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**STATEMENT OF  
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**Before**

**CONGRESSWOMAN MAXINE WATERS'  
FORUM ON COMMUNITY REINVESTMENT AND ACCESS TO CREDIT:  
CALIFORNIA'S CHALLENGE**

**January 12, 1998**

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## **Introduction**

Congresswoman Waters, I appreciate the opportunity to appear before this forum to discuss the community reinvestment and development activities of commercial banks in California. In my tenure as Comptroller of the Currency, I have made access to credit and financial services a top priority of the Office of the Comptroller of the Currency (OCC). I welcome this opportunity to share with you my thoughts on this important issue and to describe the various actions that the OCC has taken over the last five years to promote community reinvestment and fair access to credit and other financial services.

Few, though, in public service can match your sustained leadership in this area. You have long asked the hard questions about many of the most difficult issues facing our nation. Convening today's forum is only the latest example of your long effort to seek expanded economic opportunity for distressed communities and citizens here in Los Angeles and across the nation.

During my tenure as Comptroller I have visited scores of community development projects, programs, and lenders. This is, in fact, my third personal visit as Comptroller to the South Central community to learn first-hand of reinvestment opportunities and accomplishments. I have conducted outreach sessions all across the country in diverse markets with many of our nation's leading bank and non-bank practitioners of community development finance and investment. All of this has improved my understanding of what can be achieved and assisted the OCC in supporting innovative and sustainable community development bank lending and investment programs.

Over the last five years, the OCC has pursued a broad strategy to support and promote sound and innovative national bank community development lending and investment. We have worked toward this goal by revising regulations and policies (including licensing policies), issuing formal legal decisions and opinions, approving specific national bank community development or public welfare investment proposals and improving the capacity of our staff to effectively supervise and assist national bank community reinvestment activities.

From 1993 to 1996, the OCC conducted a top-to-bottom review of its regulations to remove unnecessary burden, promote national bank competitiveness, and allow for industry innovation and improve the effectiveness of our supervision of national banks. Many revisions, such as those of the Community Reinvestment Act (CRA) and national bank community development, or 'public welfare', investment rules, directly impacted bank community reinvestment and development activities. Our regulatory reform program has been backed by new and more effective supervisory procedures and techniques in both the CRA and fair lending areas.

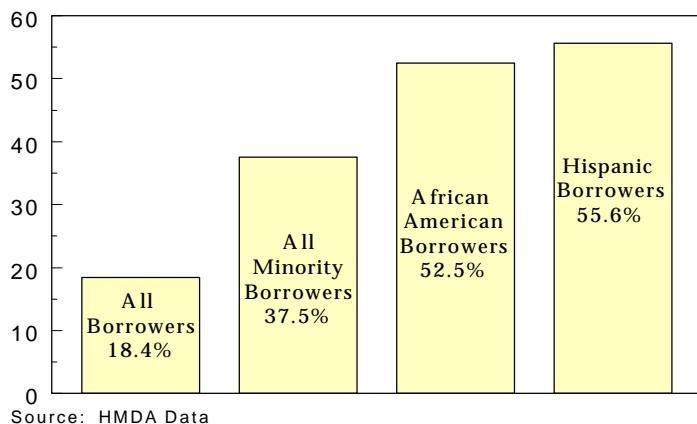
We have supported innovation in the field of community development lending and investment by approval of creative and sometimes legally novel national bank activities. In the licensing area, we have made it easier for banks to offer services in low- and moderate-income communities by waiving fees for applications for new national bank charters and new branches

in low- and moderate-income areas not currently served by depository institutions. All of these efforts have been supported by a vigorous program of outreach to promote sound community development among national banks and their development partners.

The increased attention given to the CRA and community development has had concrete results, providing new opportunities for many to participate in the American dream of home ownership and asset accumulation: home mortgage loans to African Americans and Hispanics increased dramatically--by 52.5 percent and 55.6 percent, respectively--from 1993 to 1996, as shown below in Figure 1.<sup>1</sup> Overall, the growth in mortgage lending to minorities was more than twice the growth rate for all borrowers during this time period.

This encouraging trend is reflected in the mortgage lending figures for your district, Congresswoman Waters, where loans to African Americans and Hispanics increased by 56.2 percent and 64.5 percent, respectively, in the 1993 to 1996 time period.

**Figure 1: Increased Loans to Minorities  
% Change 1993-1996**



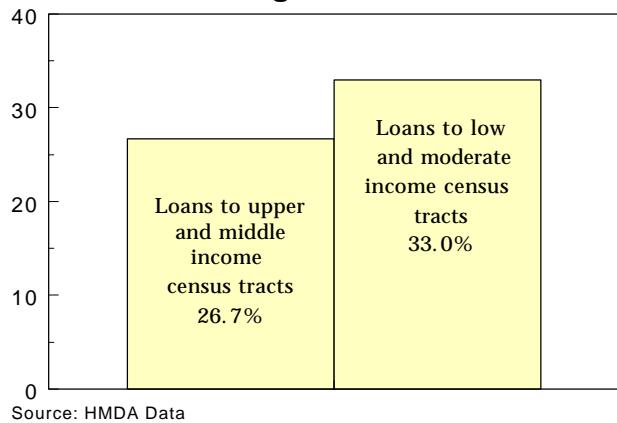
Moreover, mortgage loans for homes in low- to moderate-income census tracts increased 33 percent nationwide from 1993 to 1996, notably more than the 26.7 percent increase in middle- and upper-income census tracts, as shown below in Figure 2.<sup>2</sup>

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<sup>1</sup>Source: Home Mortgage Disclosure Act (HMDA) data.

<sup>2</sup>Source: HMDA data.

**Figure 2: Increased Home Purchase Loans  
% Change 1993-1996**



Recently released figures on small business lending are also encouraging. Under the U.S. Small Business Administration's largest lending program, known as the 7(a) program, loans to African Americans increased by 171 percent between 1992 and 1997 in the Los Angeles area, and 154 percent nationwide.<sup>3</sup> Loans to Hispanics increased even more--by 526 percent in the Los Angeles area and 144 percent nationwide during the same time period.<sup>4</sup> Moreover, in the Los Angeles area, small business loans were distributed relatively evenly across all census tracts. Specifically, in 1996, low- and moderate-income census tracts--which are 32.9 percent of the total--received a proportional share of small business loans--27.6 percent of the total.

Other CRA and community development-related bank activities have also increased. In the past four years, bank and thrift CRA and low- and moderate-income lending commitments have totaled \$270 billion, representing 86 percent of all reinvestment commitments since the enactment of the CRA.

Since I became Comptroller in 1993, national banks and their community development partners have increased their community development or public welfare investments fourfold over their investments in the previous three decades. These special equity investments have provided new capital for community development corporations, individual housing and commercial development projects and the growing industry of specialized community

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<sup>3</sup>Source: U.S. Small Business Administration, Loan Approval Activity, FY1992-FY1997.

<sup>4</sup>Ibid

development financial institutions, or CDFIs. These institutions include new OCC-chartered national banks--two here in California<sup>5</sup>--that focus explicitly on providing community development loans and services to traditionally underserved communities.

While we can take pride in our accomplishments to date, many challenges remain. I commend you, Congresswoman Waters, for your sustained leadership on behalf of your constituency in attracting community reinvestment funds and promoting access to credit and other financial services. These needs still exist in this community. The benefits of our strong economy will not serve all of our citizens if the credit and financial service needs of some sectors go unmet. Forums like this one are essential to an improved understanding of weaknesses in our credit and financial service delivery systems and developing practical and effective strategies to overcome access barriers. We must do all that we can to ensure that more and more Americans have the tools necessary to build better lives for themselves and their families.

I have structured my statement today to respond to the issues you raised in your invitation letter. First, I elaborate on the interagency CRA reform effort and OCC organizational changes to improve bank understanding of and involvement in community development activities. Next, I discuss the significance of increases in CRA-related bank activities for distressed communities. In particular, I provide this forum with my assessment of the community impact of the large CRA commitments made by banks over the past few years, stressing that it is not commitments, but results, that the OCC evaluates in the CRA examination process.

I then discuss some fundamental principles and strategies for sustainable community development. This section includes a discussion of additional OCC actions to foster community development, as well as innovative bank strategies that are helping to provide credit and other financial services to underserved low-income and minority communities throughout the nation. In the next section, I briefly summarize the economic situation in California, and, in particular, Los Angeles and South Central Los Angeles. Finally, I outline some of the remaining challenges that regulators and financial institutions face in continuing to

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<sup>5</sup> *Neighborhood National Bank, San Diego, California.* The OCC approved the application for this new, full service bank with a community development focus. Wells Fargo sold a branch to the bank for its use as the main office, and transferred to it approximately \$10 million in deposits and loans. The bank applied for and received financial support from the CDFI fund. It opened for business on September 19, 1997.

*Mission Community Bank, NA, San Luis Obispo, California.* The OCC approved the application for this new bank with a local business and community development focus. The bank proposed to open with two operating subsidiaries, Mission Community Development Corporation and Mission Community Services Corporation. The main purpose of the subsidiaries is to focus on low- and moderate-income areas and small businesses, and they will offer micro-enterprise loans, community development loan products, small business technical assistance and training, special project funding, and Small Business Administration loan packaging. The bank opened for business on December 18, 1997.

expand the provision of credit and other financial services to those in need. The statement includes two appendices as well. Appendix 1 outlines significant OCC actions since 1993 ensuring fair access to financial services while Appendix 2 describes the types of permissible small business-related investments and activities for national banks.

### **Increased Focus on CRA**

One of the accomplishments of which I am most proud in my tenure as Comptroller is how the OCC, community leaders, and bankers have worked together to improve access to credit for all Americans. As I mentioned above, we have revised our regulations to encourage community development activities. We also have improved the effectiveness of our fair lending examinations and made organizational changes to support the added focus on community development. Let me discuss these initiatives in greater detail.

*CRA.* Congress reaffirmed the important responsibility that banks have to help serve their local communities when it passed the CRA in 1977. However, the regulations to implement the CRA that were in place when I became Comptroller were not as effective as they could have been. Though well-intentioned, they were in many respects counterproductive, primarily because they focused on activities other than the bank's performance in providing loans, services and investments. More importantly, no one was satisfied with how the agencies implemented CRA--not the banks, not the public, not our examiners. As you know, there were many who preferred that the regulators simply do away with CRA. I strongly believed that CRA could and should work for all of us. When President Clinton challenged the federal banking regulators to make fundamental changes in the way we administer CRA, I led an interagency effort to improve its effectiveness.

To revise the CRA regulations so they would better achieve their intended purpose, and to ensure they focused on performance, rather than process, we traveled across the country to hear from everyone with a stake in the new CRA, and we put out two proposals for public comment. In 1993, we held seven public hearings on CRA reform--including one here in Los Angeles--and we received thousands of comment letters from the public. This process enabled us to move beyond confrontation. Although the process of reforming the regulation was difficult, our efforts are being rewarded by the creation of effective partnerships--partnerships that are, today, growing in strength and helping to rebuild communities.

Importantly, we have revised the regulation in a way that both eases the industry's compliance burden and improves its performance. For example, the CRA regulations provide for different evaluation methods to respond to basic differences in institutions' structures and operations<sup>6</sup>. This type of flexibility and customizing permits institutions to be evaluated more

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<sup>6</sup>The regulations provide an assessment method for large, retail institutions that focuses on lending, investment, and service performance; a streamlined assessment method for small institutions that emphasizes lending

fairly and accurately in conformance with their business approach. Finally, and most importantly, the revised regulation focuses CRA examination on a bank's performance and not on documentation of its process for compliance. To support the examination emphasis on performance, the revised rule includes requirements for large banks and thrifts to geographically code and report their small business lending activities.

*Community Development.* Recent changes to our regulations have helped to spur rapid growth in national bank equity capital investments to promote public welfare--investment activities that would otherwise be prohibited by law. Today, national banks throughout the country are making capital investments in a variety of community-based development efforts that provide special financing and tax credit investment for low-income housing, small business development, neighborhood and commercial revitalization, and industrial development. Since I became Comptroller in 1993, national banks and their community development partners have made targeted investments of over \$4 billion in these public welfare investments alone. In 1996 alone, we approved 187 national bank community development corporations and projects, with investments for the year totaling \$1.4 billion.

Our efforts to ease regulatory requirements and promote greater flexibility for national bank investment in community development have contributed to the increase in bank capital investment in this area. In 1996, we revised the OCC's Part 24 regulation, the governing provisions for national bank equity investments in community development corporations and community development projects. The revised Part 24 facilitates bank community development investments by eliminating application requirements in favor of a self-certification process in many instances and streamlining application procedures in some other circumstances. Part 24 was also revised to relax restrictions on the reinvestment of these funds in an effort to attract new capital.

*Fair Lending.* Over the past four years, the OCC has also taken a number of actions to improve our enforcement of fair lending laws. We issued new comparative file fair lending examination procedures in 1993, and the OCC has conducted 4,000 examinations using these new procedures. Last year, we further revised our fair lending examination procedures to cover all credit products and stages of the lending process. Our improved fair lending enforcement resulted in 25 referrals of national bank violations of fair lending law to the Department of Justice and the Department of Housing and Urban Development.

In 1995, the OCC became the first depository institution regulator to incorporate into its enforcement program the use of mystery shoppers to test for the presence of discriminatory lending behavior. In September of 1995, the OCC published a bulletin detailing the agency's

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performance; an assessment method for wholesale and limited-purpose institutions based on community development activities; and, an option for any institution, regardless of size or business strategy, to be evaluated under a strategic plan.

interim policy guidelines regarding the disclosure of the results of fair lending self-assessments by national banks.

Additionally, we are bringing critical new technical skills to fair lending examinations. OCC economists have begun to participate in fair lending examinations, employing statistical models to supplement judgmental evaluations in checking for the presence of discriminatory behavior. These models increase the efficiency of our examination effort, both by pre-screening banks to find possible discriminatory behavior and then to guide us in completing our actual examinations in a highly efficient, objective manner.

*Organizational Commitment.* To solidify the OCC's commitment to fair access, we have made a number of significant organizational changes and undertaken other key initiatives. We created the Community and Consumer Law Division in 1994 to provide a focal point for legal advice and interpretations with regard to consumer and community development laws and regulations and associated policy issues. We also created the Community Relations Division in 1995, which is responsible for the OCC's relations with consumer and community organizations, particularly national public interest organizations. The division provides analysis and advice to me and other senior policy makers on consumer and community organization interests and activities that affect the OCC and the National Banking System.

In November of 1995 the OCC established the Community Reinvestment & Development Specialist program. There are two Community Reinvestment & Development Specialists in each of the OCC's six districts. These individuals work as a team to improve our CRA examinations and to foster community development in low- and moderate-income neighborhoods, rural communities, and inner cities throughout the country. They have diverse backgrounds and specialties including non-profit housing development, small business lending, banking, community organizing, advocacy, and bank examination. Educating bankers and their community partners and acting as consultants to bank examiners and national banks are key aspects of their jobs.

In addition, we continue to help banks identify effective and innovative community development strategies through the efforts of our Community Development Division. This division oversees national bank community development investment activity and develops special initiatives, which I describe later in my statement.

In sum, actions taken by the OCC in recent years to improve access to credit and other financial services have yielded positive results. The contrast between what we have accomplished since 1993 and the relatively slow pace of progress that preceded these efforts underscores the importance of maintaining a vigorous, focused approach to community development and fair lending programs. Let me now turn to a discussion of the growing level of community development commitments that banks have made, particularly over the past few years.

### ***Significance of Bank CRA Commitments***

In your letter of invitation, you asked for my assessment of the community impact of large CRA commitments made in recent years, particularly commitments made by banks or thrifts in the context of acquisitions or mergers. As you state, these are important financial commitments that have the potential to bring renewed capital investment and economic development and affordable housing finance to distressed communities.

As I mentioned before, the CRA evaluation process doesn't look at promises, it analyzes results. Our assessment of banks' CRA-related activities focuses on accomplishments by the banks: the effective provision of credit and other financial services to low- and moderate-income families and communities. Commitments only represent a first step in bringing needed funds and expertise to underserved communities.

*Definition.* Let me first discuss what is commonly meant by the term "CRA commitments." The CRA regulation does not incorporate an explicit definition of a bank or thrift "CRA commitment." Consequently, banks, community advocates, and the media often use the term differently. There are two distinct types of CRA commitments. The first are public statements by a bank or thrift of future lending and investment goals in low- and moderate-income communities or to low- and moderate-income consumers. A second category of more formal written commitments, sometimes called CRA agreements, are direct agreements between a bank or thrift and a community organization or other members of the institution's community.

As you note in your letter of invitation, many institutions announce these commitments in the context of a bank or thrift merger. In some instances, commitments may be written agreements that reflect the outcome of negotiations between a lender and a community organization who may have protested a merger application. It would be wrong, however, to believe that CRA commitments arise only from protested mergers. Both informal and formal CRA commitments are entered into by all parties completely outside of a merger context.

CRA commitments also vary considerably in time period covered and the scope and depth of the discussion of lending and investment goals. Some may refer only to lending and investment in a single market and a narrow product area. Others, particularly the significant commitments large institutions sometimes make, outline lending and investment goals across a broad range of credit and investment products and financial services lines and incorporate an institution's goals across its entire, sometimes multi-state, lending territory.

Notwithstanding these differences, there is one important common thread to CRA commitments, particularly more formal written commitments: they are most often the outgrowth of discussions between a lender and community organizations and other local or regional community development leaders on unmet community credit and investment needs. Whether or not these discussions lead to formal agreements, they help lenders to better

understand the community development lending and investment needs, to recognize new business opportunities in traditionally underserved communities, and to identify local community development resources and partners that they may not have recognized previously.

*OCC Review Under the Bank Merger Act.* Let me turn to how the OCC considers formal commitments and agreements in our review of national bank mergers. The OCC's review process for merger applications is quite comprehensive and, in some ways, unique.

When we revised our policies and procedures for processing national bank corporate applications during late 1996 and in the early part of last year, I instituted a major policy change at the OCC to preserve the recent gains made by traditionally underserved communities. In particular, I wanted to make certain that these gains were not lost in the course of the ongoing consolidation and restructuring of the national banking system. It is now OCC policy to require the surviving bank in a merger to indicate in their application--on the public record--whether it will honor the commitments made by the target bank to community organizations (or similar entities) and if not, to explain the reasons and the impact on the affected communities. If an acquiror indicates it does not plan to honor the commitments made by the target bank, we will consider that to be a significant issue. This will result in a removal of the application from our expedited review procedures and we will investigate the situation as part of the application process. Currently, the OCC is the only federal bank regulator to have such a requirement of bank merger applicants, although I understand OTS is considering adopting this standard. Since we began this procedure, we have never had an acquiring bank indicate it would not honor CRA commitments made by a target bank.

When the OCC reviews a merger application, we look at the CRA performance of both of the merging parties. We review their most recent CRA evaluations and more recent information. We consider not just the current overall CRA ratings, but also whether the evaluations identified any weaknesses. In particular, we review actions taken by the bank in response to our examiners' recommendations. We require the applicants, if they have received any CRA examination rating of "less than satisfactory", to describe in the application--on the public record--what actions they have taken to address the deficiencies.

Our Community Reinvestment and Development Specialists inform us whether their community contacts have revealed any relevant information about the parties to the transaction. If one of the parties to the merger is not regulated by the OCC, we contact the staff at the Federal Reserve Board, the Federal Deposit Insurance Corporation, or Office of Thrift Supervision and ask for any relevant information. The OCC expects to issue new public involvement guidelines in the near future that will reiterate the seriousness with which we consider public comments and requests for meetings.

In addition to this retrospective CRA review, we also conduct a prospective convenience-and-needs analysis to ensure that the proposed merger will not have an adverse impact on any given community. We require the applicants to identify in the application--on

the public record--any branches that they know will be closed as a result of the merger. We also require the applicants to describe in the application--again on the public record--whether they will discontinue or significantly reduce services to any customers of either applicant and, if so, to explain the reasons.

When we reach a decision on a merger application, we address the CRA issues in the OCC's decision documents and publish them in our monthly Interpretations and Actions so that the public can see how we have handled these issues and taken them into account in our decision. Our decisions may include requirements on the banks before the transaction can be consummated, or they may include conditions that the acquirer must comply with after the transaction is consummated.

*Compliance Review.* Let me now discuss our CRA compliance examination process. Since we began implementing the CRA, the banking regulators have jointly taken the position that examiners should not consider an institution's commitments for future action as part of the CRA record of performance of a bank or thrift<sup>7</sup>. A financial institution's good words do not necessarily translate into CRA performance. Until recently, there was one unfortunate exception to this rule: examiners could point to commitments as evidence of potential for improvement in addressing specific problems in an institution's otherwise satisfactory CRA performance<sup>8</sup>. In these circumstances, institutions were sometimes given credit for commitments that addressed specific weaknesses identified by the examiners, although this provision was never used to raise a CRA examination rating from unsatisfactory to satisfactory. I am pleased to say that the new performance-based CRA regulation eliminated this consideration in CRA examinations.

In the case of written commitments or agreements, the agencies have maintained a policy of neither approving nor enforcing agreements between lenders and community organizations or other members of the institution's community. This is based on the premise that written agreements are entered into freely by a lender and external parties. Thus, they are generally outside of the CRA supervisory process, and often cover activities and practices well beyond the scope of the CRA statute and the authority of the CRA regulation. While not formally enforcing written agreements, however, the agencies have evidence of a lender's compliance with provisions of an agreement when examiners assess the CRA record of the institution in helping to meet its local credit needs. Consideration of a financial institution's lending or investment activity that may adhere to the provisions of a written CRA agreement, however, is relevant only to the examiner's assessment of the performance record of the financial institution on the basis of standards set forth in the CRA regulation and its examination procedures.

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<sup>7</sup>Banking Bulletin 89-12, "Joint Statement on Community Reinvestment Act," March 22, 1989, FFIEC, and Banking Circular 149, "FFIEC's Community Reinvestment Act Statement," September 30, 1980, FFIEC.

<sup>8</sup>*Ibid*

The OCC and the other banking agencies believe this is the right approach for treatment of CRA commitments in the context of the CRA examination process. No matter their origin, size, or depth of detail, commitments are no more than expressions of intent. Our focus must be on what banks do, not what they promise. Under the revised CRA regulation, OCC examiners now focus their assessment of a bank on the basis of the number, amount, distribution, and innovative nature of the loans and investments made and the services offered.

While it is certainly not the only factor, I am confident that the performance-based reform of the CRA regulation has helped to spur the recent dramatic growth in CRA commitment levels, and more importantly, these commitments are being translated into actual increases in community development lending and investment.

*Community Impact.* Banks have achieved an increased level of expertise, sophistication, and capacity in the field of community development lending and investment. The evolution of community development finance and investment now involves the rapidly increasing availability of, and diffusion of knowledge about, the tools and techniques to recognize and successfully exploit genuine business opportunities in previously underserved and overlooked markets. Providers of community development finance and investment have now had much more experience with identifying risks in underserved markets. Thus, they are more confident about their ability to manage these risks and to identify appropriate development partners with whom they can successfully pursue these newly discovered business opportunities.

An assessment of the potential impact of CRA commitments on local communities is, thus, greatly influenced by the availability of local development capacity to absorb new sources of investment capital and credit. At this stage, what may most require our focus is assuring that local communities have available the know-how, expertise and leadership to assist lenders in the identification and pursuit of genuine business opportunities. Where that development capacity is found to be lacking, nurturing it must become the priority of economic development efforts involving banks, community development partners and government at all levels.

The increase in the level of bank CRA commitments and tangible community development lending and investment indicates that banks are finding these activities to be profitable and sound. In the next section, I discuss my views on the relationship between expanding community development lending and investment opportunities and bank safety and soundness.

## **A Foundation for Long-Term Success**

Sustaining and expanding recent gains in community development lending and investment poses difficult challenges for financial institutions and their public and private economic development partners. One of these challenges is that many lenders lack adequate information on prospective borrowers and market conditions. Thus, profit-making opportunities for lenders can go unmet in distressed markets because lenders are unable to make both rational and optimal credit decisions. Another challenge for financial institutions is

the limited means of many borrowers in low- and moderate-income communities. In many instances, particularly in the real estate area, borrowers must rely on public subsidies, often from multiple sources, in order to meet standards of creditworthiness. Although they can sometimes obtain collateral or equity through innovative public and private equity investment vehicles and publicly funded sources of credit enhancements, many borrowers in distressed communities lack access to these vehicles. Occasionally, lenders' willingness to innovate can overcome the financial limits of these types of programs.

The balance of funding sources and project financing requirements represents a particular challenge to community development finance. As financial intermediaries, commercial banks' traditional function is to provide shorter-term credit than that often necessary for many community development projects. To overcome these challenges, lenders must find alternative matched funding sources, rely on secondary markets to help manage interest rate and liquidity risks, or identify specialized investment intermediaries for securitizing community development assets.<sup>9</sup>

Clearly, then, successful community development lenders must address the complexities of these emerging markets by following a strategy that combines flexible, innovative delivery practices and sound risk management principles. Let me turn to a more thorough discussion of that now.

### ***Managing Risks in Community Development Lending***

In your invitation letter, you asked me to address the way in which regulators can best balance safety and soundness concerns with the need to make credit more readily available to all segments of the communities served by banks. Let me now discuss how banks should approach the management of risk in this area.

Over the past four years, the national banking industry has come a long way in expanding its community development lending, achieving some impressive results and demonstrating that community development lending is good, sound business. Nonetheless, some observers have asserted that the goals of CRA--lending to low- and moderate-income individuals and communities--conflict with the goal of ensuring that we have strong, safe and sound banking institutions. I disagree. As in every other stage in the history of the democratization of credit--the ongoing expansion of credit and other financial services to

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<sup>9</sup>In February 1997, the OCC issued an advisory letter noting that a bank's investment in CD securities is considered a "qualified investment"--and therefore one that can receive positive consideration under the CRA regulation--if it benefits the bank's assessment area(s) or a larger statewide or regional area that includes its assessment area(s). CD securities are securities that are backed by interests in pools of community development loans, such as loans to borrowers in low- and moderate-income areas, or to small businesses. These securities typically are not rated by a nationally recognized statistical rating agency. Nonetheless, the OCC determined that national banks may invest in those securities if the bank documents that the issuer of the security will perform.

unserved or underserved populations--we are finding that in the vast majority of cases, lending to low- and moderate-income Americans and other community development lending and investment is also safe and sound. The recent increase by commercial banks in their lending and investment activities in traditionally underserved markets does not represent charitable investment, rather, it represents an improved bank understanding of the nature of the financial risk of these activities and acknowledgment of business opportunities in these markets--markets that banks may have left unexplored only a few years ago.

Lenders can increase their community development lending and investment in a safe and sound manner by following good risk management strategies. The OCC believes that national banks should view the risks of making community development loans and investments in the same way as they view the granting of traditional loans and investments<sup>10</sup>.

An effective risk management strategy for community development lending and investment requires an understanding of what is actually happening in the marketplace. Depository institutions and regulators need to get the facts, face up to the challenges they pose, and respond to those challenges with creativity and innovation. For example, a few affordable housing lending programs are experiencing higher than normal delinquency rates. Some have said that the higher delinquency rates indicate that aggressive lending programs for low- and moderate-income individuals are potentially unsafe and unsound, while others suggest that we should disregard those delinquencies for the sake of expanding home ownership. Neither position is entirely accurate. By carefully examining programs with higher delinquency rates, as well as programs with lower delinquency rates, we have an opportunity to learn a number of important lessons, two of which are readily apparent.

One of the lessons we have learned is that there are prudent steps--risk management strategies--that banks can pursue to lower delinquency rates for these programs. For example, in the July 1997 OCC advisory letter on affordable mortgage portfolios,<sup>11</sup> we highlighted that banks with lower delinquency rates on affordable mortgage programs had common characteristics: requirements for borrowers to participate in credit counseling programs; rapid response delinquency intervention programs; and a limited layering of risk factors such as high debt-to-income ratios and minimal borrower reserves.

The second critical lesson that emerges from our analysis is that even in those programs with the highest delinquency rates, more than nine out of ten borrowers are paying in full and on time. The vast majority of borrowers using these programs have proven to be good credit risks because they have been able to access credit through innovative programs.

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<sup>10</sup>To promote supervisory consistency in the review and analysis of these loans and investments, the OCC developed special training for our examiners. Last year, for example, our Community Development Division prepared a Community Development Lending Training manual for safety and soundness examiners.

<sup>11</sup>OCC Advisory Letter 97-7, "Affordable Mortgage Portfolios," July 23, 1997.

One way for depository institutions to mitigate the risks of community development lending, and ensure that it is safe and sound lending, is the formation of community development partnerships with, for example, public, nonprofit, and other community organizations. Community partners provide additional knowledge about the community and the borrowers, knowledge needed to create a successful project. Other partners may provide a guarantee that makes the project viable or provide technical assistance or expertise necessary to structure a transaction. Often, nonprofit development partners can help lenders leverage their funds with public sources of financing and equity capital.

As I mentioned before, successful community development lenders' strategies incorporate not just risk management, but also other actions that help support these investments. In the section that follows, I discuss the OCC's efforts to gather and disseminate information on additional strategies used by successful community development lenders.

### ***Effective Practices of Community Development Leaders***

To underscore our commitment to safety and soundness in the areas of community development lending and investment, bank and thrift regulators should provide examiners and regulated institutions with information about specific techniques and strategies that lenders have used to enhance the credit quality or the profitability of these loans and investments. In 1997 the OCC conducted a detailed analysis of affordable single-family and multifamily housing and small business lending programs at ten national banks to determine common strategies and effective practices of successful bank community development programs.

The OCC focused on a group of national banks that do an outstanding job of meeting the credit needs of their communities by financing affordable single-family and multifamily housing or small businesses. Many of the institutions we interviewed have been operating community development programs for almost a decade and have encountered challenges along the way. Their willingness to share experiences and strategies in support of activities that benefit low- and moderate-income families and small businesses is consistent with their approach: successful banks are open to new ideas and go back to the drawing board to develop something new when an approach does not work.

The OCC will publish the results of this analysis soon, but let me mention the main community development themes that emerged from our analysis:

- Strong bank commitment: Bank leadership supports community development activities by dedicating resources and establishing strong goals and objectives. They apply their

knowledge of the local market to design programs that address the credit needs of local residents<sup>12</sup>.

- Integrated business strategy: Banks integrate community development financing with their broader business strategies, thereby promoting the community development products as a way to generate revenue and profits and expand their customer base. They often design affordable multifamily programs that address the differences between financing conventional and affordable rental housing. Banks actively solicit potential small business customers. Some banks have an extensive branch network, and others rely on advanced technology or obtain referrals from community development intermediaries and government agencies to generate small business loans.
- Partnerships: Banks often seek out other banks, government agencies, and other resources in the community to help address credit and other needs, establishing the partnerships so essential to effective community development lending and investment. These partnerships help to create a sustainable, comprehensive economic base in underserved neighborhoods, rather than the fragmented, piecemeal economic development approaches that are prone to failure.

Although many banks that have developed effective strategies indicate there is no single successful approach to building strong communities--since local economies differ from neighborhood to neighborhood and from state to state--the OCC believes that developing and maintaining viable community development products involves banks learning as much as they can from the best in the business and replicating appropriate strategies in local markets.

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<sup>12</sup>For example, in the area of affordable mortgage lending, these banks often hire specialized loan officers who understand how to handle borrowers with irregular credit histories and have knowledge of government and nonprofit programs that can help them. Many of them also implement enhanced servicing programs to identify and assist borrowers early in the nonpayment cycle at a time when repayment problems can be resolved more readily.

In their small business lending activities, these banks invest the capital, staff, and organizational resources to develop and manage the portfolio in a way that differentiates small business credit and service needs from middle market or large corporate customers. Banks also develop internal processes that emphasize quick, convenient, and efficient loan processing by using consistent underwriting and centralized loan processing. They may use credit scoring models, stay open extended hours on Saturdays and evenings, have on-line services that give quick access to small credit advances, and prepare written materials in various languages. They often offer a variety of business-related services and products, such as savings accounts, overdraft protection, payroll, retirement, insurance and equipment lease products. Banks develop internal processes that provide innovative and flexible loan underwriting and referrals for technical assistance and equity capital, when needed. Often they rely on lending officers to obtain additional information from the borrower and to provide input on borderline cases.

## **Economic Situation in Los Angeles and South Central**

Let me now describe the unique economic environment in California, Los Angeles, and South Central Los Angeles. I will also respond in this section to the request made in your invitation letter to highlight some innovative bank activities and initiatives approved or promoted by the OCC that could be useful in improving access to credit and other financial services in this community.

As I discussed before, successful lenders establish and maintain a variety of ties to the communities they serve. These relationships serve as a mechanism for banks to acquire knowledge about local economic conditions, information that is critical to effectively serve any community. As you know so well, Congresswoman Waters, Los Angeles is a large, complex city full of both opportunities and challenges for its governing officials, financial institutions, and citizens. Los Angeles is the second largest city<sup>13</sup> in the United States, with nearly 3.5 million residents and 470 square miles<sup>14</sup>. Los Angeles has experienced tremendous change in its economic infrastructure and its demographic profile in the last twenty years. In the early 1980s, manufacturing accounted for over one quarter of the area's nonfarm jobs. That figure is currently 17 percent, which, while still above the national metropolitan area average of 13.7, is clearly far below its peak level.

Many of the manufacturing job losses that occurred during the most recent recession, which started in the late 1980s, were the result of corporate downsizing and consolidation in the defense and aerospace industries. Specifically, manufacturing employment declined by 253,000 between 1988 and 1995.

These job losses had a devastating impact on the region, affecting other sectors of the economy. Overall, Los Angeles lost nearly half a million jobs in the 1990-1993 period alone.<sup>15</sup> Residential real estate markets were particularly hard hit, mainly because this recession followed a period of such significant growth that the supply of housing could not keep pace with demand, driving prices up. By 1996, housing prices had dropped by an average of 20 to 25 percent. As you well know, some communities were so severely affected that, to this day, they have yet to recover.

In the past five years, many of us have been made painfully aware of how difficult it can be to revitalize a community afflicted with tremendous job losses, social unrest, and all the difficulties inherent in a restructuring economy. For example, there are fewer high-paying

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<sup>13</sup>U.S. Census Bureau, Census Counts for Cities with 1990 Population Greater than 100,000.

<sup>14</sup>U.S. Department of Housing and Urban Development, Los Angeles, California Consolidated Plan, 1994.

<sup>15</sup>DRI/McGraw-Hill U.S. Markets Review, Metro Focus (Los Angeles), Third Quarter 1997, p. W-81

jobs in the Los Angeles economy today than before the recession. Many jobs in high-paying industries were lost during the recession, nearly 100,000 in aerospace alone, and an additional 12,000 aerospace jobs were lost through 1996. Many of the jobs that have been added over the past couple of years are in low-paying industries such as women's outerwear manufacturing and personnel supply services<sup>16</sup>.

*Recent statistics.* 1997 marked the third consecutive year of recovery for Los Angeles County. The unemployment rate fell to 6.5 percent in October of 1997, down from 8.0 percent in October of 1996. The migration from the area in the early 1990s has ceased and population growth has recently increased in conjunction with the economic recovery. Los Angeles County and City both posted 1.2 percent growth rates in 1996, compared to only 0.3 percent in 1995.

Los Angeles' housing market is only recently beginning to recover from the devastation of the early 1990's. Between 1989 and 1994, new housing construction dropped by nearly 85 percent and sales plummeted by 40 percent. As stated earlier, home prices declined 20 to 25 percent between 1990 and 1996. Currently, the County's housing market is stabilizing: median resale prices are up 6.6 percent in October from one year ago and new home permits increased by 18 percent in the first three quarters of 1997. However, home foreclosures continue to run at high levels. In the first half of 1997, the County recorded a total of 17,000 foreclosures, a 7.0 percent increase from the same period in 1996. In fact, home foreclosures have increased each year since 1990.

In addition, the Los Angeles housing market has other difficulties. For example, a research paper published by The Lewis Center for Regional Policy Studies at the University of California found that the housing in South Los Angeles is notoriously expensive, overcrowded, and in poor physical condition.<sup>17</sup> According to the California Association of Realtors in discussing the housing market for the Department of Housing and Urban Development's (HUD) 1994 California Consolidated Plan for Los Angeles, "80 percent of Los Angeles households could not afford a median-priced home in 1991. Although that figure declined to 64 percent by 1995, most households are still priced out of ownership."<sup>18</sup> HUD's Consolidated Plan for Los Angeles also reports the following about the area: "[o]ver 119,000 extremely low-income households (0-30 percent of median family income) are severely cost-burdened, paying more than 50 percent of their income for housing expenses, and three

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<sup>16</sup>Bank of America, Economic and Business Outlook, Los Angeles On The Mend [Online] Available, [http://www.bankamerica.com/econ\\_indicator/ebo\\_la9703.html](http://www.bankamerica.com/econ_indicator/ebo_la9703.html), May 1997.

<sup>17</sup>"South-Central Los Angeles: Anatomy of an Urban Crisis," A.J. Scott and E.R. Brown, editors, June 1993, p. 22.

<sup>18</sup>U.S. Department of Housing and Urban Development, Los Angeles, California Consolidated Plan, 1994.

quarters of them are renters.”<sup>19</sup> The need for affordable housing, particularly affordable multifamily housing, remains high.<sup>20</sup>

Commercial real estate vacancy rates remain relatively high. The metropolitan area office vacancy rate reached 18 percent in the second quarter of 1997, down only modestly from the 18.8 rate of one year ago. This is the highest rate among the 53 markets we track.<sup>21</sup> The region’s industrial vacancy rate, at 8.1 percent in the second quarter of 1997, is the same as the national average. Rents are rising for all commercial property types, but, as with home prices, they have yet to return to pre-recession levels.

**Small Businesses.** Small businesses have traditionally been an engine of job growth, creating approximately 65 percent of new jobs nationwide in the 1970-1990 time period, and projections from the Bureau of Labor Statistics and the Small Business Administration suggest that industries dominated by small businesses may generate 68 percent of new, nonfarm jobs through 2005.<sup>22</sup> Small businesses also serve as a signal of the vitality of a community--they are present and prospering in vibrant communities, absent or failing in communities in distress.

Small businesses sometimes have difficulty obtaining credit because of factors such as insufficient credit histories and relatively small loan sizes. The geographic location of business borrowers has long been cited as a barrier to credit as well. However, recent statistics are encouraging. For example, under the U.S. Small Business Administration’s 7(a) loan program, loans to African Americans increased by 171 percent between 1992 and 1997 in the Los Angeles area, and 154 percent nationwide.<sup>23</sup> Loans to Hispanics increased even more--by

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<sup>19</sup>U.S. Department of Housing and Urban Development, Los Angeles, California Consolidated Plan, 1994.

<sup>20</sup>See *Life in the City*, a report by the Urban Neighborhoods Task Force, 1997, and U.S. Department of Housing and Urban Development, Los Angeles, California Consolidated Plan, 1994. To address these needs, the OCC recently approved national bank requests to make equity investments in the *California Equity Fund* (CEF). The CEF is a limited partnership managed by the National Equity Fund, Inc., a non-profit corporation controlled by the Local Initiatives Support Corporation (LISC). The CEF invests in partnerships with non-profit community development corporations that are developing low- and moderate-income housing that qualifies for low-income housing credits. In 1995, the OCC approved a request from Bank of America, San Francisco, to make a \$25 million equity investment in the CEF; in 1996, we approved a \$1.7 million equity investment by City National Bank, Beverly Hills. These investments support community development by providing affordable housing to low- and moderate-income households.

<sup>21</sup>CB Commercial, June 30, 1997.

<sup>22</sup>Community Development: A Profitable Market Opportunity, 1997, OCC, page 13.

<sup>23</sup>Source: U.S. Small Business Administration, Loan Approval Activity, FY1992-FY1997.

526 percent in the Los Angeles area and 144 percent nationwide during the same time period.<sup>24</sup>

As noted earlier, the revised CRA regulation requires large banks and thrifts to geographically code and report their small business loans. Recently released CRA data on lending to small business show that, for the greater Los Angeles area, banks are making small business loans relatively evenly across all census tracts. The distribution of loans across tract income levels closely mirrors the distribution of small businesses. In 1996, 28 percent of small business loans<sup>25</sup> were made to businesses in low- or moderate-income census tracts, compared with 31 percent of small businesses<sup>26</sup> which were located in low- or moderate-income census tracts.

Table 1: Small Business Loans in the Greater Los Angeles Area

Tract Income Level	Tracts	Small Businesses	Small Business Loans
Low or Moderate	522 (32.9%)	108,388 (31.4%)	19,793 (27.6%)
Middle or Upper	1047 (65.9%)	235,793 (68.3%)	51,680 (72.1%)
Undefined	19 (1.2%)	844 (0.2%)	213 (0.3%)
Total	1588 (100%)	345,025 (100%)	71,686 (100%)

Notwithstanding these encouraging figures, I recognize that many small businesses are unable to obtain the financing needed to grow and prosper. I believe this may be particularly true for minority-owned businesses. Over the last year, the OCC sponsored a number of

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<sup>24</sup>*Ibid*

<sup>25</sup>Federal Financial Institutions Examination Council, 1996 CRA Aggregate and Disclosure Software.

<sup>26</sup>PCI Services, CRA WIZ. Small businesses are defined as those with less than 20 employees.

“Banking on Minority Business” forums<sup>27</sup>--including one here in Los Angeles--to bring together minority small business entrepreneurs and national bankers to discuss how to break down barriers to minority small business lending. All start-up businesses--whether minority-owned or not--sometimes find it difficult to obtain bank financing due to the size of loan requested, a lack of a formal business plan, or failure to maintain adequate accounting records. Similarly, young firms or firms in certain business sectors, like the service or retail industries, may be unable to pledge collateral or have inadequate borrower equity invested in the enterprise. Because minority business borrowers often have fewer personal assets to invest or pledge and, on average, are more likely to seek loans for collateral-deficient service sector enterprises, these common challenges loom larger and become more difficult to overcome. Let me point out two innovative bank programs that focus on helping fill equity gaps in small business lending: the California Economic Development Lending Initiative<sup>28</sup> and the First

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<sup>27</sup> This initiative has helped participating bankers, businesses, and the OCC to better understand common barriers minority-owned firms share with other small businesses and to identify unique challenges minority-owned firms may face.

Our *Banking on Minority Business* forums also identified bank programs that have proven successful in serving the minority small business market. Some of these practices include innovative cash flow underwriting and receivables financing by lenders who look less to secondary sources of repayment, like collateral, and more to the demonstration of the borrower’s ability to repay. These kinds of programs are often tied to the availability of hands-on, non-bank technical assistance providers who help borrowers lacking experience in demonstrating their creditworthiness develop business plans and meet application documentation requirements.

<sup>28</sup>The California Economic Development Lending Initiative (CEDLI) has provided several loans, training, and screening services to groups located in or servicing South Central. CEDLI was founded in July 1995 as a multibank community development corporation to make loans to small businesses and community organizations throughout California.

CEDLI offers three major loan programs focussed on assisting small businesses and local community development. The Co-Lending Program for Small Business was established to aid in financing businesses which are likely to succeed, but cannot obtain traditional bank financing. This program gives preference to women- and minority-owned businesses. The Loans to Lenders Program extends credit to intermediaries, such as local community development organizations, from which financing is extended to local small businesses or micro-enterprises unable to qualify for conventional loans. Finally, the Direct Real Estate Lending Program gives permanent financing to community organizations for the development or purchase of community service facilities. To date, CEDLI has made three loans in South Central. *Willing Workers, Inc.*, a nonprofit corporation that provides transportation services to disabled people, received a loan from CEDLI. The purpose of the loan was to purchase additional buses. In a joint lending arrangement, Willing Workers, Inc. loaned \$50,000, while Founders National Bank loaned an additional \$50,000. *Community Counseling Service* also received a CEDLI loan. This \$500,000 real estate loan helped the organization acquire an old building in South Central to set up a boys home for at-risk youth. *Pacific Coast Regional Corporation* received a \$300,000 line of credit under CEDLI’s Loans to Lenders program. The organization is re-lending the funds in South Central and other parts of Los Angeles, in loan amounts ranging from \$5,000 to about \$25,000.

National Bank of Boston.<sup>29</sup>

In other efforts to make it easier for these firms to access capital, the OCC has also approved bank applications to make a variety of equity or equity-equivalent investments--investments otherwise prohibited for national banks--in community development and nonprofit

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<sup>29</sup>*Bank of Boston Community Development Investment Bank.* The First National Bank of Boston received OCC approval in January 1997 to make an equity investment of \$300,000 in a for-profit limited liability company (LLC) structured as a community development corporation. The LLC's total capitalization was projected to be \$5.2 million. The purpose of the investment is to stimulate economic development by financing small businesses, including minority-owned small businesses, particularly those that create jobs for low- and moderate-income persons in disadvantaged communities in the Bank's market areas. Specifically, the LLC is planning on doing the following: 1) provide loans, equity financing, and technical assistance to low- and moderate income persons in the bank's market areas; 2) offer equity and mezzanine financing consisting of non-traditional loans including variable repayment terms and gap financing; 3) assist small businesses in the Bank's market areas in Connecticut, Massachusetts, Rhode Island, and Florida by providing technical assistance and business management training; and 4) provide affordable housing for low- and moderate-income persons and families.

In its first venture, the LLC invested in an affordable housing rehabilitation project. The LLC made an equity investment of \$6.5 million in the 227-unit housing project. The entire project is expected to cost \$15 million.

organizations<sup>30</sup>. These regulatory decisions<sup>31</sup> and informational exchanges have facilitated increased levels of small business and affordable housing finance in underserved communities.

*The 35th Congressional District.* The thirty-fifth Congressional district is an ethnically diverse community with a large proportion of both African American and Hispanic residents. Figures from the 1990 Census show that, compared to the greater Los Angeles area<sup>32</sup> and the state of California, this community has relatively lower income, more low- and moderate-income census tracts, fewer owner-occupied housing units, a much higher proportion of households on public assistance, and nearly twice the proportion of households below the poverty level. It is also an area of high unemployment.

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<sup>30</sup>Following revision of the CRA regulations, the OCC advised a community development lender that investments in nonprofit organizations would allow a bank to take advantage of the community development loan "pass-through" provision, thus fostering investments in nonprofit organizations and leading to greater credit and investment in low- and moderate-income areas. Under the CRA regulations, if a bank has made an equity investment in a third party, the bank may ask its examiners to consider its pro-rata share (based on its equity investment) of community development loans made by that third party. Because nonprofit organizations cannot sell stock, equity investments are not possible. We opined, however, that banks' "equity-equivalent" investments in nonprofit organizations, i.e., investments having attributes similar to those of equity investments, would trigger the "pass-through" provision.

In 1997, the OCC issued an interagency interpretation stating that an investment in a community development real estate investment trust (REIT) would be favorably considered as a qualified investment. The properties in the proposed REIT consisted primarily of shopping centers in underserved, primarily minority areas of a city. We opined that banks' investment in the REIT would help to revitalize and stabilize these low-income geographies.

<sup>31</sup>One area in which I think regulation currently hinders our efforts to identify illegal discrimination in the lending process is in the implementation of the Equal Credit Opportunity Act (ECOA). For example, existing prohibitions on creditors from inquiring about the race, color, sex, religion, or national origin of the applicant hampers our efforts to examine for disparate treatment in non-mortgage lending.

The OCC's position is that creditors should be allowed to collect--on a voluntary basis--monitoring information about all loan applicants. Permitting monitoring information to be voluntarily recorded by creditors in loan categories besides home purchase and mortgage refinancing transactions would help creditors and the government in the fight against discrimination. Indeed, without such monitoring information, self-testing in other loan categories is virtually impossible and government monitoring is difficult at best.

<sup>32</sup>The greater Los Angeles area is defined as the Los Angeles/ Long Beach MSA (4480) minus the towns of Calabasas, North and South Antelope Valley, Newhall, and the islands of Palos Verdes.

Table 2: 1990 Census Demographic Characteristics for  
the 35th District, the Greater Los Angeles Area, and the State of California

	California	Greater Los Angeles Area	35th Congressional District
Median Family Income (weighted average)	\$43,283	\$42,209	\$28,610
Low-income tracts as a percent of area tracts	6	9	30
Moderate-income tracts as a percent of area tracts	22	24	36
Middle-income tracts as a percent of area tracts	41	33	26
Upper-income tracts as a percent of area tracts	27	33	8
Owner occupied units (%)	51	44	34
Households on public assistance (%)	9	10	17
Households below poverty level (%)	10	12	20

*Housing Market.* As in the rest of the greater Los Angeles area, 35th district residents devote a significant proportion of their income to housing expenses. In fact, almost one in five residents in the 35th district spends over 30 percent of his or her income on rent, and given the local prices, many are probably priced out of home ownership. The district's lower median family income is reflected in lower home ownership rates. In fact, only 34 percent of housing units in the district are owner-occupied, compared to 44 percent for the greater Los Angeles area and 51 percent for the state.

In spite of the socioeconomic disparities evident in the figures in Table 2, the most recent Home Mortgage Disclosure Act (HMDA) numbers for this Congressional district are encouraging. In the 1993 to 1996 time period, the number of home purchase loans for properties located in the 35th district increased by 52.9 percent, versus increases of 30.7 percent for the greater Los Angeles area and 22.9 percent nationwide. African American and Hispanic borrowers received many of these mortgage loans, with growth rates for these groups at 56.2 percent and 64.5 percent, respectively. In the greater Los Angeles area, home purchase loans to African Americans increased by 43.5 percent and loans to Hispanics increased by 49.4 percent; nationwide, loans to these groups increased by 52.5 percent and 55.6 percent, respectively. Moreover, there was a 63.4 percent increase in mortgage loans to

low-income census tracts in the 35th district, compared to a 50.2 percent increase for the greater Los Angeles area and a 33.0 percent increase nationwide.

Although conditions appear to be improving, partly because of the dedicated efforts of individuals such as yourself, Congresswoman Waters, it is important that we keep our attention focused on the remaining needs of the community. Continued improvement depends, to some degree, on financial institutions' ability to implement effective strategies and partnerships that maximize the impact of their community development loans and investments.

### **Challenges to Continued Expansion of Community Development Activities**

In your invitation letter, you asked me to express my views about the remaining challenges the regulators face in helping financial institutions meet the credit needs of their communities. In determining how to meet these challenges, we can draw useful lessons from our experience in meeting similar kinds of challenges in the past. To build on the progress we have achieved to date, I believe we must do five things: 1) government, including regulators, must work with financial institutions to establish partnerships; 2) innovation must be rewarded; 3) we must work to continue to elicit the facts and analyze what these facts mean; 4) we must secure government commitments at all levels; and 5) we must assure that banks remain competitive. Let me discuss these issues in more detail.

*Partnerships.* Strengthening neighborhoods and expanding economic opportunity requires the collective strengths of community development organizations, government, business leaders, religious and social organizations and committed members of the financial service industries. Vibrant partnerships are the key to successful and lasting community development and we are all challenged to assure their continued growth and formation.

Development partnerships aid lenders in identifying new business opportunities and managing credit risks. Community-based partners may also refer borrowers to revolving loan funds and other bank-supported community development intermediaries that are effective at developing business plans and correcting operating deficiencies of local small businesses. In addition, banks can partner with other banks through loan consortia and multi-bank community development corporations to make very small loans, equity capital investments, develop expertise, and test more flexible debt financing terms and instruments. Government and community organization partners can also be sources of gap financing for closing costs and down payments.

Frankly, there are limits to what banks can do alone. All the confrontation in the world will not solve our community development problems. To take a big step forward from where we are today, we need many more strong community-based partnerships.

*Innovation.* One of the things that stands out in the history of banking and bank regulation is the extent to which traditionally-held views about the creditworthiness--or lack thereof--of a

particular group of Americans have been proven wrong. At one time, virtually all working class Americans were deemed unworthy of credit. It took experience to prove that this view was mistaken. Most of all, it took initiative and innovation to revise the old approaches and to begin to assume that most Americans would know how to use credit responsibly if they were only given the chance.

While innovation has characterized the retail credit market<sup>33</sup>, at least in recent years, until very recently there had been relatively little innovation in retail service delivery. For much of this century, the banking industry has faced legal and regulatory limits on its ability to innovate in this area. However, Congress and the regulatory community have taken a number of steps in the last several years to remove restrictions on banks' ability to open branches and provide alternative delivery vehicles for financial services. As a result of these changes in the law and other operational innovations by banks, alternative retail service delivery systems such as Automatic Teller Machines (ATMs), point of sale terminals, electronic banking, and supermarket branches are spreading rapidly. In addition, the OCC has clarified the ability of national banks to provide telephone and other electronic banking services to their customers by not considering these services as constituting branches subject to regulatory and legal requirements. The OCC will continue to review and update its regulations to ensure that we do not unnecessarily restrict banks from being creative in their offering of financial services to underbanked populations.

The bottom line is that to increase credit and services to underserved populations, innovation is essential. We should encourage it aggressively but within the limits of safety and soundness.

*Reliance on analysis.* Increased partnerships and continued innovation, though, will only advance the cause of community development if they are based on sound factual analysis of the needs and capacities of underserved borrowers and communities. Take the example of what many often refer to as the "nonbanked".

Despite the numerous accomplishments of U.S. depository institutions to date, we know that millions of American households do not have deposit accounts. What we do not know well is why so many households conduct their financial service needs outside of the mainstream banking system. One thing I am certain of in this area: this is a very heterogeneous population and no one solution will work for all. To develop innovative products that reach these underserved populations, it is important for regulators and financial institutions to work hard to elicit the facts and to carefully analyze the needs and preferences of these potential customers.

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<sup>33</sup>The credit card, adjustable rate mortgage, home equity loans, asset securitization, targeted community development lending, microfinance and support group lending--these are all innovations that have helped to propel that market.

The OCC is aware of--and applauds--the pioneering research in this area by banks and other financial institutions, consumer organizations, and academics. Some of the key research is presented in the recent OCC publication, "Financial Access in the 21st Century," which represents the proceedings of a forum convened by the OCC earlier in 1997. The findings reported in this volume indicate that many organizations around the country have already begun the process of learning about the nonbanked and underserved. The OCC will also be conducting a survey of the needs of the nonbanked population during 1998.

I encourage banks, consumer organizations, and others to continue this process of learning by pooling the information they may already have on the credit, savings, insurance, transaction, and other financial needs of the nonbanked and underserved. Even better, they might consider working (together or separately) on market research on local area needs--certainly an essential part of the process of designing and introducing new, more appropriately designed products for this emerging market. Of course, financial regulators also need to be aware of this information in order to assess the new, innovative practices of banks and other financial institutions seeking to better meet these financial needs.

*Government commitment.* As you have often reminded us, Congresswoman Waters, government, at all levels, cannot shy away from its responsibility to dedicate the resources necessary to attract private sector investment for economic development. Obviously, public sector resources are, and are likely to remain, scarce. The delivery mechanisms and channels of these available resources are also undergoing change. These facts make urgent the need to better leverage public resources for community development and assure that available funds help support the ongoing innovation of private sector lenders.

Continued government provision of project-based equity investment and credit enhancement is needed. In addition, I believe the community development efforts of banks will have greater impact in particularly distressed communities if government, at all levels, maintains a focus on the need to support traditional and innovative community development intermediaries including CDFIs and the growing field of small business technical assistance and equity investment providers.

*Keeping banks competitive.* The plain fact is that traditional banking activity -- taking deposits and making loans -- has declined in this country relative to other countries. If, in the future, we limit banks to only engaging in these traditional activities, or only have these traditional activities of banking covered by CRA, the CRA program will decline in impact almost immediately. We must, in my view, rather, allow banks to grow and expand their activities and allow these new bank activities to support CRA into the future. That is why I think the OCC's bank operating subsidiary rule is so important to the future of community reinvestment.

To compete in the market for financial services, and thus continue to serve their communities, banks must have the flexibility to engage in a broader range of financial and financially related activities, to the same extent as other financial providers. Product

diversification not only enhances the safety and soundness of the banking system, it enables banks to serve their customers and their communities with the broad, integrated range of financial products and services that, as I have earlier pointed out, is so crucial to bringing more Americans successfully into the economic mainstream. In contrast, unnecessary restrictions on bank activities not only hinder their ability to compete, but also diminish their ability to serve the inner city.

CRA is only as strong as the institutions that are subject to it. Stronger institutions, with diversified sources of income and potential for growth, are better positioned to help meet the credit needs of their communities and support the economy as a whole than deflated institutions that have been deprived of new growth businesses.

Congress must keep these issues in mind as it continues to debate proposals for financial modernization legislation. I feel strongly that certain provisions in H.R. 10 would shift new and expanding activities to holding company affiliates, instead of keeping them in the bank's affiliates, namely, its subsidiaries. Such rules, I am convinced, would not only make the bank a less stable enterprise, but also one less able to meet its obligations to its customers and community.

## **Conclusion**

In conclusion, banks are a critical element in supporting and sustaining economic development for our underserved communities. Effective regulation that permits innovative bank practices also fosters the revitalization of these communities. In recent years, the OCC has taken a number of steps to facilitate the CRA-related activities of banks, and recent figures suggest that banks are increasingly recognizing and taking advantage of these market opportunities.

While I am encouraged by the progress we have made thus far, I also recognize that we can and must accomplish even more. Although significant challenges remain, I commit to you that the OCC, working together with national banks and our fellow regulators, will continue to do everything we can to advance the gains already made in providing our neediest citizens with improved access to credit and other financial services.

## **Appendix 1**

# **SIGNIFICANT OCC ACTIONS ENSURING FAIR ACCESS TO FINANCIAL SERVICES**

**1993 - 1997**

# **Significant OCC Actions**

## **Ensuring Fair Access to Financial Services**

<b><u>DATE</u></b>	<b><u>EVENT AND IMPACT</u></b>
Mar 10, 1993	<b><i>OCC Credit Availability Initiative Results in Formation of Interagency Program on Credit Availability.</i></b> Program addresses: loans to small and medium sized businesses; real estate lending and appraisals; agency procedures for handling appeals by bankers and consumer complaints; examination procedures; and paperwork and regulatory burden on banks. (I/A) <sup>1</sup>
Mar 30, 1993	<b><i>Credit Availability Program Initiates Reforms</i></b> aimed at eliminating unnecessary documentation of loans to small and medium-sized businesses and farms, and reducing costs to lending institutions and the time it takes to respond to credit applications. (I/A)
May 4, 1993	<b><i>OCC Issues New Procedures to Detect Lending Discrimination.</i></b> New approach involving comparative reviews of bank lending decisions results in more effective and efficient examinations. Previously, OCC did not review bank files--relying only on reviews of bank audit results and bank representations. Since implementation, OCC has conducted over 3,000 fair lending examinations under the new procedures.
May 18, 1993	<b><i>OCC/HUD/DOJ Form Working Group on Lending Discrimination,</i></b> undertaking a comprehensive review of fair lending enforcement.
May 26, 1993	<b><i>OCC Issues New Real Estate Appraisal Rules to reduce costs that can restrict the availability of credit,</i></b> by increasing the threshold level for required appraisals from \$100,000 to \$250,000, expanding exemptions, and identifying additional circumstances when appraisals are not required. (I/A)
May 27, 1993	<b><i>Banking Agencies Issue Interagency Letter on Discrimination Concerns,</i></b> announcing a strengthening and refining of fair lending enforcement activities and transmitting a list of 11 suggested measures by which banks could prevent illegal discrimination and improve access to credit by underserved groups. (I/A)

<sup>1</sup> I/A indicates event was part of an interagency effort.

<u>DATE</u>	<u>EVENT AND IMPACT</u>
June 10, 1993	<i>OCC Announces Additional Credit Availability Initiatives that improve the availability of credit to businesses and individuals</i> , by changing regulatory reporting requirements, issuing joint policy statements on the valuation of real estate collateral, using the “special mention” category in reviewing loans, and improving the coordination of examinations. (I/A)
July 15, 1993	<i>OCC Acts to Facilitate Community Development Investments</i> , by issuing new rule utilizing increased statutory authority permitting such investments.
Aug 2, 1993	<b><i>OCC Announces CRA Reform Hearings</i></b> , seeking input from financial services industry, social scientists, and consumer and community representatives.
Aug 31, 1993	<i>OCC Issues New Regulation on Disposal of OREO</i> , easing bank restrictions and making OREO more available.
Dec 8, 1993	<b><i>OCC Proposes New CRA Regulation.</i></b> OCC at the forefront of moving to performance based assessments and a streamlined assessment method for small banks.
Jan 21, 1994	<b><i>OCC/DOJ Settle the First National Bank of Vicksburg, Mississippi Lending Discrimination Case</i></b> , the first settlement for violations under the Equal Credit Opportunity Act for a national bank.
Mar 8, 1994	<b><i>Bank Agencies Adopt Joint Policy Statement on Lending Discrimination</i></b> , joint statement by OCC, DOJ, HUD, FTC, and the other banking regulators that interpreted the fair lending laws, stated policies related to enforcement of those laws, and advised lenders on self-compliance measures. (I/A)
Apr 1994	<b><i>OCC Forms Native American Working Group</i></b> , aimed at improving the delivery of banking services to Native Americans.
June 1994	<b><i>Comptroller Initiates Community Outreach Program</i></b> to directly learn of credit access concerns, holding over 15 forums with over 300 regional and local community development leaders across the country.
June 2, 1994	<b><i>OCC Creates Community and Consumer Law Division</i></b> , as a step to help implement community, consumer and fair lending laws.

<u>DATE</u>	<u>EVENT AND IMPACT</u>
Feb 9, 1995	<i>OCC Grants First Community Development Financial Institution Charter.</i>
Apr 19, 1995	<i>OCC Adopts Final CRA Regulation</i> , creating performance-based standards.
Dec 14, 1995	<i>OCC Issues Risk Based Capital Guidelines for Sales of Small Business Obligations with Recourse</i> , expanding bank lending capabilities to small businesses.
Feb 20, 1996	<i>OCC Names District Community Reinvestment and Development Specialists</i> , creating specialists in all OCC district offices to help foster national bank involvement in community development.
Feb 22, 1996	<i>OCC Holds Community Development Conference</i> , convening the largest conference of its kind in OCC history, with over 500 attendees.
Jun 3, 1996	<i>OCC Establishes CRA Web Site</i> , to give the public broader access to information about the national banking industry.
Sep 17, 1996	<i>Comptroller Announces Changes to Part 24</i> , launching major initiative to stimulate investment in low- and moderate-income housing, including empowerment zones.
Sep 20, 1996	<i>Secretary Rubin Announces the Creation of the Consumer Electronic Payments Task Force, Chaired by Comptroller Ludwig</i> , to study how emerging electronic payment products will affect consumers and whether these products will be available and beneficial to low- and moderate-income persons.
Sep 30, 1996	<i>OCC Waives Application Fees for New Charter and Branch Applications in Low- and Moderate-Income Areas</i> , acting to improve access to financial services for low and moderate income consumers.
Oct 1, 1996	<i>OCC Sponsors Seminars on Federal Low Income Housing Tax Credits</i> , actively marketing tax incentives for low and moderate income housing.

<b><u>DATE</u></b>	<b><u>EVENT AND IMPACT</u></b>
Nov 1996	<i>OCC Announces it is Conducting Community Development Best Practices Study</i> , a study of national banks' loans and investments that benefit their communities. The purpose of the study is to provide banks and other financial institutions, agency personnel, community development organizations and the public with information about successful strategies that promote affordable single- and multi-family developments and small business growth.
Nov 20, 1996	<i>OCC Issues Revised Part 5</i> , expanding activities that may benefit underserved communities, and enhancing the availability of assets and income for community reinvestment purposes.
Jan 9, 1997	<i>OCC Publishes Community Development Finance: Tools and Techniques for National Banks</i> , a reference work designed to continue stimulating creative and profitable community development lending and investment opportunities.
Jan 22, 1997	<i>OCC Publishes "New Opportunities to Excel: Outstanding CRA Actions for Community Banks,"</i> spotlighting Community Reinvestment Act performance of small national banks. The pamphlet is intended to recognize the efforts of some of the community bankers who have made the revised CRA work for them, and most importantly, to provide examples, inspiration and ideas to other small banks throughout the country.
Feb 12, 1997	<i>OCC Holds Industry Forum on Financial Access in the 21st Century</i> , convening leaders from a variety of sectors -- banking, bank vendor, non-bank financial institution, check cashing, community development, academic, and government -- who would not otherwise meet in substantive discussions.
Feb 20, 1997	<i>OCC Announces the Availability of its New Online Community and Consumer Organizations Database</i> . The database, available through the Internet, will function as a registry to help identify local contacts for CRA examinations and for community and consumer input to the agency's supervisory and regulatory processes.

<b><u>DATE</u></b>	<b><u>EVENT AND IMPACT</u></b>
Feb 25, 1997	<i>OCC Issues Advisory on Community Development Securities</i> that informs national banks of the standards that community development securities must meet to qualify under the authority granted by the investment securities regulation, 12 C.F.R. Section 1. It also explains the treatment of these investments under the CRA regulation, 12 C.F.R. Section 25.
Mar 14, 1997	<i>OCC Forms National Access Committee</i> , to conduct research on access to financial services, oversee an initiative to extend the frontiers of banking to households who are not now bank customers, conduct research on the impact of credit scoring on access to banking services, and analyze how on-line banking may be used to facilitate access to financial services.
May 29, 1997	<i>OCC Releases Videotape and Workbook Set on the Low-Income Housing Tax Credit</i> , showing how national banks can participate in this program to provide affordable rental housing in their communities.
June 5, 1997	<i>OCC Hosts “Banking on Minority Business” Forum</i> , bringing together bankers, representatives of the minority small business community, and leaders of minority business and community organizations to discuss how to overcome barriers to small business lending and build mutually profitable relationships.
July 23, 1997	<i>OCC Sponsors Affordable Housing Symposium</i> , to promote broader discussion among lenders and their community development partners about the performance of single family affordable mortgages and effective practices in managing risks in banks’ affordable mortgage portfolios.
July 24, 1997	<i>OCC and Department of Justice Sponsor “Banking in Indian Country: Expanding the Horizons,”</i> a conference on effectively providing financial products and services to Native Americans living in Indian country. OCC also publishes the Guide to Mortgage Lending in Indian Country, designed to help banks deal with the challenges of lending to Native Americans, including some unique legal challenges.

<b><u>DATE</u></b>	<b><u>EVENT AND IMPACT</u></b>
Sep 18, 1997	<i>OCC Releases “Financial Access in the 21st Century: Proceedings of a Forum.”</i> The booklet reports the discussion at an all-day meeting held in February 1997 to explore ways to improve access to financial services for the 12 million households -- about 12.5 percent of the U.S. population -- that do not have deposit account relationships with banks or other depository institutions.
Sep 30, 1997	<i>OCC Releases “Community Development: A Profitable Market Opportunity.”</i> The publication reports the proceedings of a two-day conference held in February 1996 to encourage national bank involvement in community development activities.

## **Appendix 2**

### **TYPES OF PERMISSIBLE SMALL BUSINESS-RELATED INVESTMENTS AND ACTIVITIES BY NATIONAL BANKS**

#### **1. Investments in SBICs:**

*15 U.S.C. § 682(b):* Permits a national bank to invest in small business investment corporations (SBICs) subject to a 5% of capital and surplus limitation. SBICs are SBA-regulated vehicles for providing debt and equity financing and loans with equity features to small businesses, including small businesses that are owned or controlled by minorities.

*12 C.F.R. Part 25:* Provides that a national bank's investment in a SBIC may receive positive consideration in assessing the bank's performance under the Community Reinvestment Act (CRA) if the conditions of the CRA statute and regulations are met.

#### **2. Investments in Community Development Corporations:**

*12 U.S.C. § 24(Eleventh):* Authorizes a national bank to make investments designed primarily to promote the public welfare, including the welfare or low- or moderate-income communities or families (such as providing housing, services, or jobs) subject to a maximum limit of 10% of the bank's capital and surplus. The investments may be made directly or through a community development corporation or project.

*12 C.F.R. Part 24:* Clarifies that providing or supporting equity or debt financing for small businesses that are located in low- or moderate-income areas (or other areas that are targeted for redevelopment by a government) or that provide permanent jobs for low- or moderate-income individuals is promoting the public welfare for purposes of 12 U.S.C. § 24(Eleventh).

*12 C.F.R. Part 25:* Provides that a national bank's investment in a community development corporation or project may receive positive consideration in assessing the bank's performance under CRA if the conditions of the CRA statute and regulations are met.

#### **3. Investments in Small Business-Related Securities/Securitization:**

*12 U.S.C. § 24(Seventh):* Subject to certain limitations and restrictions, authorizes a national bank to purchase, sell, deal in, underwrite, and invest in certain securities, including the authority to invest in small business-related securities (as defined in the securities laws).

- For purposes of 12 U.S.C. § 24(Seventh), a small business-related security includes a security that is rated in one of the four highest rating categories by a nationally recognized statistical rating organization (NRSRO) and is backed by the obligations of a small business concern and sold by a bank in the secondary market.

*12 C.F.R. Part 1:*

- Provides that a national bank may purchase and sell small business-related securities (classified as Type IV securities under the regulation) for its own account without limitation except if the small business-related securities are rated in the third or fourth highest investment grade rating categories. If the securities are rated in the third or fourth highest rating categories, a national bank only may hold the small business-related securities of any one issuer up to an aggregate par value of 25% of the bank's capital and surplus. National banks may also deal in Type IV securities that are fully secured by Type I securities, such as U.S. government securities and State general obligation bonds.
- Authorizes a national bank to treat any debt security as an investment security under Part 1 notwithstanding that it is unrated by a NRSRO if, on the basis of reliable estimates, the bank concludes that the obligor will be able to satisfy its obligations under the security and the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value. Banks may invest up to an aggregate of 5% of the bank's capital and surplus in securities acquired on the basis of reliable estimates.

*Advisory Letter 97-2 (Feb. 25, 1997):* Clarifies that securities backed by interests in pools of community development loans, such as loans to borrowers in low- and moderate-income areas or to small businesses (CD securities), also may qualify as investment securities under Part 1. A national bank also may purchase CD securities as an investment under the authority in 12 U.S.C. § 24(Eleventh) and 12 C.F.R. Part 24 (described above) if the CD securities meet the public welfare requirements of that statute and regulation. In addition, this Advisory Letter clarifies that a national bank's investment in CD securities may receive positive consideration for purposes of CRA if the conditions of the CRA statute and regulations are met.

4. Lease Financing Transactions:

*12 U.S.C. §§ 24(Seventh) and (Tenth):* Authorizes a national bank to engage in lease financing transactions that may assist small businesses in obtaining equipment but, in some cases, the investment is subject to a 10% of assets limitation.

*62 Fed. Reg. 52105, 52127 (Oct. 6, 1997):* Interprets CRA to provide that a bank may receive positive consideration for purposes of CRA for leasing transactions that benefit small businesses if the conditions of the CRA statute and regulations are met.

5. Investments in Bank Service Companies:

*12 U.S.C. § 1861, et seq.:* Authorizes insured banks to invest in bank service companies (BSC). Activities of BSCs in which national banks are shareholders are limited to those permissible for national banks or, subject to Federal Reserve Board approval, activities that are closely related to banking under the Bank Holding Company Act. A bank may invest 10% of its capital and surplus but no more than 5% of its total assets in a BSC. If approved by the Federal Reserve Board under the closely related to banking test, a BSC may, for example, be able to engage in additional lease financing transactions or other transactions that a national bank could not conduct directly that could assist small businesses. A bank may receive positive consideration under CRA for this investment or for the lending or other activities of the BSC if the conditions of the CRA statute and regulations are met.

6. Other Provisions That May Provide Incentives for Small Business Lending and Investments:

*12 U.S.C. § 1835:* Provides for alternative capital calculations that apply to a qualified insured depository institution with respect to the transfer of certain small business loans or leases of personal property with recourse. These rules are implemented for national banks in 12 C.F.R. Part 3, App. A, Sec. 3(c).

*12 C.F.R. § 7.1006:* Permits a national bank to take a share of profits, income, or earnings from a business enterprise of a borrower in lieu of or in addition to interest on a loan. These so-called "equity kickers" only may be used to repay interest and would not affect the obligation to repay principal.

*12 C.F.R. § 7.1015:* Permits a national bank shareholder in a SBIC to retain stock dividends. These stock dividends are not purchases of stock for purposes of the investment limitations and, therefore, the stock dividends are an additional investment in the SBIC.