Not Just Adding Up the Numbers: Achieving CRA Objectives in Challenging Times

Even as the national economy begins to show signs of a rebound, many local housing and small business credit markets are recovering slowly. The economic downturn of the past few years resulted in reduced loan volumes at many financial institutions, including lending considered during Community Reinvestment Act (CRA) examinations. Rising levels of past-due loans and charge-offs are putting earnings and capital pressures on more institutions, and increasing the need for hands-on attention in working with strapped borrowers who are facing the consequences of reduced housing values and employment disruptions.

Despite these challenges, financial institutions can continue to achieve strong ratings under the CRA if they review their strategy and consider new approaches to meeting community credit and service needs, including a strong focus on existing qualitative standards. For example, lenders implementing new approaches to mortgage loan modifications or addressing emerging community development credit needs in conjunction with economic recovery programs are demonstrating the kind of innovation likely to result in strong CRA ratings. CRA examination procedures call for examiners to consider the particular economic circumstances and other constraints faced by an institution and encourage creative responses to community needs. When determining a rating, concerns about a reduced volume of loans may be balanced by the strong impact of a carefully designed program focused on meeting particularly challenging community needs.

Background

The CRA provides that regulated financial institutions have continuing and affirmative obligations to help meet the convenience and needs, including the credit needs, of the communities they serve.[1] The focus of the first CRA regulation in 1978 was on serving the credit needs of low- and moderate-income (LMI) areas, while adhering to safe-and-sound banking practices. After receiving extensive public comments in response to notices of proposed rulemaking in 1993 and 1994, the federal banking agencies—the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (collectively, the agencies)—promulgated final regulations in 1995 that included a focus, not only on geographically defined low- and moderate-income areas, but also on low- and moderate-income people and small businesses and farms, particularly the very small enterprises that have a limited access to capital.[2]

The concept of community development also has become central to CRA examinations. The rule's definition of community development includes affordable housing, community services targeted to low- and moderate-income individuals, as well as activities to promote economic development by financing small businesses and small farms.[3] The definition also includes activities that revitalize and stabilize LMI areas, distressed or underserved non-metropolitan middle-income areas, and major disaster areas.

[1] 12 U.S.C. 2901 *et seq.,* http://uscode.house.gov/download/pls/12C30.txt.

[2] See 43 Fed. Reg. 47146 (Oct. 12, 1978), 58 Fed. Reg. 67466 (Dec. 21, 1993, 59 Fed. Reg. 51232 (Oct 7, 1994) and 60 Fed. Reg. 22156 (May 4, 1995).

[3] See 12 C.F.R. § 345.12(g), http://www.fdic.gov/regulations/laws/rules/2000-6500.html.

Originally, the evaluation of an institution's performance was based on 12 assessment factors that addressed the process banks used to identify community needs and the results of that process. The banking industry criticized the inconsistency in evaluation standards and documentation requirements, while community groups questioned the lack of results-oriented criteria. To respond to these issues and implement new public disclosure requirements, the agencies significantly revised the examination standards in the mid-1990s. These changes established a set of quantitative data comparisons for housing and small-business loans.

For large banks (which CRA currently designates as those with assets over $1.1 billion), the standards were divided into three tests: lending, which constitutes 50 percent of the rating; and community development investments and services, which each account for 25 percent. Small banks (which CRA currently designates as those with under $277 million in assets) were given a streamlined test focused on lending and lending-related activities. Later still, in 2005, a new category of intermediate small banks (with asset size exceeding the current small bank size standard, but under the large bank standard) was created using the small bank lending test and a new community development test.[4]

These changes did not alter the long-standing principle that the **responsiveness** of lending products and services to community needs (especially for LMI areas, LMI borrowers and small businesses) and the **soundness and sustainability** of this lending are complementary, not competing, goals. The Interagency Examination Procedures and the ratings guidance that accompanies them emphasize that examiners should look at the **quantity and quality** of CRA-related activities, and evaluate them within the context of the bank's capabilities, safe-and-sound banking practices, and the needs of the community.

Agency Guidance for CRA Supervision

The Interagency CRA Examination Procedures vary in focus and emphasis by bank size and type. However, CRA evaluations consistently:

- Consider performance in the context of economic conditions, bank capacity and condition, and the specific needs of the assessment area under review;
- Assess the volume of lending inside the assessment area and the distribution of lending to LMI areas and borrowers as well as to small businesses and farms;
- Review the extent to which activities are responsive to the particular needs in the assessment area, including the impact they have on LMI people and very small businesses;
- Consider community development activities that include lending, investments, and services in support of LMI areas and people and small businesses, including their responsiveness and impact;
- Evaluate how these activities are undertaken within the framework of safe-and-sound practices; and
- Consider any illegal, abusive, and discriminatory practice that reduces the positive impact of CRA initiatives.

In the current environment, it is particularly important that examiners pay close attention to an institution's responsiveness to community needs and the quality of its loans. First, examiners should evaluate how an institution responded to declining lending volume (its own or in its market) during a time of

[4] See 70 Fed. Reg. 44256 (Aug. 2, 2005) and 12 C.F.R. § 345.26(c), http://www.fdic.gov/regulations/laws/rules/2000-6500.html.

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broad economic slowdown and, in many cases, community-specific economic distress. A proactive institution will have developed a strategy to adapt its activities to economic conditions, by considering emerging needs and determining how to respond given its capacity and condition.

Second, because lending that does not fully consider the borrower's ability to pay creates serious adverse consequences for borrowers, communities and lenders, examiners must evaluate CRA performance in the context of consumer compliance and safety and soundness. Examiners should consider whether loans are safe and sound and whether they involve any unfair, illegal, or discriminatory practices. Such an evaluation ensures that loans benefit the borrower and the community, and therefore support the purpose of the CRA. The CRA always has focused on meeting credit needs in a safe-and-sound manner, and the results of recent studies show that loans made in their assessment areas by lenders subject to the CRA have performed better than those made by independent mortgage companies.[5]

With this information in mind, how should examiners approach their evaluation? The first step is developing a performance context.

Performance Context

In developing the performance context, demographic and economic information on the assessment area is assembled, and community needs are considered. Community characteristics and needs may be changing during a time of economic turmoil. To update the context information, examiners should consult state and local non-profit organizations with financing programs focused on small business, affordable housing, foreclosure prevention or economic recovery and development; governments and housing authorities; and organizations actively monitoring abusive practices and tracking complaints.

Another aspect of the performance context is considering how institutions similar to the one under review are adjusting to community conditions. Examiners should request information from community contacts on how other lenders are responding to foreclosures, small business needs, and community development opportunities. Examiners should evaluate other recent CRA Public Evaluations to update their understanding of how the bank under review compares to others in the area dealing with adverse economic conditions.

Examiners also must consider the capacity and constraints of the bank, particularly its financial condition. Because of the increase in supervisory actions that have occurred in the current adverse economic environment, compliance and safety-and-soundness examiners should continue to work closely to appropriately document the context of affected institutions. The existence of an enforcement action or required remedial action for safety and soundness does not in itself justify a reduction in the institution's commitment to prudent CRA lending or alternative lending-related activities. A significant, disproportionate reduction in attention to LMI areas or borrowers or small businesses or an increase in out-of-area lending warrants follow up with management and may indicate CRA performance is less than Satisfactory. The great majority of institutions are pursuing lending and other community development strategies taking into account the opportunities and constraints in their markets. Some of these approaches are illustrated below for large and intermediate small banks.

[5] Elizabeth Laderman and Carolina Reid, "CRA Lending During the Subprime Meltdown," Federal Reserve Bank of San Francisco, in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act,* published by the Federal Reserve Banks of Boston and San Francisco, February 2009.

Large Bank Lending Test

Having created a performance context, examiners assess key aspects of bank performance within that frame of reference. The Large Bank Lending Test rating matrix consists of seven elements. Four of these factors are quantitative: (1) overall lending activity levels; (2) lending in the assessment area compared to outside the area; (3) geographic distribution, particularly to LMI areas; and (4) borrower distribution according to borrowers' income, with a focus on LMI borrowers or the revenue of the business (especially those under $1 million in annual revenue).

During a time of economic contraction, the quantitative factors in the lending test should be compared to an updated performance context and current aggregate lending data. The distribution of lending during the examination period, particularly in LMI areas or to LMI borrowers, compared to other lenders, is first assessed to identify disproportionate declines or gaps. The examiners then consider underlying causes. For example, a sharp curtailment in housing lending in LMI areas compared to all areas could indicate the lender has not considered strategies to meet the needs of LMI borrowers in the new environment. In 2008, the percent of Federal Housing Administration (FHA) lending compared to total Home Mortgage Disclosure Act (HMDA) lending increased, and the ability of lenders to sell other high loan-to-value (LTV) products in the secondary market declined significantly. A lender that increased its role in FHA (or Rural Housing or State-guaranteed) lending responded to both needs and constraints. A lender with declining volume that did not consider government lending may not be as responsive to the LMI segments of its community.

The remaining three Large Bank Lending Test rating factors are qualitative: (1) responsiveness to highly economically disadvantaged geographies and low-income persons and small businesses; (2) community development lending; and (3) product innovation or flexibility tailored to serve the needs of the assessment area. These factors are discussed below, and the inset boxes on *Quality Factors* provide suggestions for examiner inquiry.

- **Responsiveness to highly economically disadvantaged geographies and low-income persons and small businesses**. This factor applies to each type of lending considered in the examination, particularly home mortgage, small business, consumer, and community development. Examiners should request that financial institutions identify whether and to what extent their product marketing, delivery, and design respond to the needs of borrowers and the local community. Institutions may provide information on such products or programs as:
  - *Small consumer loans*. In June 2007, the FDIC issued guidance (see FIL-50-2007[6]) that encourages banks to consider small consumer loans that meet the needs of LMI borrowers. Furthermore, FDIC examiners will consider information provided on small-dollar loans even if the institution has not provided other data on consumer lending.
  - *Effective mortgage modification programs*. These programs represent an example of how responsiveness to community and individual borrower circumstances, in the context of safe-and-sound underwriting, can benefit borrowers and lenders. The success of these initiatives, particularly in LMI areas, may be more critical now than at any other time.

[6] Affordable Small Dollar Loan Products: Final Guidelines, June 19, 2007, hthttps://www.fdic.gov/news/inactive-financial-institution-letters/2007/fil07050.html.

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- **Community development (CD) lending**. Examiners measure a financial institution's CD lending activity by evaluating quantitative factors, such as the number and dollar amount of CD loans. Examiners also consider the CD lending opportunities available to an institution. Qualitative factors for evaluating an institution's CD lending include the responsiveness to area needs and the degree of leadership an institution demonstrates. Responsiveness can be shown, for example, by an institution's collaboration with community development leaders in its assessment areas to find solutions to area problems, including those resulting from the economic downturn. Leadership requires more than board membership. A leader works to design and structure the most appropriate financing for a particular project, and uses bank financial commitments to leverage support from other private and public participants.
- **Innovation and flexibility to serve assessment area credit needs, consistent with safe-and-sound practices**. To be innovative, an activity does not need to be "new" but rather could be modified to respond to changing needs. For example, if the bank made small adjustments to an existing loan modification program to make it more successful over time, that program remains innovative and flexible.

Overall, qualitative factors can be as important as quantitative measures. Examiners may conclude that a highly responsive and targeted program is making as much of an impact in the community as a program with greater volume that is less targeted to area needs. Of course, institutions with greater size and capacity should be evaluated using a higher standard for quantitative and qualitative factors than smaller institutions with limited capacity.

Large Bank Services and Investments: The results of the services and investments tests contribute significantly to an institution's performance evaluation. As with lending, especially CD lending, the quality and responsiveness of services and investments are key to a strong rating. Community contacts that assist in identifying opportunities and leadership in CD lending also should be asked for input on services and investments.

Intermediate Small Bank (ISB) Performance Standards

Intermediate small banks are covered by the small bank lending test and a community development test. Qualitative factors, particularly responsiveness, are especially important in the community development test.

The community development test represents half the ISB's evaluation. Examiners assess the number and amount of qualified loans and investments; the extent of community development services, including those for LMI areas and borrowers; and the responsiveness of these activities given community needs, opportunities, and bank capacity. The examiner evaluates the responsiveness of the bank's activities compared to needs identified by the bank and the performance context developed by the examiner.

If a bank has a thoughtful, well-designed community development strategy, it may combine loans, investments, and services to leverage investments from public and other private participants that result in measurable positive impacts on community needs. On the other hand, a program developed without strong community relationships, and, for example, that relies simply on investments in mortgage-backed securities, does not respond to particular community needs. Such limited efforts should prompt an examiner to discuss with the institution responsiveness to local community credit needs and opportunities to work more effectively with local or state-level community development resources.

Quality Factors: Housing and Small Business Lending

- Has the bank reviewed whether it can adapt current products to meet recent credit market challenges, for example, by using or increasing use of FHA programs for mortgages or Small Business Administration (SBA) programs to support local employment?
- Is the bank taking a significant role in state and local economic development programs that address the needs of firms that would qualify for SBA or state assistance? This could be considered small business or CD lending, depending on loan size.
- Is there an example of a product or program that is particularly responsive to local economic needs and conditions? Has volume in this product been consistent with opportunities identified in the performance context? The examiner should consider requesting community feedback on this question.
- Does the bank have a record of effectively making loan modifications, and is there an affirmative effort to include LMI borrowers and areas?
- Is preserving home ownership an element of the bank's agenda in the wake of the mortgage crisis; did the bank support specific initiatives; and are there demonstrated results?
- Has the bank identified whether there are areas that are being hard hit by foreclosures, and has it worked with local organizations to promote neighborhood stability with demonstrated results?
- Is the bank ensuring that all of its products and programs are consistent with Compliance requirements (including Unfair and Deceptive Acts or Practices, Equal Credit Opportunity Act, Fair Housing Act, Truth in Lending Act and, for housing loans, Home Ownership and Equity Protection Act and Real Estate Settlement Procedures Act) and safe-and-sound underwriting practices?
- If the bank makes credit cards available to small firms, is it ensuring the products are compliant and do not involve unfair or deceptive practices?
- Does the bank work with existing non-profit or quasi-public or private intermediaries in the state or assessment area to further small-business lending goals, and do these entities view the bank as a significant contributor?
- Does the bank evidence a commitment to broad-based outreach in small-business segments that may not have existing banking relationships to ensure the bank is not limiting service to long-standing clients and word of mouth?
- Is the bank working with any micro-lending initiatives where new or very small entrepreneurs receive small loans and other technical support?
- Has the bank offered a small loan program consistent with FIL-50-2007, "Affordable Small-Dollar Loan Products: Final Guidelines"?

Larger scale and small-scope loans and investments can be responsive to community needs. For example, an institution may participate in a state-wide community development organization with a broad geographic mandate that includes the assessment area. Such an organization can leverage a larger pool of capital to make larger and more diversified investments and better support a qualified professional staff. At the same time, small-dollar grants for non-profit organizations working in local churches and schools to improve access to mainstream financial services for LMI people could meet an important need, particularly if the bank designs complementary savings incentives and accounts.

Before drawing a conclusion about the community development test, the examiner should review the performance context, including evaluating how a

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Quality Factors: Community Development

- Can bank management explain and validate how the loan or investment supports community development initiatives, including affordable housing, small business development, or community facilities and services that address the needs of LMI individuals?
- Does the bank evaluate and proactively pursue community development opportunities so that community development leaders in the state, county, community or in non-profit organizations are aware of the bank's interest in supporting community development?
- Does the bank's amount of support for local, state, or regional community development organizations represent an adequate level of involvement given the groups' activities, the role of other similar banks, and the bank's capacity?
- Has the bank's role been critical to the initiation or success of area projects and programs?
- Has the bank been a leader in creating and participating in loan programs or other assistance designed for recovery from a natural disaster or acute economic problems?
- Does the level, scope, responsiveness, and impact of the institution's CD lending and investment represent a significant contribution to meeting community development credit needs given the opportunities?
- Has the bank taken the opportunity to offer facilities, alternative access tools, and technical assistance services that help consumers and small businesses become part of the mainstream and broaden relationships over time? Is the bank measuring success?

bank compares with its peers. But the most critical question the examiner should ask is what the bank is doing to respond to the most important needs of its community, including LMI populations and small enterprises. If the bank's programs evidence a poor response to those needs and are limited, considering its capacity, a less than Satisfactory rating is appropriate.

Considering Loans Not Consistent with Safe-and-Sound Banking Practices

Loans that are not consistent with safe-and-sound underwriting practices will not be favorably considered during a CRA examination. Where examiners have strong evidence that a particular product set or lending activity resulted in loans that were not sustainable, or such lending is or may be subject to formal enforcement action, the effect on the CRA rating could be significant, depending on the scope and impact of the affected loans.

For example, loans that do not reflect prudent underwriting standards or comply with regulatory guidance are not considered favorably for CRA purposes. However, if loans were generally reasonably underwritten, and asset quality deterioration is due to local economic factors, they should be given full consideration for a CRA evaluation. If poor underwriting controls resulted in a significant negative impact on CRA-related lending activities and customers or communities of the bank, a less than Satisfactory rating should be considered. In addition, once the preliminary rating has been established, the examination procedures require the examiner to review the results of the most recent compliance examination and determine whether evidence of discriminatory or other illegal credit practices that violate an applicable law, rule, or regulation should negatively affect the institution's overall CRA rating.

Not Just Adding Up the Numbers

It is reasonable to expect that lending volumes will be adversely affected during an economic downturn, including in LMI or economically distressed communities. Institutions with a strategic approach to identifying and serving community needs and that emphasize the quality of their lending and community development financing likely will be most successful in adapting to change. Quality is demonstrated when banks remain committed to providing responsive products consistent with safe-and-sound lending, even in difficult times.

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