Statement of Ellen Seidman
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Improving CRA for Community Development: Geographic and Other Considerations

Governor Duke, Vice Chairman Gruenberg, Mr. Wides, Mr. Barnes, thank you very much for holding these hearings and for inviting me here today to participate in them. The massive shifts in the financial services industry since the last major CRA regulatory revision in 1995, the current economic situation—which has disproportionately and greatly hurt communities and families most affected by CRA , and the ongoing restructuring of the financial services and financial services regulatory system all make your focus on revising CRA regulations both timely and important. Your decision to work together and to reach out openly and interactively, as well as the staff work that has gone into developing the hearing agenda, gives those of us who believe this statute and regulations are extremely important to the health of our nation confidence that you will come to a timely and positive conclusion. This is difficult. Good regulations must both provide guidance and a degree of certainty and, especially in this field, leave room for creativity, innovation and thoughtful evaluation. Thank you for taking on the task.

My name is Ellen Seidman. I am testifying here today in my capacity as former Director, from 1997 to 2001, of the Office of Thrift Supervision. As many of you know, I was a strong supporter of CRA during my tenure, and worked hard to ensure that OTS institutions not only understood their obligation under the statute but also understood that meeting that obligation in a responsible, thoughtful way, would be beneficial not only to the communities in which the institutions worked, but also—since the health of a community bank is heavily dependent on the health of the communities in which it works—beneficial to the institution itself. We also stressed examiner education, training and recognition for thoughtful, forward-looking work. Much work in this field, especially relating to community development activities, is complex and unfamiliar even to examiners well versed in the other aspects of compliance and community affairs. Without sufficient training to understand how deals are put together; the various roles banks can play in the planning and execution of these activities—which sometimes take place over several years and involve many private, public and philanthropic partners; and the importance of intermediaries with the capacity, both intellectual and financial, to actually meet community needs, it is all too easy to turn CRA into simply a numbers game. That hurts both the communities at risk and the institutions that are trying hardest to serve them well.

While I learned a lot about CRA and its implementation as Director of OTS, my remarks today are also informed by my experience both before and after my OTS tenure, including five years at Fannie Mae (from 1987 to 1993) and work with ShoreBank (in the consulting firm and holding company, from 2002 to the present) and on the Boards of three major Community Development Financial Institutions (CDFIs), the Low Income Investment Fund; Coastal Enterprises, Inc; and City First Bank of DC. I have also been influenced and educated by a series of extremely thoughtful discussions over the course of the last several years with many colleagues in the regulatory, banking and community development fields. The views I express today reflect those discussions. My views are personal and not those of any institution with which I am affiliated.

My remarks today focus on community development. I will cover geographic considerations, the performance tests and examiner judgment and training. I would like to start with a few basic premises. First, I think it's important to say it once again: CRA did not cause the current economic problems, nor play a major role in their development. Work of number of scholars, including several at the Federal Reserve Board and the Federal Reserve Banks, has demonstrated that very little high cost mortgage lending was done by institutions subject to CRA in their CRA assessment areas. Other findings by some of those same scholars that many institutions subject to CRA, both directly and through affiliates, did a good deal of high cost lending <u>outside</u> their assessment areas, say troubling things about the lack of reach of CRA, and strongly suggest that affiliates that are engaged in activities that a bank could directly do itself should be covered. But the necessary conclusion is that CRA lending was not the culprit. Other studies demonstrate that CRA-qualifying loans made by CRA-subject lenders have performed better than non-CRA loans made to similar borrowers. And much of the debacle cannot be laid at the feet of commercial banks and thrifts at all. Private conduits, the highly-leveraged investment banking industry, the ratings agencies and world capital markets all were significant elements in the disaster, and they had little if anything to do with CRA.

Second, community development has been a consistently successful element of CRA. Conversely, CRA is a necessary, although not sufficient, condition for implementation of community development. CRA has encouraged banks and thrifts to provide the funds that leverage government and philanthropic support to enable community development activities to reach the scale necessary to make a difference and to achieve sustainable market-level returns. It has also encouraged banks and thrifts to contribute to the financial and technical capacity of the intermediaries that do much of the hard work in community development. These CDFIs, CDCs and other similar entities work with communities to assess their needs; pull together both the community support and the financial resources to get the job done; advocate for and develop understanding of and expertise in the government programs that bring public purpose to the transactions; and put their own funds at risk, often in subordinated positions. By serving on Board and loan committees; providing equity capital and funds to on-lend; and participating in individual transactions and lending pools for affordable housing, charter schools, economic development, green retrofits and many other purposes, banks vastly leverage their own capacity to meet community needs, as required by CRA.

Notwithstanding CRA's community success in spurring and supporting community development, there is room for improvement

Notwithstanding this success, CRA could, with some regulatory changes, be far more effective. For example, the fragmentation of community development among the three large-bank CRA tests frustrates efforts to address community development needs in a comprehensive and integrated way and elevates form over substance. This is exacerbated by the fact that community development loans effectively count only as "extra credit" while community development investments are at the heart of the investment test. A related problem is that the inclusion of MBS purchases as investments rather than loans detracts from true community development activities, such as economic development, affordable housing and community facilities. Conversely, some important community development activities, such as providing non-financial technical assistance and services to community development entities, don't count at all as a community development service.

An equally fundamental problem is that all too often all too often, community development activities are looked at only in their quantitative dimension, that is, how much money was lent or invested? This is in part an issue of examiner training, but it is even more related to the concept of "limited-scope examination." Thus, while the examiner handbooks recognize that appropriately evaluating a community development activity requires attention to both the quantitative (how much?) and qualitative (how effectively did this meet community needs, what was the bank's role—did it lead or simply participate in funding), in a limited scope examination, which is what happens in assessment areas outside of those in which banks have a significant portion of their deposits, only the quantitative is considered.[1] The effect is to reduce banks' incentives to do the hard work that is often essential to meeting community needs in favor of, for example, simply buying mortgage backed securities backed by loans in the "right" location, or providing senior debt to an affordable housing project that, while useful, may not meet a community's most urgent needs. This is not to denigrate quantity. How much is still important. Rather, it is to ask that leadership, partnership and overcoming barriers be recognized and thus encouraged.

Uncertainty also permeates the system. Community development projects are often large, complicated, multi-year and multi-party affairs. Many are already subject to significant uncertainty with respect to garnering community support, the availability of government support (e.g., tax credits), local political issues (including permitting), and pulling together multiple sources of financing. Banks have limited incentive to choose this level of difficulty over a simpler, if less impactful, way of responding to CRA. If it is uncertain whether a bank will get

[1] See for example, OCC examiner guidance at http://occ.treas.gov/ftp/bulletin/2000-35a.pdf, at pages 9-10.

CRA credit for undertaking the more difficult activity, making the choice that better responds to community needs is even more difficult to justify.

Making CRA more effective in promoting community development

How can regulators make CRA more effective in promoting community development? By focusing attention on community needs, providing a greater degree of certainty than is now the case, and incenting institutions to go beyond the simple and easy. I also suggest that it is time to recognize different roles for different types of banks. Even leaving aside truly small, local, community banks, a billion dollar bank that is located in a single metro area is quite different than a regional bank, which in turn is different from a bank that covers much of the nation with branches, which in turn is different from a bank that essentially has no geography.

Better define community needs and capacity

The strategy, as the statute, starts with community "needs." The question is how to define them. Right now, especially for larger institutions, the needs assessment is undertaken in connection with an examination, and is individually done for each institution for each assessment area that receives a full scope examination. The problems with this system are multiple: the needs assessment is done after the institution acts; there are multiple, overlapping and potentially inconsistent needs assessments for a given area; examiners have insufficient time and frequently expertise to do the job right; there is lack of coverage for many assessment areas; and the name confuses needs assessments with assessment areas and ignores capacity to meet those needs.

How to fix the problem is less clear. But here is one suggestion: create the concept of a "community needs and capacity analysis" that banks' community development activities would be evaluated against. The needs analysis would start with community development needs, but would include other types of needs, such as for small business lending or quality consumer financial services. The concept of "capacity" would put greater focus on identifying, and, if needed, creating or enhancing local institutional capacity for community development.

On an inter-agency, and rolling periodic basis (e.g., every three to five years), the agencies would either undertake themselves, or commission from a respected third party, such as a university, foundation, or consortium of community groups, such a "community needs and capacity analysis" for each of the 50 to 100 largest metro areas[2] and for the remaining portion of each of the 50 states. While this is a significant undertaking, it actually should take less agency and examiner time, and be more comprehensive and accurate, than the current system. All parts of the country, including rural areas and smaller cities, where large institutions are rarely subject to a full-scope exam, would have their needs and capacity assessed, enabling a qualitative assessment of activities in those areas. Because the analysis would be done on an inter-agency basis, inter-agency discrepancies as to "what counts" should be diminished. The analysis could also reflect the priorities of government entities that would be likely to participate in some of the community development activities and could be informed by, e.g., work on financial services needs by the new Consumer Financial Protection Bureau. The analysis would be subject to public comment and publicly available, which means that smaller institutions would also have the benefit of the work. The concept is conducive to a pilot project in a place where collaborative efforts of this type are already under way, such as Cleveland.

Evaluate an integrated community development test

Establishing a comprehensive analysis of needs will only make it more obvious that effectively responding to those needs requires focused and integrated action. The current tri-partite community development system for large banks works against this. By giving virtually no credit for community development loans, a good deal of credit for investments, and very limited credit for community development services, the system encourages unproductive structuring and discourages integrated responses. The intermediate small bank unified community development test appears to avoid this problem, although there is some concern

[2] The 50 largest metro areas had a population of approximately 164 million in 2008, or about 55% of the total national population. The 50th largest, Raleigh-Cary, NC, had approximately a population of about 1.1 million. The 100 largest metro areas had a population of approximately 199 million in 2008; Modesto, CA, the 100th, had a population of approximately 500,000.

that if the test were made applicable to larger institutions, the most valuable type of support for intermediaries, namely equity support, would dry up. Regulators should undertake an evaluation of whether the ISB community development test has in fact encouraged integrated activity through use of the most appropriate financial tools, and use this to both improve the ISB test and develop a similar strategy for large banks, keeping in mind the equity support issue.

Reduce uncertainty

The concern about uncertainty can be met in a number of ways. The most traditional would be a private letter ruling system much like the agencies had before about 1998 and that exists at the Internal Revenue Service. The agencies should reconsider the decision to do away with this system, in essence in favor of a Q&A system that is no more efficient and almost certainly less timely. On the other hand, this type of system is a significant bureaucratic undertaking and far more difficult with multiple agencies involved. A second alternative would be to reinvigorate the strategic plan concept, but focus it primarily on community development. Community development activities are usually large, collaborative, highly public, and take a good deal of time. A strategic plan would enable institutions to publicly plan and announce their intentions to undertake such activities, with the certainty of receiving a specific degree of credit for success. Given the level of uncertainty inherent in these types of activities, however, an institution that does not meet its plan goals should be able to demonstrate that it has met community needs through a more traditional analysis. A third alternative would build on the "community needs and capacity analysis." Institutions that engage in activities that are specifically identified in the analysis would be guaranteed credit for those activities, subject to any geographic requirements (see below).

Support partnership building with credit for loans to and investments in intermediaries dedicated to community development, no matter where located

Banks also need to be assured of credit when they engage in partnership building, especially in parts of the country that are not in the assessment areas of many institutions.

These are the places where the capacity to meet community needs is in short supply. Community development intermediaries, such as CDFIs, CDCs, multi-state investment funds and others that are focused on creatively and constructively responding to community needs in lower income communities need equity capital, loan capital, and the expertise and experience banks can provide. In turn, the intermediaries are good conduits for banks that may not want or be able to provide financing directly. They offer scale efficiencies, risk diversification, expertise and tailored systems that enable banks to have significant impact without building their own. Similarly, banks should be given credit for activities that create and enhance the secondary market for community development loans. Nascent efforts to create this market ground to a halt in the more general secondary market freeze. Moving the market again, which requires assistance with structuring, credit support, and purchases, is important to enhance the efficiency of community development lending

By making CRA credit certain for loans to and investments (including equity investments) in and providing expertise to, these organizations, no matter where they are located, the agencies could have an enormous positive effect on the ability of banks and other institutions to meet the most challenging community needs.

Improve effectiveness by better differentiating among sizes and types of institutions, especially with respect to assessment area responsibilities

Regulators have long recognized that not all institutions are the same for CRA purposes; in both 1995 and 2005 size differentiations were added to the functional differentiations that had long been part of the system. However, this is in need of additional updating. The size variations now are so large they are qualitative as well as quantitative, especially with respect to how each type of institution can effectively meet community development needs. Each of the largest four institutions has over $1 trillion in assets. Fifteen additional institutions (including some related to the top 4) have between $100 and $300 billion in assets. Several of the top 50, some affiliated with enormous holding companies, are essentially branchless. Yet the 100th largest institution has barely over $10 billion in assets.

This suggests the possibility of a typology of institutions with respect to community development (and perhaps other) CRA obligations. True community banks—those operating from branches within a limited number of states—should be expected to meet the community development needs of the places where they operate, as at present. Regional institutions with branches would similarly be expected to meet their communities' needs. However, many of these institutions have the financial and technical capacity to be helpful outside of their assessment areas, in places where community needs often exceed the capacity of local institutions. If these regional institutions have earned satisfactory ratings in their own assessment areas, they should be provided the incentive of achieving an outstanding overall rating by serving the community development needs—including partnership building needs—elsewhere.

The largest of the brick and mortar multistate institutions—for example, those with more than $100 billion in assets—would, in addition to assessment area evaluations, be subject to an "institutional community development evaluation" which will consider how well the institution meets "special community development needs." These would be regulator-defined needs that are beyond the capacity of local institutions (the case in many small towns and rural areas) or require a level of investment and expertise the largest institutions have. This list would change, and could include in addition, difficult or long-term national needs such as affordable housing preservation, regional economic development and green building that benefits low and moderate income communities, tax credits for special needs housing and equitable transit-oriented development.

Finally, the large non-brick and mortar institutions, such as investment banks, wholesale banks, credit card banks and internet banks, which do not serve any particular geography, should not have local assessment areas at all. Instead, they should be expected to meet community development needs on a national basis, working from the regulator-defined list of special community development needs and places in particular need. A strategic plan could be a very useful way for these institutions to commit to the needs they would focus on. In addition to focusing resources where they are most needed, this would help reduce the sometimes dysfunctional competition for "CRA loans" in places where these and other large banks congregate for business reasons unrelated to serving the local population.

Improved examiner training and enhanced examiner judgment are essential to better CRA community development evaluations

While these suggestions can ultimately bring both efficiency and certainty to the community development aspects of CRA, doing them well requires well trained and informed examiners, who are both allowed and encouraged to exercise judgment. Examiners need regular training in the frequently-changing community development opportunities, strategies and structures. They need access to subject-matter experts, including experts from outside the agencies who are on call for this purpose. Community development needs and capacity analyses, strategic plans, and private letter rulings could provide an additional framework within which examinations would take place, providing a degree of certainty within which judgment would be exercised. And each agency, as well as the FFIEC, should have reviewers, preferably including people with experience in community development, to provide advice and ensure a level of consistency, including across agency supervisory districts or regions and across agencies.

Conclusion

In taking on comprehensive revision of the CRA regulations, you have agreed to do something extremely important but equally difficult. Hard as the process was in the early 1990s, it is far more difficult now. But the stakes are also much higher. Our nation is in the grip of a serious economic crisis, in which the communities on which CRA is focused have been disproportionately and deeply affected. In many areas, 20 years of progress toward making neighborhoods places where people wanted to live is in serious danger of being totally lost. Banks' CRA activities, both directly and through intermediaries, are largely what brought those communities back once; what you do in this effort may well determine whether the communities are able to recover from the current crisis.