Written Comments
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To the
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Comptroller of the Currency
Office of Thrift Supervision

Supplement to
Oral Testimony Provided by Janneke Ratcliffe at the
Hearing on Community Reinvestment Act Regulations on August 6, 2010

It is an honor to be asked to share thoughts on the Community Reinvestment Act, particularly the service test. Your review comes at a critical time, as our financial system is being rethought, and communities and families are trying to rebuild. Today, as in 1977, the hope is that CRA can foster a more inclusive path to financial opportunity that strengthens all of our communities.

The role of the Act in mortgage lending has received much attention. Ample evidence shows that, while the broader market pursued reckless practices, CRA loans remained a constructive source of credit for low income and minority families. Between 2004 and 2006, higher-priced loans under the CRA accounted for less than 6% of all subprime loans and just 1.3% of all originations in this period.[1] Moreover, CRA loans have suffered significantly fewer defaults than high-cost and subprime mortgages, even when they made to similar borrowers.[2]

Mortgage lending is not the only test. But it and small business lending are dominant evaluation factors, because access to such productive capital is critically important for a community to flourish.

However, building financial opportunity from the ground up doesn't begin with there. Accumulating savings and using credit constructively are precursors to obtaining and sustaining mortgages and small business loans. CRA encourages banks to meet the "need for credit services as well as deposit services,"[3] thereby recognizing that basic financial services are the gateway to other opportunities such as homeownership and entrepreneurship.

If that is true, then we have a problem. A recent FDIC survey finds a quarter of U.S. households un- or underbanked, including 54% of black and 43% of Hispanic households. Nearly one in five lower-income households does not have a bank account at all.[4] Further, between 35 and 70 million Americans lack sufficient credit history to determine a credit score.[5] For such individuals, reliance on alternative financial services adds costs and handicaps one's chance of achieving greater financial security.

Yet, from the ratings on CRA tests, it would appear that our banks are meeting the credit needs of their communities well. In the prior two years, 98% of large banks rated satisfactory or better (25.3% Outstanding and 71.5% satisfactory),[6] and rejections of bank applications for merger or acquisition on CRA grounds are extremely rare. Between 1988 and 2007 of over 13,500 application for the formation, acquisition, or merger of banks reviewed by the Federal Reserve Board, only eight were denied based on unsatisfactory consumer protection and community needs issues.[7]

Consider Charlotte, where Wachovia and Bank of America hold 92% of deposits and both received "Outstanding" ratings on their 2006 service test.[8] Yet, in this banking city, 37% of households (286,000 total households), are un- or underbanked (10.9% unbanked; another 26.5% underbanked), above the national average.[9]

We can only conclude that the service test must be measuring the wrong thing. It is time to find a new approach. We offer two recommendations.

First, better assessment tools. The evolution of the Home Mortgage Disclosure Act (HMDA) can serve as a guidepost. HMDA was originally enacted in 1975 in order "to provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located…"[10] But it wasn't until 1989, when FIRREA (Financial Institutions Reform, Recovery and Enforcement Act) advanced the public availability of both CRA ratings and HMDA data that HMDA was amended to require reporting the disposition of loan applications and originations through a loan level application register (LAR). Further amendments in the 1990s resulted in a detailed publicly-available database of nearly every mortgage loan and application made in a metropolitan area in a given year. The database has come to include characteristics of the mortgage, the lender, the borrower and the neighborhood which is specifically identified through Census tracts.

FIRREA also amended the Community Reinvestment Act (CRA). Bank regulators were required to disclose CRA ratings with the belief that public pressure would ensure honest evaluations. As Louis Brandeis wrote, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." Disclosure was intended to curb rating inflation and provide a better understanding of the underlying performance standards used by regulators.

Today, HMDA provides information on access to and quality of mortgage credit that is widely used by community advocates, researchers, policymakers, and the industry itself. And it allows for a data-driven mortgage lending test. The richness of HMDA data enables advocates to quantify claims of discrimination by pointing to specific rates of application denials, higher-priced lending, and other credit flows into low-income and minority communities. Consequently, HMDA became the de facto basis of the lending test under CRA.

In contrast, the CRA service test is very subjective, and conducted under a pre-FIRREA mindset complete with rating inflation and poor disclosure. Michael Stegman et al. documented that institutions with poor lending and investment test ratings received much higher than expected service test rating and concluded that 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."[11]

Currently, the service test is largely based on the distribution of branch offices and ATMs across socioeconomic neighborhood status. Disproportionately fewer offices and ATMs are indicative of insufficiently meeting the financial needs of the community. Branch presence is important for serving communities, but in and of itself does not mean the needs are being met. The test should include outcome-based measurements.

The evaluation of community development services evaluation that constitutes the rest of the service test is even more opaque. A review of Chicago-area banks by the Woodstock Institute found the qualitative part of the service test relied on ambiguous language and inconsistent data.[12] Institutions are often touted simply as "leaders," and in the infrequent occasion in which details of a community development initiative are provided, they are not placed in any context of the community's needs or the institution's capacity.

Just as an example, Bank of America's public community development services evaluation highlights that, within one MSA examined, the bank "served 14 organizations pursuing a variety of initiatives targeted at LMI areas and individuals" and "provided a high level of home buyer education…through partnership with 47 non-profit organizations." [13] The test seems to encourage banking institutions to have a broad but shallow commitment to community development, while the efficacy of such activities is not discussed.

The service test is even less outcome-based for smaller and intermediate banks, which don't have a standalone service test. Instead, small and intermediate banks and thrifts are evaluated on such items as their loan-to-deposit ratio, the distribution of credit activities across their assessment area and across borrower income, and actions taken in response to written complaints. Intermediate sized banks face a community development test which includes community development loans, services, and investments. For small banks and thrifts, community development investments and services are not required, but may be used to improve their CRA rating.[14] Though smaller institutions hold just 16% of all deposits nationwide, they operate 32% of branch offices and represent 91% of total institutions.[15] These banks and thrifts can play an important role in some metropolitan areas, particularly more rural and lower-income areas. Yet their CRA ratings are based on largely subjective measures. As with the evaluation of community development services of large banks, even quantifiable investments are not given the context to make them meaningful.

As a result, the public has insufficient tools to gauge the performance of financial institutions or regulators with respect to the important matter of basic financial services. Imagine on the mortgage side if all we knew was whether a lender had offices located in low- and moderate-income census tracts, for only some markets for that lender, for only some years. And imagine that we had to get that information in narrative form by going through each lender's examination. What could we possibly discern about the provision of mortgage loans to lower income and minority households?

The solution—better dataDetailed data for the CRA service test, similar to that HMDA provides for the lending test, might be burdensome on institutions and infringe on the privacy of consumers. However, data (deposits, loan receivables, etc.) aggregated by the neighborhood (tract, zip code, etc.) location of the consumer would alleviate some of these concerns and provide meaningful information on the availability of financial services in these communities. Specific metrics of financial services with geographic detail could supplement the basic physical proximity to such services.

A more quantitative service test could, to paraphrase the stated purpose for HMDA, "determine whether depository institutions are filling their obligations to serve the ***financial services*** needs of the communities and neighborhoods in which they are located."

Our second recommendation is to better address the needs of the community using a consumer-centered view. Underserved consumers need low-cost bank accounts; they do not need checking accounts that are advertised as free, but with built-in snares that have those with the least disposable income cross-subsidizing checking accounts for the rest of us. They need low cost savings accounts, not accounts where the monthly fees far outweigh interest earned. And even when consumer-friendly accounts are included on an institution's product menu, there is little evidence that these are promoted and disseminated as widely as the market need suggests they might be.

Research also tells us that the needs go beyond accounts, mortgages and business loans. One of the clearest needs is for small consumer loans, provided they are responsible, transparently priced and repayable. Today, consumer lending is a minor element in the evaluation, and should be examined given more weight, whether in the service test or lending test.

Underserved consumers also need the opportunity to build strong credit histories in order to avoid higher cost services. The fees earned by check cashers, payday lenders, pawn shops, automobile-title lenders, high-priced subprime credit cards, tax refund advance lenders, rent-to-own stores and the like siphon billions of dollars from the very communities where CRA seeks to encourage mainstream banking.[16] Even at their best, such alternative financial services lack features that help build financial security, money management skills, savings habits, and good credit histories. Moreover, disparities in product assignment, regardless of the underlying credit risk of the borrower, can perpetuate themselves through their impacts on credit scores over the long run.[17] Effective community reinvestment would interrupt this feedback loop by offering greater access to safe, traditional banking services.

Nevertheless, in an FDIC survey of banks, less than 18% identify expanding services to the un- and underbanked as a priority, and most have undertaken no research on this potential opportunity.[18] But there is extensive research available into what underbanked and low income people want in transaction accounts. We can also look to non profit, community-based financial institutions including more than 600 community development banks and credit unions[19] providing a range of financial service to lower income communities, such as basic bank accounts, check cashing, on-line banking, ATM access, youth and school savings programs, electronic transfer accounts, insurance products, remittance services, bill payment, consumer credit and payday loan alternatives. Their work, often funded by mainstream financial institutions, can offer a source of insight into how to meet the needs of the underserved community.

If it true that "you get what you measure," than we will continue to get little out of the service test until we improve the way it is evaluated. Today, the subjectivity of the service test undermines the effectiveness of the entire CRA evaluation. In closing I encourage you to broaden the service test through incorporating the community perspective in defining credit needs and to collect more quantitative data to determine how well those needs are being met.

Thank you for your consideration of these remarks.

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[5] Ericca Maas (2008). "Credit scoring and the credit-underserved population." Federal Reserve Bank of Minneapolis. http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=2452

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[7]Sandra Braunstein (2007). "Bank mergers, Community Reinvestment Act enforcement, subprime mortgage lending, and foreclosures ." Testimony before the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform, U.S. House of Representatives, at the Carl B. Stokes U.S. Court House, Cleveland, Ohio. May 21, 2007. http://www.federalreserve.gov/newsevents/testimony/braunstein20070521a.htm

[8] Deposit market share calculated from FDIC's Summary of Deposits, Deposit Market Share Report, for the Charlotte-Gastonia-Concord, NC-SC Metropolitan Area. http://www2.fdic.gov/sod/sodMarketBank2.asp; CRA Ratings for Charlotte-Gastonia-Concord, NC-SC Multistate Metropolitan Area from OCC. (http://apps.occ.gov/cra/crasrch.htm):
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[9] Federal Deposit Insurance Corporation (2009). Summary Table: Top 69 Metropolitan Statistical Areas (MSA). http://www.economicinclusion.gov/pdfs/MSA_Summary.pdf

[10] 12 U.S.C. Sec. 2801

[11] Michael Stegman, Kelly Cochran and Robert Faris (2002). "Creating a Scorecard for the CRA Service Test." Brookings Institution, Policy Brief No. 96.

[12] Geoffrey Smith, Malcolm Bush and Nathan Paufve (2007). "Measuring the Provision of Banking Services for the Underbanked: Recommendations for a More Effective Community Reinvestment Act Service Test." Woodstock Institute, Reinvestment Alert Number 37.

[13] Community Reinvestment Act Performance Evaluation. Bank of America, N.A. Charlotte-Gastonia-Concord NC-SC Multistate MSA Rating (Page 22). http://www.occ.gov/ftp/craeval/Jun08/13044.pdf

[14] Federal Reserve Bank of San Francisco (2006). "CRA 101: An Introduction to the Community Reinvestment Act." http://www.frbsf.org/community/craresources/CRA101JO.ppt

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[16] Janneke Ratcliffe (2009). "A Bridge to Somewhere." The American Prospect Special Report: The Credit Crisis and Working America. July/August 2009.

[17] Jonathan S. Spader (2010). "Beyond Disparate Impact: Risk-based Pricing and Disparity in Consumer Credit History Scores." *The Review of Black Political Economy*. Vol. 37, No. 2, 61-78.

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