Prepared Testimony of
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Good morning. My name is Michael Stegman. I am Director of Housing and Policy at the John D. and Catherine T. MacArthur Foundation. I represent solely myself at this hearing on the CRA Service Test, and not the Foundation

As background, Prior to joining MacArthur in 2005, I was a professor of public policy at the University of North Carolina where I taught courses and conducted research in housing policy and community development finance for 40 years, which included substantial work on the unbanked, their use of alternative financial services, and the CRA. I have also held senior policy positions at the Department of Housing and Urban Development during the Carter and Clinton Administrations, the latter as Assistant Secretary for Policy Development and Research.

Though a long-term student of the Community Reinvestment Act writ large, I am especially pleased to be testifying at this hearing that focuses on the Service Test. In serving the nation's needs for financial intermediation, a foundational role for banks is to provide a safe and convenient place for individuals to store their excess capital. Only then can these specially chartered organizations meet the consumption and investment needs of those with insufficient savings (through the extension of mortgage and related credit.) That low- and moderate-income populations might not have fair and reasonable opportunities to have their depository and transactional needs met by banks would be an especially egregious failing of our financial intermediation system. This is because, in the words of the vice-chairman of FDIC, "access to a basic bank account and to financial services is a starting point for economic opportunity."[1]

Regarding how well banks are doing in this area, let's look at the record. While we have seen the overall share of all households and all non-Hispanic white households fall by half over the past twenty years to 7.7% and 3.3%, respectively, minorities have made proportionately smaller gains that still leave them very far behind. The share of unbanked black and Hispanic families has fallen from more than one-third in 1989, to 21% in 2009.[2] So, today, we face the unacceptable reality that, relatively speaking, there are

[1] FDIC Releases First National Survey of Banks' Efforts to Serve the Unbanked and Underbanked Banks Offer Products and Services for the Unbanked and Underbanked; Opportunities for Improvement Remain, February 5, 2009.
[2] Data for 1989 is for families as defined by the Survey of Consumer Finances, and defines unbanked as having no "transaction" account. Data for 2009 is from the 2009 FDIC survey of unbanked and underbanked and is for households without either a transaction or savings account.

seven times more unbanked Black and Hispanic households than there are whites—a minority "achievement gap" that should be as unacceptable in the banking sphere as it is in the education sphere. And these figures ignore what FDIC records as underbanked: the 21 million American households,[3] who though banked, rely on higher-cost, non-bank providers to meet a significant portion of their financial services needs. As one might expect, the percentage of underbanked minorities--(44.5% of blacks and 43.3% of Hispanics)—also greatly exceeds that of non-Hispanic whites (14.9%).[4]

Need for Stronger Service Test

The argument for a strong Service Test is greater than ever because financial reforms will tighten access and to consumer revolving credit, while an inevitable return to lower leverage and more conservative mortgage underwriting standards will require more upfront cash to buy a house in the years ahead. And, accumulating savings is all the harder when one lacks an account relationship with a mainstream financial institution.

The service test was created in 1995 as part of a larger overhaul of CRA regulations designed to address widespread complaints that examination standards were vague, burdensome, and left too much room for inconsistency among examiners. Of the three component tests, the service test remains the least performance-driven. The lending test requires extensive quantitative spatial analysis of bank loans as to number and amount, geographic distribution, and borrower characteristics. The investment test focuses primarily on the amount of qualified community development investments. The service test, however, covers several different subjects and includes a broad mix of both quantitative and qualitative metrics. There are two prongs to the service test—retail banking services and community development services.

With regard to retail banking services Examiners consider the "availability and effectiveness" of a bank's systems for delivering retail banking services, specifically:

- The current distribution of branches among low-, moderate-, middle-, and upper-income neighborhoods;
- The bank's record of opening and closing branches, particularly those serving low-and moderate-income (LMI) neighborhoods and individuals;
- The availability and effectiveness of alternative delivery systems serving LMI neighborhoods and individuals; and
- The range and degree of tailoring of services provided in low-, moderate-, middle, and upper-income neighborhoods.

Regarding outcomes on this component of the CRA exam for large banks, research by me and my colleagues at the University of North Carolina has demonstrated the subjectivity and uneven application by examiners of the specified service test criteria. A series of

[3] According to the FDIC, underbanked households are defined as those that have a checking or savings account but rely on alternative financial services. Specifically, underbanked households have used non-bank money orders, non-bank check-cashing services, payday loans, rent-to-own agreements, or pawn shops at least once or twice a year or refund anticipation loans at least once in the past five years.
[4] FDIC National Survey of Unbanked and Underbanked Households, 2009.

much-needed reforms that I discuss at the close of my testimony would make the test more performance-based and would help eliminate the glaring "grade inflation" that we found in our analysis.

What do I mean by grade inflation? Simply that the results of our statistical analysis of 2,000 CRA exams, indicate that under-performing banks—those on the border between a "needs to improve" and a "satisfactory" rating overall—are more likely to receive higher service test scores than other institutions, including some with significantly better lending and investment records (and the higher scores that go with them). Indeed, when banks performed so poorly on the lending and investment tests that they were in danger of receiving a "needs to improve" rating overall, their service test scores were not only much higher than would otherwise be expected, but just high enough to enable them to eke out a "satisfactory" rating overall. This suggests that some CRA examiners, consciously or not, inflate the service test scores of under-performers in order to help them get an overall passing grade.

While not directly addressing the service test in its first-ever national survey in 2008 of what banks were doing to serve the unbanked and underbanked, FDIC's pioneering work strongly implies the need for more performance-based service-test standards. Among other things, this pioneering study found large gaps in participating banks' product offerings. "While most banks, said FDIC, offer basic checking accounts to all customers, few offer deposit, payment, credit and electronically based products that address the unique needs of unbanked and underbanked customers."[5] Lack of profitability "of doing business with unbanked and underbanked individuals," is identified by banks as their greatest defense against the charge that they are not doing enough in this area.[6]

Though no broadly representative reliable data exists, on the profitability of doing business with these populations goes back many years, in my many years of working on issues relating to this issue, I have been told by bankers on more than one occasion that innovative account products at their respective institutions developed specifically for underserved markets were closed down or never permitted to reach scale or maturity because while achieving breakeven or a little more, they failed to meet their institution's internal hurdle rate. This is particularly problematic they tell me because whether or not a particular product passes a hurdle rate may be as much a matter of how a given institution allocates indirect costs on to that product as it does with market response and take up rates.

The debate about profitability and long-term revenue potential of first-account products and customers has been with us about as long as the argument that the unbanked and underbanked are better served and more satisfied in their dealings with non-banks such as payday lenders and check-cashers than they are with banks; if that's true, then why all the fuss?

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[5] FDIC Releases First National Survey…op cit.

[6] Another defense has to do with running afoul of recently imposed "regulatory issues related to anti-money laundering laws and regulations."

My problem with walking away from this issue is two-fold: First, policymakers have insufficient information on the economics of banking services marketed to underserved populations to decide how serious the problem is, and how much, if at all, to ratchet up requirements. At the same time, while there is better and more representative demand-side data showing unbanked and underbanked populations' preferences for non-banks, we must be cautious in interpreting these surveys because they compare fringe banking products against an inadequate menu of mainstream bank products, services, and price points. What is lacking is reliable, generalizable data on the cost and revenue characteristics of a wider array of products, services, and delivery channels targeted to what the FDIC calls "the unique needs of unbanked and underbanked individuals."

I propose two major actions to address this problem, both of which are outside of present law and regulations. The first would be an independent audit of the cost and revenue structure of a wide range of accounts and savings products offered by large banks. To protect the proprietary rights of participating entities, product data would be pooled into a large data set with all identifying records removed. The goal of the audit would be to identify the costs and profitability of basic account products and services, operating margins, the existence of scale economies, the sensitivity of indirect cost allocations on outcomes, and so forth. The audit or survey could be conducted by the Fed, FDIC, or by an independent organization chosen by regulators in consultation with the institutions.

The second, even more ambitious effort would attempt to put an end to the tiresome debate about whether banks or nonbanks are better positioned to meet the financial services needs of underserved. The idea is to create an independent Institute for Financial Innovation Research and Evaluation (FIRE). This non-profit entity would be modeled after the internationally recognized MIT Poverty Action Lab, which, to great policy effect, uses rigorously designed randomized evaluations to answer questions critical to poverty alleviation across the globe. In this case, these same scientific techniques would be used to answer questions about the efficacy, effectiveness, and economic sustainability of innovative financial services, technologies, platforms, delivery channels, and marketing strategies in meeting the needs of unbanked and underbanked individuals.

Who should pay for such an entity? My answer is that CRA–covered mega-institutions should pay for it as part of a new overlay responsibility that I would impose upon them called a "Duty to Lead" under a modernized Community Reinvestment Act.

Today, America's 10 largest CRA-covered institutions together have deposits of more than $3.1 trillion, which translates into a combined market share of 45 percent. Just the top five depositories have a combined market share of more than 37% of all deposits. Not only should this top tier of America's financial institutions have an obligation to meet the credit needs of their communities as currently required, but they should have an additional *duty to lead* the financial services industry in the development, testing, and commercialization of innovative, affordable, and sustainable account and credit products serving low income families and other underserved communities. Given their charter obligations, and market dominance, there is no reason why policymakers should not demand that these institutions become beacons of innovation and creativity in serving

unbanked and underbanked. Such an overlay over existing regulatory requirements has a precedent in the federal regulation of the GSEs.

On a related issue, one of the questions asked of those of us testifying today is whether the federal government should subsidize the provision of financial services to low- and moderate-income populations. My answer is "perhaps; but not as a replacement for banks' obligations under the Service test, but, as a possible supplement. So, I am pleased that the Dodd-Frank Act authorizes Treasury to subsidize initiatives to expand product offerings and accounts for low- and moderate income people. But before we go about subsidizing these trillion dollar institutions, we should first get the empirical data right. So, let's do the audit and let's get the testing facility up and running so we will know what, if anything needs to be subsidized, and if so, by how much.

I close my testimony with a few more modest, though still impactful recommendations for strengthening the Service Test that can be implemented under existing law and authority. These recommendations have their origins in the body of UNC research I mentioned earlier in my testimony.[7]

1. **Evaluate alternative delivery channels based on actual effectiveness and availability**. Banks should have the freedom to select among different delivery channels based on popularity with customers, competition with other financial service providers, costs, and other factors. Once a choice has been made, however, CRA regulations require these channels to be evaluated as to their availability and effectiveness in serving poorer neighborhoods and customers. The alternative channels should be evaluated based on actual usage rates that measure effectiveness and extent of service, and not be credited simply because they are in place.

2. **Analyze consistently the size and usage of low-cost account programs and r community development services, and not just their availability.** While federal regulators refused in 1995 to base the service test on general deposit growth, the CRA regulations state that community development services should be evaluated as to (1) the extent of the bank's service provision and (2) the innovation and responsiveness of the service in meeting community needs. Ensuring consistent application of these standards is particularly critical given widespread complaints by community groups that banks with low-cost products sometimes refuse to promote them or even to inform consumers of their existence. Simply inquiring as to the number of low-cost accounts maintained or opened by the institution, or the number of checks cashed for non-accountholders, during the current examination cycle relative to the number of LMI households in the assessment area would be a significant improvement over current examination methods, and would allow examiners to award more credit to banks that provide extensive services.

[7] Michael A. Stegman, Kelly Cochran, and Robert Faris, Creating a Scorecard for the CRA Service Test, Brookings Institution Policy Brief No. 96, March 2002

3. **Tighten the Definition of Community Development Services Needs Eligible for Service Test Credit**. The broad definition of Community Development Services enables banks to get credit for a number of services that having nothing to do with meeting the transactions and savings accounts needs of unbanked and underbanked individuals. Thus banks get service test credit for, among others, providing technical assistance to housing and development organizations, and for pre- and post-purchase credit counseling, along with services that are more directly related to financial services such as financial education, support for Individual Development Accounts, and other savings initiatives. Important though they are, the non-account-related services should be removed from the service test and, perhaps, made part of a new community development test which would subsume and enlarge the current investment test for large banks, as others have proposed.

4. **Evaluate transaction services for "unbanked" and marginally banked populations and traditional low-cost account programs using the same standard**. Although there is some debate among community advocates over whether banks should receive CRA credit for check cashing and similar activities, examiners are in fact directed by federal examination procedures to consider whether particular community development services target new groups of customers. Giving greater attention to low-cost check cashing, money orders, bill payments, non-predatory, short-term credit products that would compete with payday loans and other standalone transaction services could encourage banks to compete more directly with fringe bankers.

5. **Give service test credit to banks that sponsor independent evaluations of the effectiveness of their community development service programs**. With regard to financial literacy programs, for instance, examiners sometimes report data on the number of seminars or participants but almost never provide information on how many "graduates" of those programs actually obtained loans, opened accounts, or otherwise improved their financial status. Tracking seminar graduates' behavior or otherwise evaluating the effectiveness of particular activities may not be feasible for every examination cycle, but it is important from a policy perspective to encourage institutions to structure their programs to have real impact on enhancing credit access. Providing credit for bank-financed evaluation programs would further this goal.

6. **Strengthen Quantitative Measures of Retail Banking Services Using Data on the Number and Growth of Accounts in Low-Income Census Tracts.** Federal regulators rejected a proposal during the 1995 rulemaking process to base the service test on deposit growth, both because they argues it would require burdensome geocoding of deposit accounts and that such a requirement would not be consistent with the CRA statute's focus on credit services. Because banks have made extensive gains in their use of technology since then, the compliance burdens related to the spatial reporting of account owners is far less taxing now

than it would have been fifteen years ago. Adding a deposit analysis would make the service test more performance-based by focusing attention on the level of financial services actually being provided to residents of low- and moderate-income communities rather than continuing to concentrate predominately on the channels available to deliver such services..

Thank you.