

CRA FOR COMMUNITY

A photograph of a building's exterior corner. The building has several windows with dark frames. The paint on the building is peeling and chipped away, revealing a lighter color underneath. The main color of the paint is a vibrant red, with some areas of blue and yellow. The building appears to be in a state of disrepair or undergoing renovation. The sky is visible through the windows, showing a blue sky with some clouds.

ISTOCK PHOTO



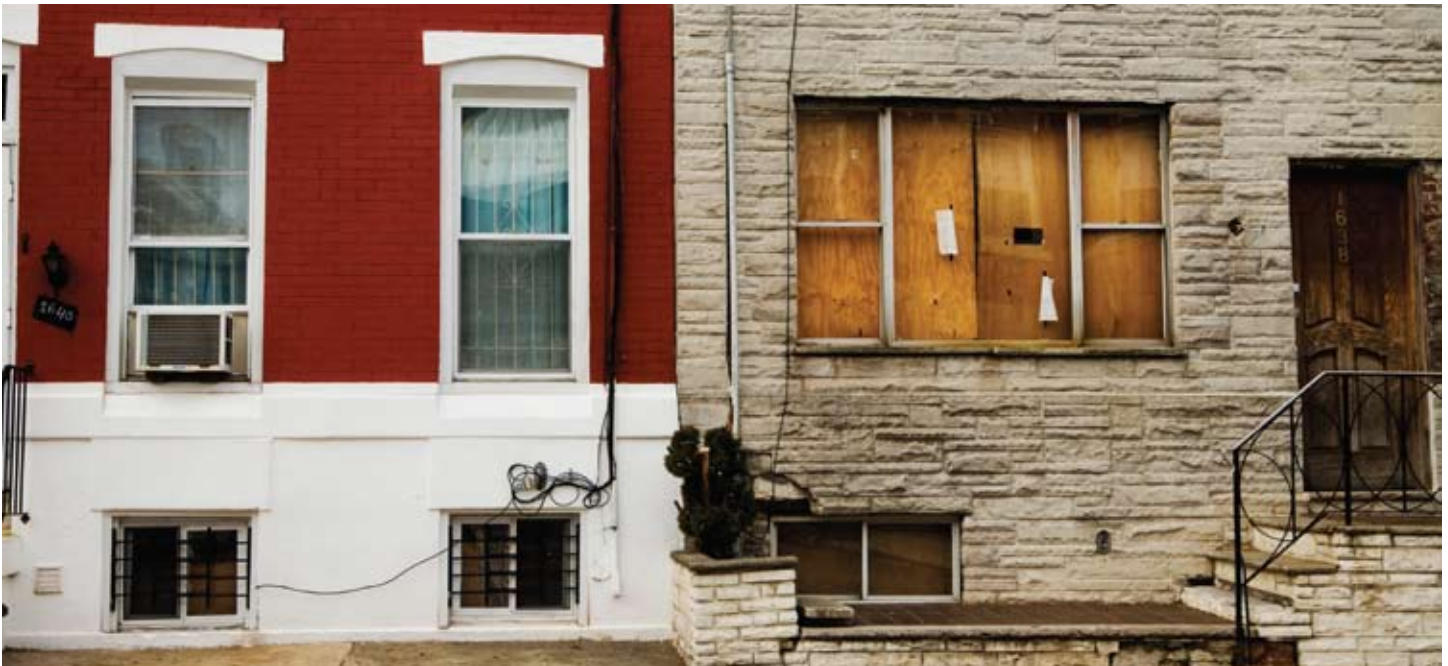
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BANKERS:

THE IMPACT OF THE 2005 AMENDMENTS

EFFECTIVE SEPTEMBER 1, 2005, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of the Comptroller of the Currency (the banking agencies¹), modified the Community Reinvestment Act (CRA) regulation's definition of "small bank," raising the asset threshold from \$250 million to \$1 billion.² The new rule eliminated CRA data reporting requirements and offered a streamlined assessment process for banks with total assets of at least \$250 million and less than \$1 billion. This new tier of banks is known as intermediate small banks (ISBs).

Editor's Note: *Bonita G. Jones and Thomas J. Healy teach a CRA class at the ABA Compliance School. For school information, visit www.aba.com or call (800) BANKERS.*



The agencies' action was partially in response to industry feedback and seemed reasonable given rating results that suggested that institutions³ between \$250 million and \$1 billion often struggled under the large bank test CRA assessment methodology. For example, CRA examination ratings reported by the Federal Financial Institutions Examination Council (FFIEC) at www.ffiec.gov show that from 2000 through 2004 the total assets of the majority of institutions rated needs-to-improve fell between \$250 million and \$1 billion. In fact, for the years of 2001, 2003, and 2004, institutions in this asset category represented 100 percent of the needs-to-improve ratings reported by the FFIEC. These institutions not only struggled with meeting the performance test, but also faced the task of annual collection and reporting of CRA loans (small business, small farms, and community development) which many perceived as burdensome.

The purpose of this article is to check in on the results of these and other amendments to the CRA regulation adopted in September 2005. To do this we posed questions that address each of the key amendments, including those that affect banks regardless of size.

The answers to these questions may surprise you. However, we believe they will give you perspective and help you gauge your performance, evaluate CRA assessment options, and focus your attention on challenges that can contribute to less-than-satisfactory performance. First, let's start with some perspective.

Question 1: Did banks with assets between \$250 million and \$1 billion opt for the new ISB assessment methodology?

Answer: A fair number did. The FFIEC reported CRA ratings⁴ for 577 banks based on the ISB performance methodology—specifically, 35 in 2005, 279 in 2006, and 263 for 2007. Table 1 recaps the total number of ratings for each of the two full years.⁵

Ratings	ISBs		Institutions with Assets Between \$250 Million and \$1 Billion Rated Under the Large Bank Test				
	2006	2007	2000	2001	2002	2003	2004
Year	2006	2007	2000	2001	2002	2003	2004
Total	279	263	350	302	360	350	334
Average	271		339				

The table also shows a yearly average of 271 ISB assessments for the first two years. Comparatively, between 2000 and 2004 the yearly average of CRA ratings assigned under the large bank tests for institutions with total assets between \$250 million and \$1 billion was 339. The 20 percent difference in the averages can be attributed in part to banks in this size category moving from the large bank test to the ISB assessment. In addition, many thrifts institutions moved from the large bank test after the Office of Thrift Supervision adopted the small bank assessment methodology for its supervised entities under \$1 billion in assets.⁶

Conversely, FFIEC data also showed that some banks eligible for the ISB assessment chose the large bank test. In 2006 and 2007, the FFIEC reported large bank test ratings for 150 institutions with assets between \$250 million and \$1 billion. Interestingly, almost half (48 percent) of the institutions fell within the \$250 million to \$499 million total asset category.

It is not entirely surprising that some banks chose the large bank test, given the debate about the pros and cons associated with the ISB methodology. In particular there was much concern about two points regarding the methodology:

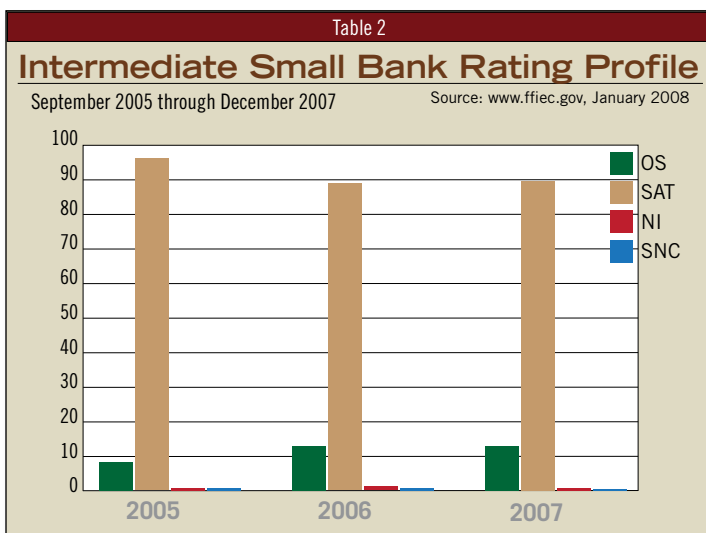
- whether the community development test assessment could actually result in a more flexible measurement of responsiveness when compared to the distinct expectations under each of the large bank tests
- the added pressure for banks to achieve at least a satisfactory rating on the community development test in order to receive an overall satisfactory rating for CRA

Moreover, some banks dismissed one of the big pros (the elimination of the requirement to report CRA loans) and continued to collect and report the data because it helped them monitor their performance. Over time, strong CRA performers have indicated that using this data for self-assessments is a best practice for CRA risk management. Now see what the performance results tell us.

Questions 2: Did ISBs fare well under the new assessment methodology?

For 2006 and 2007, the distribution of all CRA ratings regardless of institution type, size, or assessment methodology showed a measurable increase in the number of needs-to-improve ratings.

Answer: Yes. Overall rating results under the ISB assessment methodology are positive and show improved performance for some banks. Table 2 shows that since September 2005 about 98 percent of the ISB CRA ratings were satisfactory or better. There have also been positive shifts in individual performance ratings. For example, 42 banks previously rated satisfactory have been rated outstanding as ISBs. In addition, one bank achieved a satisfactory rating after having previously been rated needs-to-improve.



Earlier we indicated that institutions with assets between \$250 million and \$1 billion made up a significant percentage of needs-to-improve ratings between 2000 and 2004. At subsequent assessments a number of these banks received satisfactory ratings. In most cases the rating upgrades were achieved under the large bank test. To us the rating improvements under both the ISB methodology and the large bank test suggest that the rating conclusions are driven by performance rather than the assessment methodology.

Table 2 also shows that there were ISBs with needs-to-improve ratings for 2006 and 2007. However, the numbers were small: 1.4 percent (four banks) in 2006 and 1.2 percent (three banks) in 2007. Interestingly, the needs-to-improve ratings for prior years for similarly sized banks evaluated under the large bank test were comparable, with four banks in 2002, three banks in 2003, and three banks in 2004.

For 2006 and 2007, the distribution of all CRA ratings regardless of institution type, size, or assessment methodology showed a measurable increase in the number of needs-to-improve ratings. In each of these years, small banks represented more than 60 percent of this rating category. The increase in the overall number and the significant percentage of small banks may be attributable in part to the extended CRA examination frequency for certain small banks required by the Gramm-Leach-Bliley Act of 1999. As a result of this rule, small banks that have satisfactory or outstanding ratings are examined only every four or five years.

To manage CRA risk it is helpful to know common reasons for poor performance. For ISBs, the attributing factors for needs-to-improve performance were as follows:

- inadequate performance under the community development test (4)
- evidence of discrimination (2)
- lending outside of the assessment area and insufficient lending to borrowers of different income levels and businesses of different sizes

Comparatively, the key reasons for small bank needs-to-improve ratings in 2006 and 2007 were the loan-to-deposit ratios, followed by lending outside of the assessment area. While not a common factor, discrimination violations were a driving factor for one small bank in each year. Unlike ISBs, small banks are not subject to the community development test, so the test had no bearing on the CRA ratings.

Question 3: Was achieving a satisfactory rating for the community development test as challenging as some in the industry anticipated?

Answer: Generally, no. The majority of the ISBs did well under the community development test, with most receiving satisfactory ratings and a few rated outstanding. In some cases, community development test results drove the outstanding CRA rating.

As we noted under Question 2, more than half of the needs-to-improve ISBs can attribute the rating to inadequate performance under the community development test. Previously, these ISBs were rated satisfactory under the small bank assessment criteria, which do not require a community development evaluation. The results illustrate the challenge associated with transitioning into new performance requirements and suggest that networking with peers who have gained experience with the regulatory expectations may be useful.

Feedback from ISBs as well as a review of a sample of their performance evaluations indicates that the majority of banks engage in all three community development activity categories—lending, investment, and service. However, we noted isolated cases where banks received at least satisfactory ratings for the community development test even though they had little or no new activity in one of the three activity categories. In arriving at a rating for the test, it was clear from the written assessment that performance context was a critical consideration. Outstanding prior community development loans and investments and limited demand and opportunities were some of the considerations.

Question 4: More generally, have institutions found opportunities in areas added to the community development definition as part of the 2005 amendment to the CRA regulation (i.e., disaster areas and nonmetropolitan, middle-income areas that are designated as distressed or underserved)?

Answer: Yes. In both 2006 and 2007, a little under 25 percent of ISBs rated outstanding had lending, service, or investment activity in designated disaster, distressed, or underserved communities. In most cases, the activities were within the institution's assessment area. Activity outside of assessment areas typically supported disaster areas such as those impacted by Hurricane Katrina. Examples of noted activities in these areas in selected CRA public evaluations (public evaluations) are listed in Table 3.

Table 3

Table 3	
LOAN PURPOSE	▶ Purchase an apartment complex located in a distressed census tract to revitalize the area
	▶ Revitalize and stabilize underserved, middle-income census tracts by supporting school districts, and essential services for fire response and ambulance
	▶ Economic development and community services supporting low- and moderate-income residents or areas in a distressed/underserved nonmetropolitan middle-income geography
	▶ Revitalize or stabilize a designated disaster area in response to Hurricane Katrina
	▶ Support small businesses that create or retain jobs in distressed tracts
INVESTMENTS	▶ Municipal bond purchases to provide infrastructure improvements in underserved and federally designated disaster areas
	▶ Equity investment in a community development entity that provides loans for community development projects in distressed areas
	▶ Contributions to health service and education facilities that revitalize and stabilize underserved middle-income census tracts
BANK SERVICES	▶ Bank employees lending their financial skills to organizations that stabilize underserved, middle-income census tracts by providing facilities for public safety
	▶ Maintaining a branch that provides banking services in underserved areas and bilingual staff to serve customers who do not speak English

Formal community development efforts can be generally limited in nonmetropolitan areas. As a result, some small banks and ISBs suggest that they rely on ongoing relationships with members within the community, including bank customers, to identify opportunities. They also indicate that their banks' size and the tight-knit nature of their markets position them well to do so.

Compliance officers at these institutions also say that they foster development through routine lending and other bank services. In fact, for one bank's first ISB examination the compliance officer provided the examiner with internal loan and other data on the bank's business development and core community services in distressed and underserved middle-income areas and asked that the examiner consider the impact even if the activity didn't meet the regulatory community development criteria. The compliance officer did this for two reasons:

1. there were nominal formal development activities in these areas, even though the census tracts were all designated distressed or underserved
2. to illustrate the depth of the bank's support so the examiners understood the impact of the bank's routine business on nonmetropolitan, middle-income census tracts in her assessment area

Independently, we noted examples in ISB public evaluations where examiners had acknowledged non-community development lending in the designated distressed and underserved tracts in their evaluation of the geographic distribution of the bank's loans.

Finally, as you know, the designations for distressed and underserved are annually reviewed and updated. An ISB asked that we (please!) remind our readers to review the updated list of designated areas for changes. The compliance officer was surprised to learn that the bank's assessment area had lost many of the distressed or underserved designations previously considered despite the fact that the unemployment rate in the region continued to be one of the highest in the state. The current designated lists and information on how the

lists are derived are available at www.ffiec.gov/cra/examinations.htm. Also note that the CRA Q&A indicates that examiners will consider community development financing occurring up to one year after an area is no longer considered distressed or underserved.

Question 5: Have there been cases of discrimination or other illegal credit practice violations⁷ that have impacted an institution's overall CRA ratings consistent with the 2005 amendment in the CRA regulation?

Answer: Yes. A few public evaluations of ISBs and small banks in 2006 and 2007 indicated that discrimination violations had resulted in needs-to-improve CRA ratings. There were no cases in our sample of public evaluations where violations of other credit practice statutes caused a downgrade.

More broadly, both the FDIC and FRB recently acknowledged that discrimination and other illegal credit practice violations can result in a downgrade of a CRA rating. On October 24, 2007, Sandra L. Thompson, director of the FDIC's Division of Supervision and Consumer Protection, testified before a subcommittee of the U.S. House of Representatives that "For FDIC-supervised institutions evaluated between January 1, 2002 and September 30, 2007, fair lending violations resulted in 14 CRA rating downgrades: three downgrades to satisfactory, and 11 to Needs to Improve."

In separate testimony to the subcommittee on the same day, Sandra F. Braunstein, director of the FRB's Division of Consumer and Community Affairs, affirmed that fair lending violations can impact CRA ratings and described a specific example in which fair lending violations caused a rating downgrade. She also discussed the converse side, outlining another case in which cited discrimination violations did not result in a lower CRA rating. She indicated that the examiner concluded that a downgrade was not warranted because of "the bank's overall level of compliance with fair lending laws and regulations, the limited nature of the violation, the bank's record of meeting the credit needs of the local community, the enhanced policies and procedures the bank has in place to ensure continued compliance, and management's prompt, voluntary implementation of corrective action."

The noted rating results and regulators' comments affirm the significant alignment between bank lending practices and CRA performance. Moreover, the current concern regarding retail lending practices more broadly suggests regulatory oversight will intensify. ISBs and small banks continue the practice of internal reviews of loan denials and have incorporated more independent fair lending audits. In addition, institutions are increasingly adopting the principles of guidance issued by the regulators on subprime lending in evaluating their lending practices, even if they do not offer subprime products.

Conclusions

Were the answers to the questions what you expected? The changes have had some impact and give us something to think about. Here are the key points we take away:

A good number of eligible banks have opted for the ISB methodology, but a number have opted to stay with the large bank test. Could the "added value" of using CRA loan data as a risk management element offset the reporting requirements for this data? Perhaps. Who knew?

Overall ISB performance results are positive. Interestingly, the number



of ISBs that received a needs-to-improve in 2006 and 2007 is comparable to the number of similarly sized institutions assigned a needs-to-improve rating under the lending test between 2002 and 2004. If not for data reporting, is it worth it to be an ISB? Evidently, it depends.

Also, low loan-to-deposit ratios largely drove small bank needs-to-improve ratings in 2006 and 2007. With the current trend of tighter credit standards and the strong competition these banks report, it will be critically important to put lending in context during upcoming examinations.

The majority of ISBs have achieved satisfactory results under the community development test. Those that have not were isolated to banks that had not been previously evaluated for community development. Does this sound similar to small banks' transitioning to the large bank test? Perhaps for first-timers, networking with peers more familiar with the community development expectations could be helpful—or consider opening a dialogue with your regulator.

ISBs are supporting community development activities in disaster, distressed, and underserved communities. However, in the absence of projects we are hearing a focus on routine lending in these areas. Could this energy spur the start-up of community development projects and CRA leadership opportunities? We believe so.

Compliance with antidiscrimination and other credit practice laws is increasingly becoming the big-ticket item in CRA risk management. While our sample of performance evaluations included only cases in which discrimination violations were cited, heightened public attention and regulatory scrutiny elevate the need for effective strategies to thwart bad lending practices at all stages of the lending process.

We hope this check-in is useful and thank the ISBs, small banks, and consultants who shared their insights so we could share them with you. BC

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Endnotes

¹Unless otherwise noted in this article, the term "banking agencies" does not include the Office of Thrift Supervision (OTS).

²The banking agencies also indexed the thresholds in the definition to the Consumer Price Index (CPI) and adjust them accordingly on an annual basis.

³The term "institutions" in this article includes both banks and thrifts.

⁴Data presented in this article is based on ratings posted on the FFIEC's Web site at www.ffiec.gov. The data was retrieved in January 2008 and includes ratings for examinations conducted through December 31, 2007. The FFIEC reports ratings for all the banking agencies including the OTS. However, for this article unless noted by the use of the word "institution," the data does not include OTS-supervised entities because the ISB assessment methodology adopted in 2005 does not apply to thrift organizations. Note: The OTS adopted a comparable "intermediate" definition and methodology effective July 2007.

⁵Generally, CRA ratings are reported on the FFIEC Web site in the same year as the CRA public evaluation. However, processing lag time may cause the rating to be reported in the following year. Therefore, the rating statistics and use of the term "rating" is based on the year they were reported on the FFIEC database.

⁶The OTS adopted the small bank lending test for all of its supervised institutions under \$1 billion effective October 1, 2004.

⁷Examples of illegal credit practices outlined in the amended regulation include violations of the Home Owners Equity Protection Act (HOEPA); Section 5 of Federal Trade Commission Act; Section 8 of Real Estate Settlement Procedures Act (RESPA); and Right of Rescission provisions in the Truth in Lending Act. However, illegal credit practices are not limited to these examples.