimination can be addressed by informing bank managers of the violations and working with them to ensure compliance. In more serious cases, the FDIC seeks additional relief. Prospective remedies include requiring a bank to change policies and procedures that contributed to discriminatory conduct, to better train its employees, to establish community outreach programs, or to change its marketing strategy or loan products to better serve all segments of the community being served.

If a violation involves harm to individual consumers, the FDIC also will seek retrospective relief. This includes identifying customers who may have been subject to discrimination and offering credit if the customer(s) were improperly denied credit. If loans were granted on disparate terms, the bank may be required to modify those terms and refund any

[7] 15 U.S.C. § 1691e(g).

excess amounts paid by customers. The FDIC also may require restitution for out-of-pocket expenses incurred as a result of the violation.

Volume of fair lending violations and the FDIC response

During the period from January 1, 2002 through September 30, 2007, FDIC examiners completed 11,042 compliance examinations. In 237 of those examinations, the FDIC cited banks for substantive fair lending violations -- violations that involved discrimination on a prohibited basis. In 3,585 of the examinations, the FDIC cited technical fair lending violations, such as improper information gathering or inadequate record retention.

Although most fair lending violations are promptly corrected at the direction of examiners, informal enforcement actions such as a Memorandum of Understanding or a Board Resolution can be used to document a problem and the bank's commitment to address it. For a particularly serious violation, a formal public enforcement action such as a Civil Money Penalty or a Cease-and-Desist Order can be used. Restitution can be required as part of either formal or informal actions. In connection with the 237 examinations where substantive fair lending violations were cited, as described above, the FDIC obtained 41 Board Resolutions, 32 Memoranda of Understanding and one Cease-and-Desist Order to ensure that corrective action occurred. With regard to the remaining 163 examinations, we did not have to take such action with the banks in question because the banks either had already ceased the practice or took corrective action during our examination, and any necessary individual remedies.

Referrals to the Department of Justice

As noted above, ECOA requires the FDIC to refer pattern or practice cases to DOJ.[8] However, the standard for an FDIC referral does not require that the FDIC have sufficient evidence to prove a violation by a preponderance of the evidence.[9] This standard is therefore lower than the evidentiary standard required for DOJ to proceed with an action in court. Consequently, DOJ conducts its own independent investigation, which may be broader and more time consuming than the investigation conducted by the FDIC.

Once a case has been referred to DOJ, it has concurrent jurisdiction to address the violation. In the Policy Statement on Discrimination in Lending, the FDIC and other federal regulators agreed that when a referral has been made, the "agencies will coordinate their enforcement actions and make every effort to eliminate unnecessarily duplicative actions."[10] The FDIC is currently reviewing all cases involving possible discriminatory practices that have been referred to DOJ for appropriate enforcement action. We intend to pursue these cases aggressively and to move forward in a timely manner.

The statutory remedies available to DOJ differ from those available to the FDIC. The FDIC can order the bank to cease and desist from a discriminatory practice and pay restitution to

[8] For an FHA violation that does not also constitute a pattern or practice violation of ECOA (and thus trigger referral to DOJ), the FDIC must provide notice to HUD and to the applicant. .*See* 12 U.S.C. § 1691e(k).
[9] *See* Policy Statement on Discrimination in Lending, April 15, 1994, 59 FR 18266-01 at 18271.
[10] *See* footnote 9.

those injured by the discrimination. DOJ can seek these same remedies, as well as punitive damages for the aggrieved party.[11]

Since 2002, the FDIC has referred to DOJ 181 findings of illegal discrimination under ECOA. DOJ deferred to the FDIC's administrative handling of the matter in 169 of the cases during that time frame.[12] In those cases, the banks were required by the FDIC to remedy the harm experienced by affected consumers and to advise the consumers of their right to pursue legal action, and ordered to stop engaging in illegal discrimination.

Improvements to FDIC Fair Lending Examination Program

The FDIC regularly reviews all of its examination programs and supervisory activities to determine whether changes can be made to improve their effectiveness. In 2001, the FDIC created the position of Senior Fair Lending Specialist in the Washington Office to provide expert advice and counsel to examiners and to help oversee the fair lending examination program. In 2004, Fair Lending Examination Specialist (FLEX) positions were created in FDIC regional offices to increase the availability of subject matter experts. The FLEXs work with the Senior Fair Lending Specialist to ensure consistent application of policies and procedures, assist with the most difficult and complex examinations, and review proposed fair lending actions. They also serve as the principal instructors for the one week Fair Lending Examination School that all compliance examiners attend as part of their basic training.

[11] 15 U.S.C. §1691e(h).

[12] The examination date where a discrimination violation is cited, the referral to DOJ, and any subsequent referral back to the FDIC for administrative handling may not occur in the same calendar year.

In addition to the Fair Lending School, a new Advanced Compliance Examiner School includes a day-long module on how to conduct fair lending examinations based on the HMDA pricing data. This training incorporates lessons learned from the first two years of working with that data, which resulted in some of the most complex fair lending reviews FDIC examiners had experienced. Fair lending training also is conducted at regional and field office training conferences, and through national teleconferences. For example, a recent presentation reviewed DOJ redlining cases and relevant procedures that examiners should use when they identify risk factors during fair lending and CRA examinations.

FDIC's CRA Review and Evaluation Process

CRA was intended to expand access to credit and reduce discriminatory credit practices. Consistent with safe and sound operations, CRA assigns regulated financial institutions a "continuing and affirmative" obligation to help meet the entire credit needs of their communities, including the needs of low and moderate income neighborhoods.[13]

CRA Performance Reviews

Consistent with statutory requirements, FDIC examiners evaluate CRA the performance of the approximately 5,200 institutions under the Corporation's supervision.[14] For most institutions, this performance is evaluated under tests that draw distinctions among institutions

[13] *See* 12 U.S.C. §2901(a).

[14] As with consumer compliance examinations, an institution's size and examination history determine the frequency with which its CRA performance is evaluated. The CRA frequency schedule incorporates limits imposed by the Gramm-Leach-Bliley Act of 1999 on CRA evaluations of small institutions, i.e., those with $250 million in assets or less, that have previously received strong CRA ratings. *See* 12 U.S.C. §2908.

based on their size and business strategies.[15] When conducting CRA evaluations, examiners consider factors such as the business opportunities available, as well as the size and financial condition of institutions.[16]

Lending institutions with assets greater than $1.033 billion (adjusted annually) are subjected to a three-part examination.[17] These banks are evaluated through a lending test that considers the number and percentages of loans made to low- and moderate-income individuals and communities. They also are subject to investment and service tests that consider, respectively, the number and types of investments and services provided in low- and moderate-income communities.[18] In recent years, the FDIC and the other banking regulators established a streamlined examination for "intermediate small banks" (ISBs).[19] ISBs undergo a lending test and a community development test.[20] The community development test scrutinizes the amount and responsiveness of an ISB's community development lending, investing, and services.[21] This approach was intended to permit ISBs to make use of a flexible combination of community development activities tailored to both the needs of the community and the capacity of the bank.[22] ISBs are required to achieve satisfactory ratings on both the lending and the community development test to receive an overall CRA rating of "Satisfactory."[23]

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[15] Notably, all institutions may develop their own strategic plans to fulfill CRA responsibilities, subject to public comment and agency approval. *See* 12.CF.R. §§345.21(a)(4) and 345.27.
[16] *See* FDIC Compliance Handbook, Chapter XI (Community Reinvestment Act), http://www.fdic.gov/regulations/compliance/handbook/html/chapt11.html.
[17] *Id.* at §345.21(a)(1).
[18] *Id.* at §345.21(a) and §§345.22-345.24.
[19] With the understanding that the asset range would be adjusted annually to take inflation into account, ISBs were initially defined as institutions with assets of $250 million to $1 billion. Currently, ISBs have assets that range between $258 million and $1.033 billion. *Id.* at §345.12(u)(1).
[20] *Id.* at §345.26(a)(2).
[21] *Id.* at §345.26(c).
[22] *See* 70 FR 44256, 44259-60 (Aug. 2, 2005).
[23] *See* 12 CFR §345, Appendix A at (d)(3)(i).

Small banks[24] are evaluated under a test that focuses on their lending performance. The test encompasses the following five criteria: a "reasonable" loan-to-deposit ratio; the percentage of loans in the bank's assessment area; the bank's distribution of loans to individuals of different income levels and to businesses and farms of different sizes; the geographic distribution of loans; and the bank's record of responding to written complaints about its lending performance in its assessment area.[25] Most FDIC-supervised institutions qualify as "small" under CRA.

CRA Performance Context and Data Used by Examiners

An institution's performance under all of the relevant CRA tests is judged in the context of information about the institution, its community, its competitors, and its peers. Examiners consider the following information, as appropriate, in order to assist in understanding the context in which the institution's performance should be evaluated: (1) the economic and demographic characteristics of the assessment area(s); (2) lending, investment, and service opportunities in the assessment area(s); (3) the institution's product offerings and business strategy; (4) the institution's capacity and constraints; (5) the prior performance of the institution and, in appropriate circumstances, the performance of similarly situated institutions; and (6) other relevant information.[26] Some of these elements, such as the lending, investment, and service opportunities in the area, are difficult to assess. However, advances in technology and the availability of various economic, demographic and business data through private and public sources greatly assist examiners as they evaluate an institution's performance context.

[24] Small banks were originally defined as institutions with less than $250 million in assets. As with institutions of other sizes, the asset maximum is adjusted annually to take inflation into account. Currently, the cap is $258 million. *Id.* at §345.12(u)(1).
[25] *Id*. at §345.26(b).
[26] *Id*. at §345.21(b).

In addition, large banks must report information about their small business, small farm, and community development loans.[27] If a bank is a HMDA reporter, examiners can consider the institution's historical mortgage loan performance as well as its performance against other market participants, including the performance of other federally supervised institutions and independent mortgage companies. In the absence of HMDA or other reported data, examiners sample an institution's home mortgage, small business, small farm, and community development loans, as applicable. Consumer loans are also sampled if the institution requests that they be reviewed or if they represent a substantial majority of the institution's business.

Achieving Accuracy and Consistency

The FDIC follows a number of procedures designed to promote accuracy and consistency in the CRA evaluation process. Before examiners are permitted to lead a CRA performance evaluation, they must complete a commissioning process which includes specialized CRA training. Extensive written guidance is available to examiners as they prepare performance evaluations. Once evaluations are written, the evaluations are subject to supervisory review before they are finalized and published. In addition, we periodically conduct field and regional office reviews that sample and assess the quality of performance evaluations that have already been issued. The FDIC continually assesses our efforts to achieve consistency and accuracy in CRA evaluations and to adjust and expand procedures as warranted. This is an ongoing process.

[27] *Id*. at §345.42.

CRA Evaluation Process

Upon the conclusion of each examination, the examiner prepares a written evaluation of the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods.[28] The written evaluation must have a section available for public disclosure.[29] The FDIC and other financial institution regulatory agencies facilitate public review of CRA evaluations by posting them on their Internet websites.

Each CRA evaluation must contain the institution's rating and a statement describing the basis for the rating.[30] While the content of the public evaluation varies depending on the nature of the institution examined and the assessment method used, the public portion of the evaluation generally contains the following information:

- The institution's CRA rating;
- A description of the financial institution;
- A description of the financial institution's assessment area; and
- Conclusions regarding the financial institution's CRA performance, including the facts, data, and analyses that were used to form such conclusions.[31]

[28] *See* 12 U.S.C. §2906(a)(1).
[29] *See* 12 U.S.C. §2906(a)(2).
[30] *See* 12 U.S.C. §2906(b)(1)(iii).
[31] *See* FDIC Compliance Handbook, Chapter XI (Community Reinvestment Act Performance Evaluation Templates), http://www.fdic.gov/regulations/compliance/handbook/html/chapt11.html.

Nature and Effect of CRA Ratings

The agencies assign each institution one of four performance ratings: "Outstanding," "Satisfactory," "Needs to improve," and "Substantial noncompliance."[32] Determining the CRA rating for an institution involves an assessment of a number of qualitative and quantitative factors against the backdrop of the institution's performance context. To foster consistency in this process, the agencies rely on a matrix which sets forth a description of the elements of the various tests and what performance level is required for each of the ratings.[33]

Unlike fair lending violations, which can be addressed through mandatory corrective action and financial penalties, CRA is enforced through the application process and the public disclosure of ratings. The FDIC takes an institution's CRA performance into account when evaluating its applications for deposit facilities.[34] Such applications must be submitted when an institution proposes to open a branch, relocate a home office, merge, or acquire another institution.[35] In evaluating these applications, the FDIC must take into account the applicant institution's CRA performance, as well as the views expressed by any interested parties about an institution's CRA performance.[36] The FDIC can deny or conditionally approve applications based on CRA concerns.[37]

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[32] *See* 12 U.S.C. §2906(b)(2).
[33] *See* 12 CFR §345, at Appendix A (FDIC publication of ratings matrix used by all of the financial institution regulatory agencies.)
[34] *Id.* at §345.29.
[35] Of course, where an applicant proposes to charter a new institution, the FDIC also considers how the applicant proposes to meet its CRA objectives. *See* §345.29(b).
[36] *Id.* at §345.29(c).
[37] *Id.* at §345.29(a).

The Effect of Fair Lending Violations on CRA Ratings

Consistent with interagency regulatory guidance, illegal credit practices, including violations of the fair lending laws, are considered when evaluating CRA performance and may result in a lower CRA rating. The FDIC regulation covering discriminatory or other illegal lending practices, amended in 2005, states that:

> The FDIC's evaluation of a bank's CRA performance is adversely affected by evidence of discriminatory or other illegal credit practices in any geography by the bank or in any assessment area by any affiliate whose loans have been considered as part of the bank's lending performance.[38]

Evidence of discriminatory or other illegal credit practices considered as part of the CRA evaluation includes, but is not limited to:

- discrimination against applicants on a prohibited basis in violation, for example, of the Equal Credit Opportunity Act or the Fair Housing Act;
- violations of the Home Ownership and Equity Protection Act;
- violations of section 5 of the Federal Trade Commission Act;
- violations of section 8 of the Real Estate Settlement Procedures Act; and
- violations of the Truth in Lending Act provisions regarding a consumer's right of rescission.[39]

The 2005 amendments strengthened the CRA regulations in several respects. First, they expressly incorporated into the regulation the specific statutory examples cited above. Second, the amendments clarified that illegal credit practices carried out in any geography could be

[38] *Id*. at §345.28(c)(1).
[39] *Id.*

adversely considered by the regulators. This part of the amendment made clear that the agencies could consider lending discrimination that had occurred outside a financial institution's CRA assessment area.[40] Finally, the amendments added express coverage of illegal credit practices by an affiliate within the institution's assessment area if the relevant lending was considered as part of the institution's CRA performance evaluation.

The effect of an illegal credit practice by an institution is determined in the overall context of the institution's CRA performance. The FDIC's regulation states that in determining the effect of evidence of such practices on the bank's assigned rating:

> the FDIC considers the *nature, extent, and strength* of the evidence of the practices; the policies and procedures that the bank . . . has in place to prevent the practices; any corrective action that the bank . . . has taken or has committed to take, including voluntary corrective action resulting from self-assessment; and any other relevant information.[41]

In order to determine the impact of an illegal credit practice on an institution's CRA rating, examiners follow a deliberative process. First, they use interagency examination procedures[42] to assign a preliminary CRA rating based in the performance tests described earlier. Examiners then review the results of the institution's most recent compliance examination, which includes the fair lending review, to determine whether evidence of discriminatory or other illegal credit practices has been found. If that is the case, examiners consider the nature, extent,

[40] Under the CRA regulations, a bank chooses one or more assessment areas within its geographic regions which the FDIC uses to evaluate the bank's record of helping to meet the credit needs of its community. *Id.* at §345.41.
[41] 12 CFR § 345.28(c)(2) (emphasis added)
[42] These procedures have been incorporated into the FDIC Compliance Handbook at Chapter XI (Community Reinvestment Act), http://www.fdic.gov/regulations/compliance/handbook/html/chapt11.html

and strength of the evidence, as required by the regulation. Through this analysis, they determine the extent to which illegal credit practices will affect the institution's CRA rating.

For FDIC-supervised institutions evaluated between January 1, 2002 and September 30, 2007, fair lending violations resulted in 14 CRA rating downgrades: three downgrades to "Satisfactory", and eleven to "Needs to Improve."

Conclusion

The CRA was adopted to address redlining and over its 30-year history has made a significant contribution to the revitalization of many low and moderate income communities in both urban and rural areas. Fair lending examinations are critical to achieving complete and accurate CRA reviews. The FDIC is committed to using CRA and fair lending laws in the continuing effort to address the credit needs of low and moderate income areas and individuals.