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A Regulator's View of Banks in Community Development

*Frank Wille**

By and large, the nation's banks have not publicized the story of their significant, sometimes crucial, role in community development. For this low-profile approach, they have paid a high price in lack of public understanding and legislative empathy. Their record, however, is impressive, particularly if "community development" is broadly defined to include the various forms of assistance that banks render to state and local governments that sponsor or finance community development projects. At year-end 1975, Federal Deposit Insurance Corporation (FDIC)-insured banks (which accounted for 98.1 percent of all commercial and 69.1 percent of all mutual savings banks in the country) held more than 102 billion dollars in state and local obligations and more than 35 billion dollars in the bonds and notes of U.S. Government agencies and corporations,[1] at least some of which helps to finance community development projects across the country. Of total loans of 573 billion dollars held by the same banks, multifamily residential loans, nonfarm-nonresidential real estate loans, and commercial and industrial loans together accounted for 252 billion dollars,[2] a substantial portion of which also helps to finance community development projects across the country.

Beyond the financial commitment that banks have made and no doubt will continue to make, bank managements willingly have contributed untold hours of the time and talents of their officers in an effort to assist public officials and community groups to come up with practical projects of rehabilitation or development that stand a chance of long-term success in both financial and social terms. In many cases, the initial impetus for significant projects of this kind has come from the financial institutions themselves. An increasing number of banks, even those very large banks with the greatest number of national and international options for productive use of their lendable funds, recognize that their own long-term viability depends on a healthy environment for their domestic deposit base.

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* Chairman, Federal Deposit Insurance Corporation, April 1970-March 1976; Superintendent of Banks of the State of New York, May 1964-March 1970.

1. FDIC, Reports of Condition and Reports of Income, submitted by banks to the FDIC and the National Association of Mutual Savings Banks.
2. *Id.*

The stress, however, is no longer on "social performance," a phrase that conjures up for many bankers ill-conceived, pie-in-the-sky projects, which they are asked to finance by those in public life who have no accountability for ultimate financial success or failure. After three years of historically high loan charge-offs, and the prospect of significant additional charge-offs in 1976 and 1977, the nation's banks are willing to do their fair share in community development but only if the project in question, viewed without rose-tinted glasses, meets high standards of significance and practicality. Maximum profitability, or even a rate of return that might be justified based on risk in a purely commercial setting, is not required—but *some* return over and above the return of principal is. If these standards cannot be met, the bank reaction is likely to be that if the project is to be undertaken at all, it should be financed with general tax funds, which spreads the subsidy involved to the public at large whose elected representatives must then weigh cost against benefits and the desirability of that project against other demands for public expenditures.

With more than 14,700 insured banks in the United States today, at least half of which are independently managed and controlled, judgments on the significance and practicality of particular community development proposals will vary considerably. One bank may be willing to participate financially in a project while another will refuse. Some refusals will be based, not on the merits of the proposal, but on the cumulative risks in the bank's existing portfolio of loans and investments. Similarly, some projects will require more funds than a local community bank can prudently or even legally provide. The same type of project may be approached as to purpose and long-run return to the community more sympathetically by one bank than by another bank. In short, given a banking system in which loans and investments are made voluntarily and in which thousands of units participate, no one should expect uniformity in the responses banks give to specific requests to participate in a community development project.

Bank regnlators can encourage or discourage bank participation in community development projects, but the final decisions are still made by individual bank managements, with the regulatory agencies infiuencing those decisions only indirectly. Encouragement can take the form of exhortation, favorable rnlings on the bank's authority to participate, legislative recommendations for explicit statutory authority to participate, or an agreement not to criticize community development risks taken by banks within prescribed

limits. Discouragement can take such forms as public or private criticism of the risks involved in particular projects or types of projects, adverse rulings or recommendations on a bank's authority to participate, or the requirement that banks raise additional capital to cover the risks perceived.

It should be noted that the ability of "primary regulators" to influence bank management decisions on community development projects is significantly greater than that of the "secondary regulators." The Comptroller of the Currency, who charters national banks, has exclusive jurisdiction over the establishment of national bank branches, and administers and interprets the provisions of the National Bank Act under which they operate, is obviously the "primary regulator" for the nation's 4,700 national banks. For similar reasons, the fifty state banking authorities are "primary regulators" of the state banks chartered in their respective jurisdictions. By contrast, neither the Federal Reserve System nor the FDIC (both of which examine state-chartered banks at the federal level) can charter a bank. Their approval of state bank branches is ineffective without the approval of the state banking authority with jurisdiction, and the statutes they administer generally prohibit certain specified activities of state-chartered banks rather than grant affirmative powers, which for state banks must be found in state law. They are, therefore, considered "secondary regulators" even though national banks, being members of the Federal Reserve System, are subject to regulation by the Board of Governors in some areas, and even though both national and state member banks, which receive the benefits of federal deposit insurance, are subject to some oversight by the FDIC. While the jurisdictional reach of the Federal Reserve System was substantially enlarged by the Bank Holding Company Act Amendment of 1970, its influence over community development decisions of individual banks within a holding company system remains indirect and remote. In any event, both the Federal Reserve System and the FDIC expect the initiative in rulings on basic powers and in supervisory action generally to come from the "primary regulator" of banks over which they also may have statutory jurisdiction. General prohibitions can be adopted by both agencies if they find a particular banking practice to be "unsafe" or "unsound," but neither has used this power in the context of community development investments.

At the federal level, the Comptroller of the Currency regularly issues interpretations authorizing national banks to underwrite and invest in specific issues of state and local obligations that meet, in his opinion, the "general obligation" requirements of the National

Bank Act. Many of these issues finance capital projects important to comprehensive community development. By law, banks that are members of the Federal Reserve System, including all national banks and those state banks that have elected Federal Reserve membership, may not own corporate stock (with some limited exceptions that include the acquisition of stock in small business investment companies), but the federal prohibition does not apply to state-chartered banks that are not members of the Federal Reserve System. Accordingly, nonmember banks authorized by state law may hold equity interests in community development corporations. Faced by the prohibition on stock ownership, the Comptroller nonetheless has given a generally affirmative reaction to national bank participation, short of actual stock ownership, in the future income stream of borrowers as a means of additional assurance of repayment and a fair overall return. These arrangements may be particularly helpful in encouraging the financing of community development projects that rely in part on the success of fledgling businesses or uncertain public patronage. The Comptroller's rulings, of course, apply to national banks throughout the country, and they are frequently mirrored in the rulings of state banking authorities for state-chartered banks, when local law permits.

Virtually all bank regulatory agencies conduct regular examinations of the banks under their jurisdiction, and it is in the examination process that banks are most likely, if at all, to experience official discouragement of their community development efforts. There are more than 3,000 bank examiners at the federal level and about 2,000 at the state level. Examiners-in-charge sign the completed report of examintion and are responsible for its contents, including the evaluation of a bank's assets. Loans that constitute weak credits may be "classified" adversely into "Substandard," "Doubtful," and "Loss" categories depending on the severity of deterioration, or they may be scheduled separately as worthy of special attention by bank management. Securities that are not considered of "investment grade" may be categorized similarly. The point is that the evaluation of a bank's community development loans and securities traditionally has been left to the sole discretion of the examiner-in-charge, and not to the examiner's superiors in the bureaucratic hierarchy or the appointed officials responsible for the administration of the entire agency. Examiners-in-charge, moreover, are notoriously unwilling to change an asset classification once it appears in the final version of a report of examination, even though it may be considered unduly harsh (or unduly generous) by the examiner's superiors. The result can be significant dif-

ferences in the way in which similar or even identical credits are evaluated in different banks. In most cases, the examiner-in-charge reaches a perfectly justifiable conclusion about the overall condition of the bank being examined, but there is frequent disagreement by bank management and less frequent disagreement by the examiner's superiors over the classifications accorded particular credits.

To overcome some of the inconsistency inherent in the examination process, the Comptroller of the Currency recently instituted a centralized review of all participating loans in an aggregate principal amount of 20 million dollars or more in which a national bank is the lead bank in a syndicate.[3] Carefully selected examiners review the most recent information about the borrower, and jointly arrive at a single evaluation. This evaluation is then disseminated to all regional offices and to all national bank examiners, on whom presumably it is binding. Examiners employed by the Federal Deposit Insurance Corporation are expected to join this evaluation effort in the near future, since nonmember state banks examined by the Corporation also participate in a number of such loans. Only the largest community development projects, however, are likely to fall within the present guidelines for such review. Another recent example of an attempt to centralize the examination treatment of a particular asset had to do with bonds and notes issued by the City of New York. For most of the second half of 1975, when default on the next issue of maturing notes always seemed imminent, when new notes could not be marketed publicly, and when outstanding bonds and notes were selling at deep discounts not wholly accounted for by their coupon rates, examiners had every reason to question the "investment quality," if not the ultimate collectibility, of such obligations. A "Doubtful" classification would have required state nonmember banks, in a volatile market, to charge off the depreciation in such securities, and this in turn could have frustrated the City's efforts, and later the Municipal Assistance Corporation's efforts, to sell new securities publicly to retire those that were maturing. Pending the outcome of local efforts in New York to bring the City's budget back into balance and the outcome of the Congressional debate over proposed federal assistance to help the City avoid default, the three federal bank agencies agreed merely to schedule all New York City obligations for the special attention of a bank's board of directors. Subsequent to legislative and executive action at

3. Letter from Comptroller of the Currency to presidents of National Banks, March 18, 1976 (on file with the Vanderbilt Law Review).

the local, state, and federal level, the three federal bank agencies agreed to permit field examiners to classify New York City obligations as "Substandard"—a step that would not require a charge-off of principal.

Both of these variations in normal examination technique were dictated by exceptional circumstances of nationwide import. State examining authorites, more often than not, saw no need to follow the federal lead. Smaller community development projects in any event are not likely to receive centralized attention from the federal bank regulatory agencies, nor are less widely-held, unrated issues of state and local governments. Disparate treatment of such credits by different examiners-in-charge remains a substantial possibility. To avoid misclassification by an incompletely informed examiner, banks would be well advised to insure that their credit files dealing with local community development projects, as well as the information they have on municipal issuers of unrated securities, are kept up to date.

Most bank managements are hypersensitive about examiners' classifications, even though no regulatory agency expects a bank to be without some adversely classified credits. Such classifications help to measure the extent of the risks undertaken by a bank, and every thoughtful regulatory agency expects banks to take significant financial risks in developing or maintaining the economic lifeblood of the communities in which they do business. The concern of the regulator is that even if a classified credit appears to be manageable, the sum total of all risks taken by a bank will exceed its management capabilities or its capital resources.

Four years ago, the FDIC issued the following policy statement that attempted to reassure State nonmember banks that limited risks could be taken in the community development area without fear of adverse criticism by the Corporation's examiners:

> The Federal Deposit Insurance Corporation feels that some of its examination policies may be inhibiting insured State banks not members of the Federal Reserve System from investing in the securities of corporations who are engaged in providing capital to minority business enterprises, securities of foreign governments, or the securities of corporations which are not merely private and entrepreneurial but whose objectives and purposes are primarily of a civic or community nature or seem socially desirable to the bank's board of directors or trustees and whose risk as a bank investment may seem greater than normal. These policies include criticism by examiners of investments by banks in equity securities or other securities not of Group I or "investment grade."
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> It has been suggested that these constraints have in some instances inhibited banks from participating effectively in the broad social movements that have taken place in the United States during the past decade. Indeed, Congress has enacted laws authorizing programs for community rehabilitation, low

and moderate income housing, and many other social objectives, and the support and participation of the financial community has been solicited to achieve those goals. In this vein, the Urban Affairs Committee of The American Bankers Association has recently sponsored the formation of Minbanc Capital Corporation, a closed-end investment company whose primary objective is to make capital funds available to qualifying minority owned banks and whose capital stock has been offered exclusively to ABA member banks. Other similar corporations, such as "Mesbics," have also been recently suggested to facilitate the flow of capital to minority business enterprises.

By encouraging insured State nonmember banks to restrict their investments to "investment" grade securities, the Corporation has perhaps also inhibited some banks from acquiring debt securities of alleged merit, which technically fall short of "investment" grade quality by conventional standards or liquidity and other measureable qualitative factors. Such a situation might arise with respect to debt securities associated with community rehabiliation or development corporations, which, while lacking the qualitative elements of "investment" grade securities, are regarded by knowledgeable bankers as "tolerable" risks to depository financial institutions on a restricted and controlled basis. Similar circumstances may prevail in the case of securities of a foreign government, particularly among the new emerging nations, which not only suffer from liquidity imperfections arising from limitations on transfer and exchange rate fluctuations, but also qualitatively because of the absence of a reliable past record of debt performance and financial stability and an uncertain political climate.

The Corporation does not wish to impede those banks that feel a strong sense of responsibility from providing limited financial assistance under the circumstances described. Accordingly, the Board of Directors is adjusting the Corporation's examination policies to enable those insured State nonmember banks that so desire to invest in equity or capital debt securities falling within broad categories such as those discussed without fear of criticism by the Corporation or its examiners, subject to the following conditions:

(1) That such investments are allowed for State nonmember banks by applicable State law;

(2) That the aggregate total of all such investments not exceed the amount authorized by applicable State law or 10 percent of the bank's total capital or surplus accounts, exclusive of capital notes and debentures, whichever is less; and

(3) That all such investments have been approved by the bank's board of directors or trustees as "Leeway Securities" and are so identified on the bank's general or subsidiary ledger records.

Within the parameters outlined above, the acquisition of "leeway securities" will not be subject to criticism by Corporation examiners, and in the absence of default or bankruptcy will be permitted to be carried on the bank's books at amortized acquistion cost.[4]

The Statement of Policy appears to have served its purpose, but it should be noted that it does not apply to direct loans because of the multiple forms "community development" loans can take and the fact that in most states bank loans to a single borrower are already limited in relation to the bank's capital.

Looking ahead, there are a number of current trends and poten-

4. 37 Fed. Reg. 16,228 (Aug. 11, 1972), *as amended* 39 Fed. Reg. 8956 (March 7, 1974).

tial developments that may affect significantly the willingness of bank managements to commit the financial resources of their banks to community development projects. Foremost among these is the likely future of legislative proposals at both state and federal levels to mandate bank investments in particular sectors of the economy, rather than to leave the allocation of credit, as it is presently, to the voluntary decisions of thousands of independent managements. Given the current disarray within the congressional committees with jurisdiction and the strong tide of public opinion that is running against further centralized planning and direction of the nation's affairs from Washington, adoption of this approach at the federal level appears most unlikely in the foreseeable future. Considerably more likely to prevail, depending on the local political situation, are attempts in the densely populated urban states to mandate at the state level greater investment by banks and other financial institutions in blighted and deteriorating neighborhoods, in mortgage loans on in-state properties, or in the obligations of public units located within the state. Federally chartered banks and savings and loan associations are probably beyond the effective reach of such legislation, and state-chartered institutions no doubt will protest vigorously the competitive unfairness of that situation should the legislation pass. But the legislative debates on these proposals and on the related subject of "redlining" may prompt more intensive efforts on the part of banks to meet on a voluntary basis the financing needs perceived by the legislature.

Secondly, the low taxable income of many banks may influence them strongly in the future away from tax-exempt securities of state and local subdivisions unless an optional form of taxable security, carrying a higher effective return, is developed. Issues that are essential for local community development projects may suffer as a consequence. A longer-range cloud on the same horizon is possible accounting changes in the treatment of investment account securities that may require periodic revaluation based on market conditions, a subject now being reviewed by the Financial Accounting Standards Board and other accounting groups, with particular reference to municipal securities facing possible default in the payment of interest or principal.

Thirdly, while levels of bank capital are adequate for most insured banks, there has been a significant deterioration over the past fifteen years in the capital levels of many fast-growing banks and of banks with more than 1 billion dollars in assets, particularly those having a significant volume of foreign business. Banks in this group with a proven record of earnings coverage over and above the

high loan charge-offs of recent years will no doubt be able to float new capital issues successfully. Those unable to do so, some of which will be leading banks in their local communities, may have to apply stringent credit standards and show significant earnings improvement before the capital markets are reopened to them. This may inhibit significantly their growth in the meantime and restrain their willingness to commit financial, as opposed to managerial, resources for new community development projects.

Whatever the outcome of these matters, however, the vast majority of banks in this country will continue to be committed substantially to the improvement and growth of the communities in which they are located, since their own future is linked so inextricably with the overall health of these same communities. Bank regulatory agencies will encourage that commitment by the limited means available to them in a banking system where the final allocations of credit and management talent remain a matter for voluntary action by private citizens close to the scene. These decisions will not satisfy all the demands for credit, but the community development projects that receive bank funds are likely to be those that appear most significant to the local economy and most likely to succeed financially.