Winter 1994 A special report on bank accountability

Hank Boerner's

Corporate Governance & Accountability UPDATE™

Treasury Secretary Lloyd Bentsen on CRA Reforms...

"We've developed another element in our program to improve access to credit for Americans through proposed regulations to take the uncertainty out of the *Community Reinvestment Act (CRA)*. The heavy lifting has been done by the Office of the Comptroller of the Currency; the Office of Thrift Supervision; the Federal Reserve System; and Federal Deposit Insurance Corporation. The effort was led by [Comptroller] Gene Ludwig of OCC and [Governor] Lawrence Lindsay of the Federal Reserve System.

"The regulations, to replace the existing CRA regs in their entirety, will make it easier for lenders to show they are complying with the CRA. We will now have clear, quantitative standards by which compliance can be measured. That's important when banks ask regulators to approve mergers and new branches.

"What we are trying to do is make credit more available for small businesses, small farms, and in distressed areas of our country. The only thing that ought to matter on a loan application is whether you can pay it back, not where you live. We think this [proposed] regulatory change will make that credit available, so we can see more jobs created and deserving Americans can see their dreams fulfilled.

"We talked in March 1993 about breaking the *credit crunch*. We promised by year's end to install some sanity in the standards of the CRA, and our proposal does that."

Community Reinvestment Act Reform:

U.S. BANKS FACE NEW STANDARDS FOR FAIR LENDING AND GREATER CORPORATE ACCOUNTABILITY

Washington, DC — The pressure is on in Washington to encourage greater "accountability" on the part of American banks of all sizes — from small community banks to the huge, money center institutions. New federal banking rules are proposed that will help bring more "democracy" to bank lending practices. 1994 and 1995 promise to be years of significant change for many U.S. bankers.

The chosen instrument for immediate change is the ***Community Reinvestment Act,*** which could be made more stringent by Congress (if initial sponsors have their way) in 1994. At the same time officials of the big four regulators — **Federal Reserve**, **FDIC**, **Office of Thrift Supervision** and the **Office of Comptroller of the Currency** — are saying to Congress that enough law has already been enacted to deal with bank lending practices and that new CRA regulations will better address the issue, not more legislation.

Other reforms — including a total restructuring of the nation's bank regulatory infrastructure — are creating high stake negotiations for the Treasury Department, White House, Congress, and the Federal Reserve bankers.

The **OCC** is circulating (on behalf of the four agencies) new draft regulations for CRA compliance that would take effect in 1994 and would be phased in through 1996-97. The new rules would provide bank management with greater flexibility to meet the credit needs of their entire communities, including low- and moderate-income areas, consistent with safe and sound operations. There would be more focus on overall accomplishment and "performance" less on individual bank products (such as single-family mortgages).

This would shift the federal regulations to an emphasis on **performance** — and away from a focus on **process**.

Banks would be required to show performance in three key areas —

- Fair Lending Practices;
- Availability of Services to All
- Investment in the Communities Served

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What Direction for CRA Rules?
But even the new rules may not be tough enough for some members of Congress or for public interest groups and local activist groups representing low-income individuals and members of minority groups. Based on testimony presented by leaders of the Big Four federal regulatory agencies, it appears that the proposed CRA regulations are specifically designed to head off over-reaction by the Congress to recent news reports regarding non-compliance with current mortgage lending guidelines.

The new rules would also offer community leaders an opportunity to be more involved in CRA evaluation, on a more realistic basis, and not just when regulatory approvals are sought by banks and bank holding companies. (Bankers complain that too often, some "community groups" show up and first become known to the bank when a regulatory proceeding is underway and the bank's CRA performance is being reviewed.)

Bankers are frequently placed in the jaws of a vise — it is costly and difficult to know what the regulators want under today's CRA regulations, and then to comply with voluminous paperwork. Still more CRA regulations, or more fair lending and credit laws (and then still more regulations to enforce the legislation) coul d be in order for 1994, and the devil will be in the details. ***Compliance*** is becoming a very complicated affair; "banker accountability" is the watchword in Washington these days.

Complicating this somewhat is the White House and Treasury Department's initiative to restructure the regulatory agencies themselves. We detect a shifting of oversight priorities to include a separation of big and small banks, with money center banks and bank holding companies being regulated separate of state or community banks. The new set up will depend on the outcome of a power struggle underway.

Classic Washington Power Struggle
The Clinton Administration wants to create one super bank regulating agency out of the four existing bodies (the "**Federal Banking Commission**"); one result would be to simplify and strengthen regulations requiring that banks make loans and that services be more available in low-income areas. Exactly where ATMs are to be located could be more closely scrutinized by government, for example.

Critics of the present system say that banks shop among regulators to find more lenient examiners. One agency would tend to have uniform inspections. The move toward interstate banking would be enhanced because in some ways the separation between state and federal authority could be merged. The Federal Reserve bankers oppose such a move, stressing the need to maintain its independence. (The OCC, FDIC and OTS organizations are under the direction of **Treasury Secretary Lloyd Bentsen**.)

Federal Reserve Governor **John LaWare**, a former chairman of **Shawmut National Corporation**, advanced the Fed's position in the *American Banker* recently. LaWare suggests that the new Commission take on responsibilities of FDIC, OCC and OTS, while allowing the Federal Reserve System to oversee the bigger money center banks and bank holding companies. State bank activities would be regulated by the proposed Federal Banking Commission.

Some members of Congress are proposing that banks be allowed to compete on a more equal basis with non-bank banks, which is opposed by the insurance and securities industries (both would face greater competition from banks). The White House is luke warm on interstate banking but hot on fair lending issues and regulatory reform. There is already a lot on the Clinton action agenda — GATT and NAFTA in 1993, healthcare reform in 1994. The President doesn't need to battle over interstate banking in 1994. His administration will move on fair lending immediately and interstate banking longer-term.

Justice Involved in Fair Lending
Some administrative agencies are already flanking the bank regulators — the **U.S. Department of Justice** has singled out several major commercial banks for special inquiries regarding their record of lending (or not lending) to low-income and moderate-income groups. The department has asked for volumes of supporting documents from the banks involved.

Justice spokespersons are quoted as saying the department is willing to invest in high profile cases to send a message to all bankers. The first banks subject to the informal inquiry process received considerable media attention; one bank holding company was temporarily prevented from acquiring another institution, one consequence of the CRA regulations. Indications are more bankers will be contacted by Justice.

At **Housing and Urban Development**, **Secretary Henry Cisneros** has attacked banks for their lending bias and warned that new HUD regulations on housing loans would be forthcoming. (HUD position: If more banks were involved in affordable housing projects and community development programs, less federal funds would be needed to reach objectives.)

New CRA Regulations Proposed
Against this background, new CRA regulations are being circulated by OCC to address a number of issues, including: examiner training and increased interagency coordination to develop standards; assignment of new ratings; and use of enforcement tools. ***Home Mortgage Disclosure Act (HMDA)*** data would increase in importance. More community involvement (in determining the ratings) is probable. **President Clinton** asked the regulators to develop more effective CRA regulations and examination procedures that would "replace paperwork and uncertainty with greater performance, clarity and objectivity." Unsaid: *And place an emphasis on greater **accountability** in bank lending practices.*

There are presently 12 assessment factors for determining CRA compliance; under the proposed rules, these would be replaced with a performance-based evaluation system. Banks would be graded on their provision of loans, services and investments in their communities. **Performance**, in other words. Large institutions would continue to be graded on their loans in low- and moderate-income areas but would also be given credit for community development loans and their partnerships with community groups to promote credit availability.

A number of forward-thinking banks have created separate community development banks. The White House wants to create several hundred such entities. Candidate Clinton promised to create a nationwide network of community development banks to provide small loans to low-income entrepreneurs and homeowners in the inner cities. These banks would also provide advice and assistance to entrepreneurs, invest in affordable housing, and help mobilize private lenders. Commercial banks could directly invest in these local community development institutions.

The spirit of some of the campaign promises are to be found in the new CRA rules — bank examiners would take into account a bank's economic development activities, charitable and civic donations, staff time devoted to good works; sales on favorable terms of their branches to women- and minority-owned banking institutions; and, bank investment partnerships created in close cooperation with community organizations. (Many commercial banks already serve as funnels for the federal and state aid that flows to communities, but bankers point out that they really don't receive recognition for this in the CRA examination process.)

Bankers will be encouraged to get close and stay close to the communities they serve. This will be a challenging assignment for large banks and bank holding companies (bank holding companies are held accountable for the actions of virtually all of their individual mortgage service and lending units).

A Changed Regulatory Environment

These new CRA rules will create a changed operating environment for banks. Institutions would receive one of five ratings (from the top-rated *Outstanding* down to *Substantial Noncompliance)* for the *demonstration* of how they service the needs of their communities. (There are four ratings under the present rules.) There would be greater disclosure of compliance and/or non-compliance and tougher sanctions for those banks not in compliance with the new regulations.

CRA performance will continue to determine whether (or on what terms) a bank can obtain charters, establish or relocate a branch office or ATM, acquire another insured institution (or its assets), and have access to certain federal funds. Ultimately, CRA compliance becomes a CEO and board room issue.

Thanks to certain key changes in the **U.S. Census Bureau** methodology, rules requiring that Census tracts be used for measuring compliance and matching technology capabilities within the examining agencies, most bank lending practices will be under a more powerful microscope as examiners chart their compliance throughout the communities served. Here, HMDA data take on critical importance. Banks have had to invest in technology and staff to keep pace with these vital changes.

The media is on to the "fair lending story" and has greatly increased its coverage of bank lending —***The Wall Street Journal*** devoted a full page of coverage (12-21-93) to the "widening gap" between white and black mortgage lending. (The newspaper claims it studied 3 million mortgage applications submitted to 9,000 banks in 1992, 2.7 million in 1991 and 2.5 million in 1990; the editors found the gap between majority and minority population loan denial is widening.)

Also helping to create this now intense focus on bank lending practices was a combination of factors: While CRA was originally enacted in 1977, it was not evenly enforced. The 1989 legislation dealing with banking reform imposed tough new sanctions on non-complying banks. There was a better system of measuring lending practices thanks to the ***1989 Home Mortgage Disclosure Act*** (HMDA). There is greater activism on the part of such groups as the **Association of Community Organizations for Reform Now** (ACORN), **Ralph Nader's Essential Information** and **National Community Reinvestment Coalition**.

New FDIC Regulations

Separate of the CRA regulations, the **Federal Deposit Insurance Corporation** is using the authority granted to it under the ***FDIC Improvement Act of 1991*** and the ***Financial Institutions Reform, Recovery and Enforcement Act of 1989*** (FIRREA) to impose *new* regulations and heighten public participation in rule making. In Washington we hear talk about more "democracy and sunshine" coming to banking.

FDIC is proposing almost three dozen changes in banking, including regulations covering: Standards of Conduct for Officers; Suspension and debarment of accountants; Safety and soundness standards; Credit risk and nontraditional activities; Activities of state insured banks; Mergers and extensions of corporate powers; Conflicts of Interest; Changes in senior officers or directors; Real Estate Appraisals; Contracts adverse to safety and soundness; Operations in economically depressed regions; Golden Parachutes; Community Reinvestment; New financial disclosure rules; Branch closings; Risk-based Assessments; External audits.

More Changes and Challenging Days Ahead

Combined, various legislative, administrative, judicial and regulatory pressures on bankers will greatly increase in 1994, even as senior bank management strives to return to profitability and financial vigor. Bankers are dealing with bad loans, non-bank competition, complaints from would-be borrowers about loan denials, sluggish loan demand on the part of credit-worthy borrowers, general governance challenges mounted by shareholder activists and investors, and the need to create stronger reserves.

At the same time federal regulators and Members of Congress are applauding commercial banks for improving their financial positions and balance sheets, other voices in Washington are calling for more leniency in making credit available to Americans. Bankers and most public sector leaders want to avoid credit allocation, one result that could occur if legislators get carried along by populist waves.

Observers recall the after effects of the *Tax Reform Act of 1986.* Real estate and development industry executives and many Wall Street investment bankers were blindsided by its provisions. Luxury boat builders sank beneath the waves as a result of a misguided but well-intentioned excise tax on boats and other luxury items. Commercial banks experienced a tremendous decline in the value of properties underlying the assets (loans) on their books.

Bankers will need to be especially vigilant in 1994 as the forces for change swirl in Washington and in the various state capitals. **New York State's Banking Departmen**t, for example, is proposing a major overhaul of its own CRA. The NYS Banking Superintendent visited Capitol Hill in 1993 to suggest similar changes for the federal legislation dealing with CRA.

Bankers Can Protect Their Institutions
Bankers can take steps to protect their interests. The recent consent order (signed in December 1993) between the **U.S. Justice Department** and **Shawmut National Corp**. is indicative of the kind of steps lending institutions must take to satisfy the clamor for increased minority and low-income lending.

Shawmut took vigorous action to increase its services to the minority community and in announcing its consent order, Attorney General **Janet Reno**'s comments about Shawmut's cooperation were so positive the *New York Times* reported that she almost sounded like a commercial for the bank. The funds involved in the settlement were "compensatory" rather than "punitive," AG Reno noted. The Shawmut consent order is instructive: Banks that move quickly and positively to remedy past problems in fair lending and make available services to all members of the community served may escape prosecutorial wrath in the future. (Addressing these challenges is also good governance -- the agreement reached with Justice now clears the way for Shawmut to resume its New England bank acquisition activities.)

IRRC — STRIVING TO BE THE OBJECTIVE SOURCE FOR INVESTORS ON CURRENT CORPORATE GOVERNANCE TRENDS AND DATA

Known to institutional investors mostly by its initials, **IRRC**, the **Investor Responsibility Research Center** is a Washington-based research and advisory not-for-profit organization serving about 500 clients, including institutional investors, lawyers, banks and trust companies, foundations, educational institutions, church groups, and more recently, major corporations.

IRRC was founded in 1972 as an independent, not-for-profit corporation and today it conducts extensive research and monitors many corporations, publishing and disseminating impartial reports on proxy voting and other business issues affecting corporations and investors. IRRC conducts forums and conferences centered on improving communications between corporations and shareholders.

The Center's expertise spans such diverse fields as corporate governance; global investing; investing in and trade with South Africa; energy and the environment; and, Northern Ireland employment. This body of expertise is sought by institutional investors, corporations, law firms, securities firms, government officials, journalists, and educators with a strong interest in corporate governance and related corporate behavior and activities. These are the major topics for 1990s discussions on the governance of corporations.

IRRC's work is financed primarily by annual fees (subscriptions) paid by more than 500 investing institutions and corporations.

IRRC offers its client base: research; portfolio screening; consulting; and database searches, specifically tailored to the needs of the client on a contract basis. IRRC is an impartial group that gathers information and consults on shareholder issues — it is **not** an advocacy group.

IRRC's growth in recent years has mirrored the expanding interest in the corporate governance movement. In 1986 there were only 55 proposals on corporate governance issues. In 1991 there were 300+ proposals and some drew as much as 40% or more of the vote.

The Investor Responsibility Research Center conducted its third annual *Forum on Cooperation between Shareholders and Corporations* ("An Agenda for Competitiveness"), in Washington, DC on October 27 - 28, 1993. This was the largest gathering to date, with more than 300 persons attending from across the spectrum of corporate governance interests.

The editors interviewed Peg O'Hara, Director of Communications, and Patrick McGurn, Corporate Governance Director and Legal Counsel.

Peg O'Hara joined IRRC in 1986; she was previously assistant managing editor of ***Congressional Quarterly.*** **Patrick McGurn** was an attorney in private practice; he first joined IRRC in 1988, served a year, and rejoined the group in 1991.

Their comments:

IRRC serves as a clearinghouse on a number of issues of concern to institutional investors. South Africa is an example; the organization has conducted extensive research on the economic sanctions against the country; provides early warning on the political, social and economic events that are shaping South Africa post-apartheid; and, maintains a watch on changes in city, state and county sanctions against doing business in South Africa.

IRRC is **not** a shareholder activist organization. It was founded more than 20 years ago by a small group of institutional investors, after the 1960's social upheavals created the need for better, more timely information about issues affecting institutions and the corporations in which they invested. Today, almost 500 investors are served. Corporations may subscribe to a package of services. The majority of income is from subscribers — fees are based on a percentage or ratio of assets or equity under management.

The IRRC staff closely monitor about 1,500 major corporations, including the **Standard & Poor** *S&P 500 Index,* which IRRC believes is a good barometer for spotting emerging trends.

The staff maintains a close focus on global issues and especially on what is happening in the area of corporate governance. Subscribers want to know: *What shareholder proposals are being filed?* (IRRC has newsletters that tell them.) *What are investors seeking in reforms?* (The answers can be learned in publications and at conferences.) IRRC monitors corporate environmental activities and particularly compliance with the *Valdez Principles* (now *The CERES Principles).* Some corporations subscribe to separate environmental monitoring services. IRRC's database includes environmental information for the *S&P 500.*

While in recent years South Africa and environmental issues have been of keen interest to corporate managers, the range of corporate governance issues has broadened to include:

- Board Election and Composition of Board Committees
- Key executives' compensation
- Voting / secret ballots
- Poison Pills
- Directors - qualifications & backgrounds
- Provisions for cumulative voting

TRENDS:

In the 1960s and 1970s, social issues were at the forefront of the shareholder activists' agenda (i.e., nuclear power, affirmative action compliance). By 1983-1984, corporate governance challenges were growin,, involving the manner in which corporations were being **governed** by both managers and directors. As major owners, institutional share owners began to assert their rights, usually in conflict with the professional managers appointed by the board (and in turn elected by the share owners), says McGurn.

NEW IRRC FOCUS:

The corporation-investor relationship today centers on shareholder resolutions, shareholder opposition for some management practices and increased communication between the two "sides."

MCGURN:

"This is a struggle over ***power.*** Who has it, how is it shared. And about independent boards. These are key corporate governance issues. We maintain a database on corporate directors, and their relationships to individual companies. We track proxy issues for individual companies. We look for ties between the corporation's financial performance and executive compensation. We focus on the fate of shareholder resolutions and proxy battles.

"Our staff gathers shareholder votes on issues after every annual meeting for about 1,500 companies and we maintain exacting files on these. As a result our database is very complete."

The new SEC rules on communication and compen-sation issues adopted in October 1992 created new business for IRRC, which answered many inquiries, held workshops and gave advice to clients both old and new.

What was on the mind of the callers? *How best to depict graphically (as the new rules called for) the new comparisons for executive compensation. What was the appropriate peer group for comparison? Should the S&P 500 Index be used? Was there a better measurement of "performance?"*

There was a high level of frustration in the corporate suite, Patrick McGurn notes. "It was at times difficult for companies to come up with the appropriate comparative grids. 1993 annual meetings and annual reports were the first test of the new SEC rules."

ARE MORE RULES NECESSARY?

"Probably not, at least short-term," he says. "The SEC took three years to arrive at the new rules for compensation disclosure and shareholder communications. In effect, the prior line that was drawn in the sand — the demarcation line for shareholder rights and management prerogatives — was advanced to a certain point. As 'reform' is resisted, the line in the sand is pushed ahead, challenged, moved back, back and forth. But still, the line continues over the decades to advance in favor of the shareholders.

"So," he notes, "the new SEC rules are yet another milestone reached, as has occurred beginning in the 1930s and continuing in the 1960s, 1970s and 1980s. The new SEC rules could be construed as the culmin-ation of the effort of the 1980s. It will probably be some time before new rules of this magnitude are adopted."

PEG O'HARA OBSERVATIONS:

Peg O'Hara is the chief press contact for IRRC. The organization achieved prominence in recent years with the emergence of challenges mounted by institutional shareowners at major corporations. Her telephone lines were swamped with calls in 1992 and 1993 as the print and electronic press moved in to cover corporate governance issues. The drama was heightened as the media reported on the departures of CEOs at **GM, Westinghouse, Kodak** and **IBM** Editors wanted to know: *What was behind these changes?*

"As the new SEC rules were applied, we received many press calls for advice and information," O'Hara explains. There was broader media interest and business and financial reporters actively pursued stories as IRRC, **CalPers**, **United Shareholders Assoiation** and others with a broad knowledge of the new corporate governance movement explained what was going on."

In dealing with the press, IRRC's objectives are:

- Be available.
- Be accurate.
- Be the identified information source.
- Do not take sides, assume no advocacy role.

"We make sure the press gets the truth," she says, "and not a one-sided position. Quite often now we are seeing studies being used to create support in corporate governance struggles. We always remain objective."

The Future?
The editors posed this question to Patrick McGurn, the corporate governance director of IRRC: ***How long will the corporate governance movement go on?***

"The executive compensation issue is not one that will go away soon. There are too many forces pressing against executives who are not paid in line with their performance.

"There is, in fact, a stream of corporate governance issues that our clients deal with, some coming on line in greater force after mid-1989, when CalPERS sent letters to corporations that it had invested in and felt were under-performing. That was a wake-up call."

The institutional investor has grown in influence as institutions became the holders of about 55% of the equities markets, becoming a very powerful force and one to be reckoned with. The institutional investor is concerned with long-term values, notes McGurn. "Whether the share owner is an institution or an individual, today the shareholder is being heard. But the corporate governance movement is being led by the institutions and particularly the public pension funds."

Performance is Key
What the corporate governance movement is centered on in the mainstream is **performance**. "Performance is now the prism through which corporate governance issues are viewed by share owners," McGurn states.

IRRC observes that the larger share owners are searching for the right ways to have an impact on the board and on corporate management, all related to improving the performance of the corporation.

Criteria have become important issues — how do you measure and rate *performance?* What are the appropriate criteria? What are appropriate *peer groups?*

"Everyone" is becoming involved in governance issues, suggests Peg O'Hara — pension and mutual fund managers, financial advisors, internal staff all are now converging on the issue of *performance.* "That is how the companies targeted by activists are selected by shareholder activists. They fall below the performance of their peers or their industry, by various measurements."

"Long-term shareholders then react — that happened to date at the major companies where CEOs departed. Those companies became the most visible and often cited examples of corporate governance challenges. There will be many more companies following," predicts Patrick McGurn.

An example of a specific current focus in governance is the separation of the offices of chairman of the board and chief executive officer. McGurn observes: "Shareholders are saying, let the chairman run the board and the CEO run the company (day-to-day). Then both can focus on performance. Performance. That is key."

"The independence of directors is another crucial issue. Directors must monitor management performance for the shareholders. These issues are at the heart of the corporate governance movement spearheaded by institutional investors."

IRRC Client Services
IRRC has organized its services in these clusters:

- Publications
- Proxy Information Services
- Company Profile Series
- Corporate Governance
- Global Investing
- South Africa
- Energy and the Environment
- Northern Ireland
- Social Issues

What kind of "social issues" are intersecting with demands for greater financial performance? IRRC's clients are interested in U.S. banks and the Third World debt crisis; tobacco; defense conversion; nuclear power; environmental compliance; plant closings; Mexican operations. These are real world issues for the institutional investors.

IRRC's Social Issues Proxy Service shows clients the likely economic impact of each social policy shareholder proposal. Environmental liability is another important monitoring service — what is the impact on the bottom line of a corporation's environment policies, or ongoing compliance activities? IRRC staffers attempt to provide answers for clients.

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