CDBA Community Development Bankers Association
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June 22, 2016

The Honorable Janet Yellen
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chairman Yellen:

On behalf of the Board of Directors of Community Development Bankers Association (CDBA), I wish to thank you for the opportunity to meet on June 3, 2016 and discuss the work of banks that are certified Community Development Financial Institutions (CDFIs) in serving low and moderate income (LMI) communities. As a follow up to the conversation, below are issues and recommendations that the Board would like to advance for further consideration.

<u>Background</u>: CDBA is the national trade association of banks and thrifts with a primary mission of promoting community development. There are 122 banks with the Treasury's CDFI designation – which means at least 60% of total lending, services and other activities are targeted to LMI communities. CDFI banks work in impoverished urban neighborhoods and remote rural areas with declining economic bases.

<u>Challenge</u>: CDFI banks are more committed than ever to serving LMIs and promoting financial inclusion among the unbanked and under-banked. We are concerned that many <u>well-intended</u> Dodd-Frank regulatory changes are having <u>unintended consequence</u> of significantly reducing credit availability and access to financial services in LMI communities. We fully appreciate the intent of Dodd-Frank regulators to mitigate risk, ensure the soundness the financial system, and promote consumer protection. The "secret sauce" of CDFI banks, however, has always been our ability to be flexible and craft sustainable products and services to meet the needs of our unique customers. The effect of regulatory changes are to reduce flexibility and increase cost; thus, making it harder for CDFI banks to serve LMI communities.

As a nation, we have already seen what happens when low income markets and vulnerable populations cannot access the banking system. Non-regulated predatory lenders and service providers will fill the gaps. As the last decade has demonstrated, the consequences are dire not only for LMI families and communities, but for the economy as a whole. CDBA's recommendations are in three categories: (1) community reinvestment; (2) impact of regulation burden on financial inclusion; and (3) capital formation.

<u>Recommendation 1</u>: CDBA recommends that the Federal Reserve take a leadership role among its fellow Federal agency peers by initiating the creation of an Interagency Committee on Financial Inclusion and Community Investment. Such a Committee should: (1) examine the role of increasing regulation on the ultimate service to LMI communities and the un- and under-banked; and (2) review and streamline any rules or policies that undermine financial inclusion or investment in LMI communities.

An Interagency Committee on Financial Inclusion and Community Investment should include all of the banking regulatory agencies, the Consumer Financial Protection Bureau (CFPB), and the Treasury Department's CDFI Fund, as well as include representation from regulatory, supervisory, and consumer and community affairs divisions of the banking agencies to best inform policy making. We believe Federal policy makers need to balance the need for safety and soundness and consumer protection with the need to ensure access to affordable credit and financial services for LMI communities.

We urge Federal policy makers to recognize the important role of CDFIs in serving LMI communities and the un- and under-banked. To serve these vulnerable markets, CDFIs need flexibility to innovate. There is a long track record of CDFIs safely and soundly piloting new products and services and proving viability of offerings later adopted by bigger banks. Federal policy makers have an opportunity to partner with CDFIs to promote financial inclusion, and flexibility is key. In some cases, this review may result in giving CDFIs greater compliance flexibility or exemptions.

COMMUNITY REINVESTMENT ACT

CDFI Banks strongly support the purposes and objectives of the Community Reinvestment Act (CRA). CRA was enacted into law 40 years ago and the last significant regulatory overhaul was 20+ years ago and it has in some ways lost some effectiveness for LMI communities and those who serve them. The financial services industry has radically changed in the last two decades, but CRA has not. We believe that the CRA can be a powerful tool to: (1) promote investment in LMI communities; and (2) support and expand the capacity of CDFI banks to serve underserved communities. With a few small changes, it could help CDFI banks expand their capacity, reach and impact.

<u>Recommendation 2</u>: CDBA strongly recommends greater policy coordination between the bank regulatory agencies' implementation of CRA and the Treasury's new annual CDFI certification requirements.

In 2016, the CDFI Fund launched a new annual certification report that will require geocoding of all loans and services within a bank's entire footprint. Bank regulatory agencies have a very different set of CRA reporting and compliance requirements that measure lending and service in a more geographically limited Assessment Area. All of the Federal agencies are essentially interested in the same outcomes – improving the economic well-being of LMI communities. Yet, the lack of policy coordination results in multiple standards and voluminous double reporting that creates unnecessary administrative burden and siphons resources away from CDFI banks serving underserved communities.

Given the important public policy objectives that CDFIs fulfill, we recommend that the bank regulatory agencies and Treasury Department jointly design an alternative special CRA evaluation methodology option for CDFI banks that will utilize the same data as used for CDFI certification. The regulatory agencies have previously recognized distinctions between different types of banks by creating alternative CRA evaluation methodologies (i.e. small bank, wholesale bank, strategic plan). Today, bank examiners do not distinguish or recognize the CDFI certification when it considers a CDFI bank's performance under CRA – despite the fact that CDFI banks dedicate a greater portion of their overall activities to the lowest income communities. We recommend greater coordination and policy consistency between Treasury and the banking regulatory agencies for CRA compliance and CDFI certification requirements with the goal of streamlining data collection and simplifying reporting for CDFI banks.

We believe more information sharing among Federal policy makers could reduce reporting overlap. For example, in early 2016, Treasury and the National Credit Union Administration (NCUA) announced an initiative to share data collected by the NCUA that could also be used for CDFI certification. Banking regulators and Treasury should initiate similar information-sharing efforts to reduce the combined burden of compliance for CRA and CDFI certification.

<u>Recommendation 3</u>: CDBA strongly recommends that investments in CDFI banks receive the same treatment under CRA as those investments made in Minority Depository Institutions (MDIs) and Low Income Credit Unions.

Despite the 20+ years since CDFIs were first formally recognized by Federal policy makers and their strong performance in serving low income markets, CDFIs are not explicitly recognized under CRA in the same manner as MDIs and Low Income Credit Unions. Currently any bank can get CRA credit for providing financial or other support to an MDI or Low Income Credit Union regardless of whether or not the entity is located within a bank's designated Assessment Area. By contrast, a bank providing similar support can only be assured of getting CRA consideration if the CDFI is located in or substantially serving a bank's designated CRA assessment area.

CDFI banks should be afforded the same consideration as MDIs or Low Income Credit Unions because the CDFI standard targeting service to LMI communities is far more stringent. For example, there are 164 MDIs -- of which only 37 meet the CDFI standard of targeting at least 60% of their lending into low income communities. In recent years, the National Credit Union Administration (NCUA) has significantly revised and relaxed the requirements for qualification as a Low Income Credit Union. Twenty years ago, less than 200 credit unions met this standard. Over the past few years, NCUA has lowered the requirements and now fully one-third (2,000+) of all credit unions qualify. By contrast, only 271 credit unions (4.5% of the sector) meet the more stringent CDFI requirements.

<u>Recommendation 4</u>: CDBA strongly recommends that the Federal Reserve and bank regulatory agencies embark on an overhaul of the current CRA regulations including explicitly recognizing the valuable role that CDFIs play as innovators in facilitating access to credit and financial services in LMI communities.

CRA is highly valuable, but outdated relative to the dramatic changes in the financial services industry. Despite the politically challenging climate, we strongly urge the Federal Reserve and other bank regulatory agencies to revisit and update CRA lest it risk becoming functionally obsolete. We believe that the CRA can once again be a powerful tool to support disinvested communities, as well as expand the capacity of CDFIs serving underserved communities.

CRA needs to be updated to reflect the movement away from bricks-and-mortar branches toward mobile, internet and other digital delivery mechanisms. Federal Reserve and FDIC research reveals un- and under-banked consumers are more likely than other demographics to access financial services through mobile devices, prepaid debit cards, or other nontraditional means. Over the 20 years since that last overall of CRA, CDFIs have also emerged as impactful innovators in forging new paths to reach under-served markets.

FINANCIAL INCLUSION & IMPACT OF REGULATION

CDFI banks are on the front line in promoting financial inclusion and viability of small businesses and consumers. We have a mission and proven record of serving the most challenging communities in America. Some policies created to protect the safety and soundness of the banking system post-crisis may have unintended consequences of undermining financial inclusion and access to credit. These are highly complex issues.

The Federal Reserve has authority over some Dodd Frank provisions that may create challenges to financial inclusion; but, jurisdiction lies across multiple agencies, including the CFPB. Thoughtful consideration needs to be given to how each rule and how the cumulative impact of multiple rules impair the ability of CDFI banks to serve these markets. In some cases, new Dodd-Frank regulations are forcing CDFI banks (and other community banks) to suspend, modify or even discontinue necessary services. Yet, the demand and need does not end. The void is filled by non-regulated and possibly predatory lenders. Vulnerable members of our communities are impacted.

<u>Recommendation 5</u>: As noted, CDBA recommends that the Federal Reserve take a leadership role among its fellow Federal agency peers by initiating the creation of an Interagency Committee on Financial Inclusion and Community Investment. The mandate of the Committee should be to ensure that Federal rules and policies due not undermine financial inclusion and investment in LMI communities. Below are several specific examples of how well-intended regulation is having an unintended impact on LMI people and communities.

SMALL DOLLAR LOANS: Recent news accounts and studies have reported that as high as 62% of Americans do not have $1,000 in savings, 21% do not have a savings account and do not have

$500 for an emergency. Of those with savings 57% reported using all or some of their savings during the recession. What do these families do in an emergency or simply repairing a car to get to work? To fill this gap, many CDFI banks have created small dollar loan products.

On June 2, the CFPB released a new proposed rule on small dollar loans. We are still analyzing the impact of the 1,300+ page rule, so we do not yet have specific recommendations. Our experience today finds that these products, while not profitable, are important to provide lest our communities and residents get caught in predatory products. We strongly doubt regulated financial institutions will be interested in offering the short-term 45 day products that are the focus of the rule. Yet, many banks have experimented with an array of longer term products that may be caught up in the rule. We are concerned that the compliance costs of the proposed rule not become so onerous that responsible regulated entities cannot offer them – leaving consumers with an emergency need at the mercy of payday or other predatory lenders.

Given the critical gap that small dollar loans fill in enabling low income households to respond to emergency needs, CDBA recommends this proposed rule be reviewed by the Interagency Committee on Financial Inclusion and Community Investment to ensure that it does not create unnecessary barriers for responsible regulated institutions to offer customers.

MORTGAGE LENDING: Home ownership is one of the most effective ways to help LMI families to build assets and economic security. Changes to Regulation Z now require appraisals on home loans over $25,000 which can create barriers to home ownership among low income families. Low housing values in particularly in rural markets can result in market aberrations that do not fit the current rules. For example, in some rural communities, many home sales range from $25,000 to $50,000. Previously banks could use internal reviews in lieu of a formal appraisal – a practice that saves borrowers money. Accurate and timely appraisals can be hard to get in rural markets due to large geographic areas and very low sales volumes. Often these appraisals cannot meet regulatory standards; thus the loans cannot qualify as conventional loans to be sold into the secondary market. The cost of obtaining an appraisal is traditionally paid for by the borrower; thus, it increases the cost of home ownership for low income families.

For low income communities, CDBA recommends waiving the appraisal requirement and using the prior practice whereby regulators allowed banks to use internal assessments of value based on market knowledge. In rural communities, mortgages under $100,000 should be exempt, as well as mortgages on manufactured housing. In urban places, a scale should be developed to exempt modest value mortgages that takes into consideration cost of living and MSA housing prices.

TILA-RESPA INTEGRATED DISCLOSURE (TRID): At the heart of the new TILA-RESPA Integrated Disclosure (TRID) rules is an effort by the CFPB to provide consumers with a clear and accurate understanding of the costs associated with purchasing or refinancing a home. CDBA applauds efforts to improve transparency and consumer knowledge. Yet, the sheer volume of new disclosures required under TRID is overwhelming to a typical borrower. Most consumers simply sign the documents without understanding them – which works against the purposes of "know before you owe."

Bank compliance costs, as well as higher fees charged by closing attorneys due to the complexity of the rule are ultimately passed on to the borrower. TRID ultimately increases the cost of becoming a home owner and is particularly burdensome for lower income households and a barrier for home ownership. TRID has also increased the amount of time it takes to close a loan. While this may be an inconvenience for most households, among first time buyers or low income households just developing the financial literacy skills to become a home owner, the barriers and delays are significantly greater. The TILA rules further force quick declines of applicants not meeting all requirements – effectively preventing intervention by counselors that can help resolve problems. As a result of additional compliance costs and risks, some banks have exited the mortgage market while others have increased their minimum loan size. The impact is felt primarily by low and moderate income people - hurting the consumers the CFPB trying to help.

CDBA recommends that CDFIs be exempt from TRID, similar to the exemption under the Ability to Repay-Qualified Mortgage Rule.

PREPAID DEBIT CARDS: The 2013 FDIC National Survey of Unbanked and Underbanked Households reported that 22.3% of all unbanked households used prepaid debit cards as compared to 5.3% of fully banked households. For CDFI banks, offering prepaid debit cards is a logical step given the demographics of their core customer base and a compliment to other services. Prepaid debits cards provided by regulated financial institutions carry stronger consumer protections than those offered by many unregulated providers. Pursuant to section 1028(b) of the Dodd-Frank Act, the CFPB is proposing to establish 12 CFR part 1040 which is creating new barriers to offering these types of products because of its mandatory arbitration requirements. The rule prescribes that arbitration be precluded as an option for consumers to solve issues of complaint against a product provided by the financial institution. CFPB's own study shows that arbitration solutions provide a higher dollar resolution to consumer's issues over litigation. Due to the class action suit "permission" implicitly granted by this rule, the Plaintiffs bar is the entity which will become enriched by this action, and not the consumer. This high cost of doing business may preclude many CDFI banks from providing this much needed service to the un- and under-banked. These risks significantly increase costs to offer prepaid debit cards. If CDFI banks or other regulated institutions stop offering prepaid debit cards because the risks and costs are too high, unbanked and underbanked households suffer the consequences.

CDBA recommends that CDFI banks be exempt from 12 CFR part 1040 as proposed by the CFPB.

BANK SECRECY ACT (BSA): Residents of LMI communities, particularly those with large immigrant populations, are more dependent on Money Service Businesses (MSBs) than middle and higher income communities. Most MSBs are not predatory lenders. In rural communities or urban neighborhoods, many are simply Mom and Pop retail stores that provide customers with the convenience of cashing a check after regular bank business hours, paying bills, or wiring money to their families back home. The very broad definition of an MSB includes grocery stores, convenience stores, or other retail. These small businesses are often CDFI bank customers.

BSA is important part of our nation's security. Yet, BSA places a high burden and cost on banks – particularly small banks and small business -- that create barriers for retail customers. If CDFI banks stop serving these businesses, the businesses will stop providing the service which, in turn, hurts the low income consumers.

Regulatory agencies have significantly enhanced BSA scrutiny. BSA compliance standards are the same for small banks as the largest bank; thus, making it difficult for the smallest banks to maintain service. As a result, more and more banks will not accept or open accounts with MSBs. When this happens the business can no longer offer the service and consumers are forced to go to expensive check cashing businesses.

To preserve availability of basic financial services in LMI communities, CDBA recommends that regulators develop a streamlined version of BSA for small banks under $10 billion. Some examples of streamlining: (1) significantly raising the MSB registration threshold above the current $1,000 for cashing checks for any person on any day in one or more transactions: (2) waiving the requirement that small banks monitor MSB registration and MSB BSA compliance for small businesses; (3) clarify that banks are not required to obtain contracts or otherwise monitor the activities of a retail customers vendors (e.g. an ATM vendor that leases space from a convenience store); and (4) reduce the paperwork required for performing due diligence for Phase II Exempt Customers (e.g. confirming a business is in Good Standing with the Secretary of State).

RECIPROCAL DEPOSITS: CDFI banks operate in communities with modest discretionary income. We often find that income is insufficient to raise deposits needed to fund loans. Therefore, as an integral part of our strategy, we raise deposits from civic-minded corporations, nonprofit institutions, and other local stakeholders. Our common experience demonstrates that investors are willing to invest much larger deposits in CDFI banks if they are assured those deposits are secured. Many institutional depositors often have requirements that deposits be fully insured. Reciprocal deposits provide that assurance. Without access to large institutional deposits, many of our loans could not be made. In fact, CDFI banks are four times more likely to use reciprocal deposits than their peers. The problem is that reciprocal deposits are defined by the FDIC as brokered deposits despite the fact that they are relationship-based and as stable as core deposits. Studies have shown that reciprocal deposits do not present any of the regulatory challenges that brokered deposits do.

CDBA recommends that reciprocal deposits be exempt from the FDIC's definition of brokered deposits.

CAPITAL FORMATION: HOW BASEL III NEGATIVELY IMPACTS CREDIT IN LMI COMMUNITIES

CDBA is very concerned that the proposed Basel III regulators, as applied to small banks, will create significant constraints on access to credit in LMI communities. Basel III proposes to significantly revise and increase the regulatory risk-based and leverage capital requirements for all banks. CDBA members believe that significant refinements are needed to ensure that the Basel III rules do not result in an unnecessary reduction in credit and economic activity among people and places that have historically had tenuous access to the mainstream financial services. CDBA supports amendments to Basel III, which was originally intended to apply only to large, internationally active banks.

<u>Recommendation 6</u>**: CDBA supports a full exemption from Basel III for *all* non-systemically important financial institutions (non-SIFIs). Alternatively, if a full exemption is not possible, CDBA proposes several amendments outlined below. Ideally, we believe these amendments should be applied to all small banks (under $10 billion) as it will help bolster the economic health of the nation. If it is not possible to apply the amendments to all non-SIFIs, we urge you, at a minimum, to consider them for CDFI banks given the significantly more acute economic challenges faced by their LMI communities.**

CAPITAL CONSERVATION BUFFER: CDBA recommends exemption from the capital conservation buffer for non-SIFIs. The new capital conservation buffer provisions impose dividend restrictions that have a chilling effect on potential investors for all small banks. This circumstance is particularly acute in the case of dividend restrictions for Subchapter S banks whose investors rely on dividends to pay their pro-rata share of the bank's income tax (this same type of limitation is not applicable to C Corp banks). Exempting all non-SIFIs from the capital conservation buffer would make it easier to raise capital and maintain capital levels proportionate with their risk profile.

In the case of a CDFI bank, every dollar of capital is particularly precious because it was either earned and retained or raised in some form to meet both the financial return and social impact expectations of an investor. The new capital buffer provisions raise the aggregate quantity of capital regardless of the bank's risk profile, it inherently lowers and/or lengthens the investors' time horizon and specifically limits the type of capital to common equity that can be raised. Even though CDFI Bank investors are typically long term patient investors, the new buffers create challenges no matter what type of capital is considered.

FULL CAPITAL RECOGNITION OF ALLOWANCE FOR CREDIT LOSSES: Adequate capital is important at every bank. CDBA recommends that the allowance for credit losses be included in Tier I capital up to 1 .25 percent of risk weighted assets with the remaining amount reported in Tier 2 capital. This change would reverse the punitive treatment of the allowance under Basel III. Currently, there is no capital treatment for loan loss reserves that exceed 1.25 percent of risk weighted assets. The allowance should be captured in the regulatory capital framework since it is the first line of defense in protecting against future credit losses. CDFI Banks are particularly adept at partnering and layering financing to mitigate and share credit.

AMENDED RISK WEIGHTING: CDBA recommends providing 100 percent risk weighting for acquisition, development, and construction loans to promote economic development in LMI communities. Under Basel III, many of such loans are classified as High Volatility commercial real estate loans and risk weighted at 150%. The current risk weighting for Commercial Real Estate (CRE) does not adequately distinguish among different types of activities that have different risk profiles. For example, affordable rental housing loans are risk weighted the same as speculative commercial real estate. Yet, during the Great Recession, affordable rental housing outperformed every category of commercial real estate with minimal losses. In LMI communities, CDFIs and others often use a range of Federal, state and local subsidy programs that mitigate CRE lending risks, including the Low Income Housing Tax Credit, New Market Tax Credit, and the Historic Preservation Tax Credit. To provide a 100% risk weighting for acquisition, development, and construction loans in LMI communities would treat these loans the same as other commercial real estate loans and would be consistent with Basel III.

<u>Recommendation 7</u>: CDFI Banks have a diverse set of capital structures and types that have evolved to meet the changing financial challenges of our markets. CDBA recommends that the regulatory agencies amend its Tier 1 rules to accommodate certain types of capital that are uniquely available to CDFI banks.

CDFI banks often have access to philanthropic or alternative mission-oriented capital that may not fit customary market-rate or regulatory definitions. For example, a growing number of foundations offer Program Related Investments (long term, deeply subordinated debt at concessionary rates).

We recommend that bank regulatory agencies to allow certified CDFI banks additional flexibility in utilizing such philanthropic or impact-motivated sources. First, we recommend regulators amend the subordinated debt rules to give Tier 1 consideration to resources provided it at subordinated or concessionary rates that are borrowed by the holding company and injected into the CDFI bank as capital. Second, we ask that you to work with the CDFI banks to design new types of preferred stock ownership that can be given Tier 1 consideration which take into account due to the social inclination of our shareholders

On behalf of the Board and members of CDBA, I thank you for the opportunity to discuss how the current regulatory environment is affecting LMI communities and the unbanked and underbanked. We share the concerns of law makers and regulators about protecting the soundness of the financial system and promoting consumer protection. Yet, as noted, we are gravely concerned that many well-intended Dodd-Frank regulatory changes are having unintended consequence of significantly reducing credit availability and access to financial services in LMI communities. We believe that some modest modifications could make a significant difference in the economic well-being of LMI communities across the nation.

We welcome the opportunity to continue this dialogue with members of the Federal Reserve staff. Thank you for considering these important matters. Please contact me at 202-689-8935 ext. 222 or jacokesj@pcgloanfund.org.

Sincerely,

Jeannine Jacokes
Chief Executive Officer

cc:
Governor Stanley Fischer, Vice Chairman
Governor Lael Brainard
Governor Jerome H. Powell
Governor Danial K. Tarullo