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COMMUNITY
REINVESTMENT ACT

Preliminary Results of GAO's
Study on CRA Problems and
Proposed Reforms

Statement for the Record
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Ms. Chairwoman and Members of the Subcommittee:

This statement provides the preliminary results of our study of the implementation of the Community Reinvestment Act (CRA), which we have shared with your staffs in recent briefings. Our report is currently being drafted and reviewed internally. While we have discussed our preliminary findings with the federal bank and thrift regulatory agencies (regulators), we have not yet provided them a draft report for official agency comment. In addition, the regulators have not finalized the proposed regulations. Consequently, while we are pleased to respond to your request to share our preliminary results with you for your deliberations on CRA, we must note that these results are not yet finalized.

Our study was initially requested by former Committee Chairman Gonzalez and former Subcommittee Chairman Kennedy. Our study objectives were to address the following four questions: (1) What were the major problems in implementing CRA, as identified by the affected parties (bankers, regulators, and community groups)? (2) If adopted, to what extent would the regulators' reforms address these problems? (3) What challenges would the regulators face in ensuring the success of the reforms? (4) What initiatives have been taken to overcome community lending barriers and enhance lending opportunities, particularly in low- and moderate-income areas? To identify the major CRA implementation problems, proposed solutions, and examples of initiatives to enhance community lending, we interviewed bankers and examiners in 40 judgmentally-selected case studies, representing banks and thrifts (banks) of different sizes and types, with different CRA ratings located in different regions of the nation. We obtained additional perspectives from interviews with officials from community groups, industry groups, and regulators in Washington, DC. We also reviewed public comment letters on the initial and amended proposed CRA regulations issued by the regulators as part of our assessment of the proposed reforms.

As you know, CRA has been controversial since its enactment in 1977. CRA requires the regulators to encourage banks to help meet credit needs in all areas of the communities they serve, including low- and moderate-income areas, consistent with safe and sound operations. CRA also requires the regulators to assess banks' community lending performance during examinations. Community groups urged its passage to curb what they believed to be a lack of adequate investment in low- and moderate-income areas. Bankers generally opposed CRA as an unneeded measure that could unduly affect business decisions and mandate relatively low-profit lending that could conflict with other responsibilities to ensure safety and soundness. In more recent years, changing market conditions, along with increased public disclosure about banks' home mortgage lending, have raised concerns by bankers about the issues of competition and

regulatory burden. More specifically, bankers are concerned about advantages for nonbank financial institutions, such as mortgage companies, that compete with banks but are not subject to CRA requirements. They are also concerned that the cost and paperwork burden imposed by CRA is not offset by positive incentives to encourage CRA compliance. For example, bankers would like protection against CRA-based protests of applications for expanding depository facilities. Federal regulators are required by the CRA to take a bank's CRA record into account when considering certain types of applications from depository institutions, including applications for mergers and acquisitions of depository institutions. On the other hand, community groups have raised concerns about limited CRA enforcement, particularly against poor performers that have no plans to expand, and insufficient disclosure of information on banks' community lending performance.

In response to these concerns, both the administration and Congress have looked for ways to make CRA more effective and less burdensome. The regulators' reform initiative, announced by the President in July 1993, established goals to base CRA assessments more on results than paperwork, clarify performance standards, make assessments more consistent, improve enforcement, and reduce the cost and burden of compliance. The regulators conducted a review of the issues and suggested improvements to CRA through a series of public hearings around the nation and in two notices of proposed rulemaking. They received extensive public comments on both the initial and amended proposals and are currently in the process of finalizing the proposed regulations. Congress also enacted legislation to facilitate community lending, such as the Bank Enterprise Act and the Riegle Community Development and Regulatory Improvement Act of 1994, that authorized funds to help finance revitalization projects in low-income areas.

PRELIMINARY RESULTS

Through interviews with bankers, regulatory officials, and community groups, we identified four major problems shared by the affected parties: (1) an overreliance on paperwork focused on documenting efforts and processes rather than results, (2) inconsistent assessments resulting in uncertainty about how CRA performance is to be rated, (3) assessments based on information that may not reflect a complete and accurate measure of banks' performance; and (4) unsatisfactory CRA enforcement.

Our preliminary analysis indicates that the regulators' proposed CRA reforms would address these problems to varying degrees. The reforms would directly address the first problem by proposing a results-based assessment system. The regulators' success in addressing the problems related to inconsistent examinations would largely depend on how effectively examiners use their discretion when implementing the reforms. To address concerns

about information, the reforms would clarify the data to be used to assess performance against results-based standards. However, the affected parties disagree about whether the proposed data collection requirements would provide for meaningful performance assessment or be unduly burdensome. The proposed reforms also would not directly address the different enforcement concerns of bankers and community groups. The regulators dropped a proposal to use existing formal enforcement actions set forth in the banking laws for CRA violations due to a recent Department of Justice opinion that such actions are not within the scope of CRA. The regulators also dropped a proposal that would have clarified how banks' CRA ratings affect applications for expansion due to opposition by community groups to perceived restrictions on application protests.

We also believe from our work to date that the regulators would face significant challenges in successfully implementing the proposed reforms. During implementation, regulators would need to address the problem of examination inconsistency that has not been successfully addressed in the past. We believe that the likelihood of success could be increased if regulators (1) provide clear guidance and comprehensive training for all examiners performing CRA assessments; (2) are more consistent in ensuring that the data banks are required to collect are accurate; and (3) improve disclosure in public evaluation reports of the information and rationale used to determine banks' CRA ratings. In addition, the regulators estimate that the reforms would increase examiner responsibilities, as well as examination time and resource needs. Regulators may need to assess their resource needs and determine what actions, if any, may be appropriate to ensure that CRA examination requirements can be completed without shifting examiner responsibilities back to banks.

We also found that, independent of the regulatory reform efforts, many bankers, regulators, community groups, and others have taken part in a variety of individual and cooperative initiatives to improve banks' community lending and reduce related burdens. Through these initiatives, many banks have been able to overcome real or perceived barriers to lending in low- and moderate-income areas (community lending). Barriers to community lending and investment may include a variety of economic factors, such as higher costs and risks of community lending compared to other lending, and restrictive underwriting requirements of major participants in the secondary mortgage markets. Regulators, to varying degrees, play a key role in facilitating cooperation and disseminating information to banks about such initiatives. More systematic interagency coordination may better utilize limited resources and enhance lending opportunities for all banks.

Numerous alternatives for enhancing banks' lending in their communities have been raised by those we interviewed, as well as others. We have not assessed these alternatives, which range from reforming CRA to replacing CRA with direct financial subsidies to those willing to extend credit to low- and moderate-income areas. To some degree, the range of alternatives may be indicative of broader philosophical differences among the affected parties about banks' obligations for community lending.

Affected Parties Generally Agree
on Major Problems, But Specific
Concerns and Solutions Differ

Our analysis to date indicates that bankers, community groups, and regulators generally agree on four major CRA problems: (1) an overreliance on paperwork focused on documenting efforts and processes rather than results, (2) inconsistent assessments, (3) assessments based on information that may not reflect a complete or accurate measure of banks' performance, and (4) unsatisfactory CRA enforcement.

The specific concerns and proposed solutions of bankers and community groups differed substantially and, to some degree, reflected broader differences among the affected parties about banks' obligations to their communities. Bankers generally analyzed problems in terms of regulatory burden and sought changes that would reduce the burden of paperwork and data reporting. Bankers also generally supported proposals to increase certainty through guarantees ("safe harbor" provisions) that satisfactory or outstanding CRA ratings would protect applications from CRA-based protests. However, they opposed suggestions to increase certainty by establishing objective measures or formulas due to concerns that the standards would not be flexible enough to consider such factors as a bank's business strategy, financial condition, and its community's credit needs.

Community groups, on the other hand, generally analyzed problems in terms of their ability to hold banks accountable for performance and sought changes to increase that accountability, such as having banks publicly report additional data so that their community lending performance could be assessed more easily. Community groups also identified as a problem the fact that regulatory enforcement of CRA was limited to application denials. They pointed out that no sanctions were available to penalize poor performers that did not have plans to submit applications. To strengthen regulators' accountability for enforcing the act, they advocated regulators' use of formal enforcement actions, such as cease-and-desist orders and civil money penalties. They strongly opposed safe harbor provisions.

Reform Proposals Would Address Some,
But Not All, Major Problems

Overall, our preliminary conclusion is that the proposed reforms attempt to address the major problems of the affected parties, but would not, and probably cannot realistically, wholly satisfy the often contradictory proposed solutions of bankers and community groups. The reform proposals, if adopted and effectively implemented, would address the problem of an overreliance on documentation of a bank's compliance efforts and processes by shifting the focus of assessment standards from efforts to results in three performance areas--lending, investment, and services.

We do not believe at this time that the potential effect of the proposed reforms on some of the other problems is as clear. Effective implementation of the reforms is key to addressing assessment-related inconsistency because examiners are to continue to use considerable discretion in assessing a bank's performance. In developing the reforms, the regulators tried to balance the need for objective standards with the need for flexibility in assessing different types of banks operating under differing financial conditions and serving widely different types of communities. Thus, the proposed reforms would also increase examiner responsibilities and heighten the need for comprehensive examiner training and might also increase the time and resources needed to effectively complete examinations.

The proposed reforms also may not address the problem of data adequacy for performing CRA assessments because the affected parties do not agree on what data should be collected. The proposed reforms would establish data collection requirements to assess banks' CRA performance. However, bankers expressed concern about whether the proposed data collection requirements would be too burdensome and appropriately reflect lending results. On the other hand, community groups expressed concern that the public is not provided with adequate information about banks' actual lending performance. Moreover, the reforms would not address regulators' concerns about inaccurate data provided by banks.

The proposed reforms also would not address the universal, but differing, dissatisfaction with regulatory enforcement of the act. The reform proposals initially sought to strengthen enforcement by calling for regulators to use existing formal enforcement actions set forth in the banking laws, such as cease-and-desist orders and civil money penalties. However, the Department of Justice issued an opinion in late 1994 that such actions are not within the scope of CRA. Also, the reforms would have addressed bankers' concerns by specifying how CRA ratings would be considered in applications, i.e., a "satisfactory" or better rating would generally result in the approval of an

application. However, many commentators objected to the perceived restriction on public protests. Consequently, both of these proposed measures have been dropped from consideration by the regulators.

Challenges to Successfully Implementing Reforms

We believe that successful implementation of the reforms would require regulators to meet significant challenges that have not been met in the past. Specifically, to improve the consistency of examinations, regulators would have to provide clear examination guidance and comprehensive training for all examiners in areas that many examiners believe has been lacking. These areas include how to analyze relevant information, how and when examiners should apply discretion, and how examiners should consider unique types of programs and products that bankers may devise to address special needs in low- and moderate-income areas of their communities.

Another implementation challenge indicated by our analysis would be to ensure that lending and other data needed for results-oriented assessments are accurate and accessible. Some of the regulators have acknowledged that data quality problems exist, but their responses to banks with poor data quality have not been consistent. For example, FDIC has assessed civil money penalties for late or inaccurate reporting while the Federal Reserve has required banks to resubmit data reported inaccurately. Also, community groups have commented that the public evaluation reports do not provide sufficient information about banks' actual lending performance and the regulators' rationale for the assessment ratings.

Finally, our case studies indicate that some examiners may have lacked the time during examinations to perform many data gathering and analyses tasks regarded as critical to CRA assessments, such as making contacts in the community to assess community needs. Some regulatory officials estimate that implementation of the proposed regulations may require additional time and examiners. Recognizing that they may be facing resource reductions, some regulators are developing new techniques to reduce examination time. If not successfully addressed, examiners may either not perform needed analyses or shift responsibility for conducting such analyses to the banks. This response could reduce the quality of assessments and increase banks' related burdens.

Initiatives Have Overcome Some Barriers to Community Lending

Our analysis of successful community lending initiatives also indicates that having good communication and cooperation among

regulators, bankers, and community groups is key to overcoming lending barriers. In such initiatives, banks have made community lending an integral part of their business strategies; involved community groups in their plans and programs; and developed targeted underwriting standards, programs, and products to meet community needs. We also learned of community lending initiatives that may overcome perceived or actual barriers to lending in low- and moderate-income areas. Barriers described by bankers included higher transaction costs and credit risks, as well as restrictions related to secondary mortgage market underwriting standards. Some bankers have found ways that may lower the relatively high transaction costs and credit risks of community development loans by sharing those costs and risks through participations in multi-bank programs. In addition, some major participants in the secondary mortgage markets have recently undertaken initiatives intended to make them more responsive to community development concerns.

We have also found that regulators, to varying degrees, play a key role in helping banks to enhance their community lending programs. Using the available resources of their community affairs programs, some regulators have helped facilitate community development by disseminating information about various community lending techniques and investment opportunities. The resources and longevity of the regulators' community outreach programs differ. For example, the Federal Reserve's program has 70 full-time staff and was established in the early 1980's, while the Office of Thrift Supervision and the Office of the Comptroller of the Currency have less than 10 full-time staff in their recently established programs. More systematic coordination of these programs may better utilize limited resources and enhance lending opportunities for all banks.

Bankers Have Suggested Positive Incentives to Encourage Community Lending

Finally, in order to encourage banks to lend to all parts of their communities, bankers have suggested that CRA be replaced or supplemented with financial subsidies or other positive incentives. One example of such a subsidy is the Bank Enterprise Act, under which banks offering checking account and loan services in qualifying low-income areas are eligible for incentive grants. Others have called for modifying or supplementing CRA with incentives such as tax credits, deposit insurance credits, streamlined or less frequent examinations, revisions of safety and soundness requirements for CRA lending, broadening the base of banks and organizations that can buy low-income housing tax credits, and permitting below market financing for community development lending programs with supporting funds coming from FDIC or other regulatory premiums. Some of these proposals have been included in legislative proposals for congressional consideration.

PRELIMINARY CONCLUSIONS

On the basis of our work, we believe that the following actions by federal bank and thrift regulatory authorities could help improve the certainty and consistency of CRA examinations during implementation of the proposed regulations:

- Revise regulatory guidance and training programs by clarifying how examiners should interpret the performance standards and require that all examiners receive comprehensive training necessary to implement the new regulations.
- Ensure that the information used to assess performance is accurate and that regulatory actions to improve data accuracy are consistent.
- Improve disclosures in publicly available evaluation reports by more clearly presenting the information and rationale used to determine banks' performance ratings.
- Assess agency resource needs and determine what actions should be taken to ensure that CRA examination requirements can be completed without shifting examiner responsibilities back to banks.
- Improve interagency coordination of community affairs programs to better educate bankers and community groups on strategies that have been successful in serving communities' needs, including those in low- and moderate-income areas.

Finally, should the proposed CRA reforms, once implemented, prove to be insufficient for improving CRA performance and reducing regulatory burden, Congress may wish to consider whether alternative approaches would better enhance banks' community lending.

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This concludes our statement. Thank you for the opportunity to provide our preliminary views.

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