FEDERAL RESERVE BANK OF SAN FRANCISCO

# Community Investments Vol. 9, Issue 1 Large Banks Transition to a New CRA: From Twelve Factors to Three Tests

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*Are you the CRA Officer of a large financial institution trying to anticipate your next exam and puzzled by what to do with those soon-to-be outdated CRA files? Community affairs staff have received requests for clarification and advice on this issue. The following are practical questions raised by five 12th District banks along with responses from Senior Compliance Examiner, Paul Dillard. We'd like to thank the five financial institutions who helped us ask the right questions and we'd like to acknowledge Paul Dillard for his candid responses and valuable insights.*

First, let's assume your institution's CRA exam is scheduled for Spring, 1997, and although you could volunteer to be examined under the new CRA procedures, you'd prefer to be examined under the old examination procedures. You might ask the following question:

*Do I need to maintain my files under the twelve assessment factors for this exam, or can I begin to reorganize them in anticipation of the new procedures?*

Mandatory examinations of large institutions under the new procedures will not begin until July 1, 1997. However, effective January 1, 1996, large banks have been required to collect loan data on all small business loans, small farm loans, community development loans, and home mortgage loans (originated or purchased) for reporting in March, 1997. A large institution that is being examined in Spring, 1997, will be examined under the old CRA examination procedures unless it voluntarily elects to be examined under the lending, service and investment tests; therefore, its files should reflect the twelve assessment factors while it simultaneously collects the loan data required for the new CRA. Although this may seem onerous, there is some benefit to the bank. The collected loan data for the new CRA may be useful information for examiners, even under the old procedures, since greater emphasis will be given to the results-oriented assessment factors over those that are process-driven.

Next, let's explore how you're going to make the transition to the new procedures. The following questions have been grouped by each of the twelve CRA assessment factors. We've assumed certain documents are already in your files.

**I. Ascertainment of Community Needs**

**Assessment Factor A**
This file contains brochures, pamphlets, records of meetings, and other information about efforts to determine community credit needs.

*Is this information useful as part of the new CRA exam procedures and if so, how?*

Under the new CRA procedures, examiners will no longer evaluate a financial institution on its ascertainment efforts. However, this does not minimize the value of ascertainment efforts should a bank choose to engage in this process. It is a sound business practice to routinely identify loan product development and other lending opportunities through credit ascertainment efforts. Moreover, although financial institutions are not required to do so, information pertaining to ascertained credit needs that is shared with examiners may be very helpful to them in their development of a performance context. The performance context provides examiners with the framework by which to evaluate an institution's performance level.

*How might this information contribute to the performance context?*

The examination procedures under the new CRA require examiners to conduct their own credit ascertainment efforts. This means that examiners will establish contacts with various members of the community to gain a better understanding of the lending opportunities that may exist in the area. Realistically, an examiner will have limited time to conduct these contact meetings. Therefore, the more information an examiner has regarding ascertained credit needs, the more accurate his/her conclusions will be regarding lending opportunities within the institution's assessment area.

*What are the components of a complete performance context?*

To develop a performance context, examiners must consider, 1) the economic and demographic characteristics of the assessment area(s); 2) lending, investment, and service opportunities in the assessment area(s); 3) the institution's product offerings and business strategy; 4) the institution's capacity and constraints; 5) the prior performance of the institution and, in appropriate circumstances, the performance of similarly situated institutions; and 6) other relevant information (i.e., whatever information the institution would like to share with examiners).

**Assessment Factor C**

In the past, the board has approved the CRA statement and other CRA-related publications. A member of the board chairs the CRA committee and minutes of CRA meetings are in this file.

*Even though no longer required under the new CRA, is it worthwhile for the Board to continue its involvement in setting and overseeing CRA policy? How so?*

It is absolutely worthwhile for the Board to be involved in any integral function of the institution! Aside from the personal responsibility that a director accepts when he/she joins a Board of Directors, it's plain good business sense to have directors involved so they remain informed about all of the institution's activities.

*Is the CRA statement still a useful document or should financial institutions drop it altogether?*

This could go either way. If an institution had a bare bones CRA statement to begin with, the value of continuing to produce such a document is highly questionable. However, if the bank had adopted an informative, expanded CRA statement in keeping with FFIEC recommendations, a savvy institution could parlay such a document into a creative and effective marketing tool. Keep in mind that should a bank elect to continue producing a CRA statement, such a statement does not supersede the CRA notice that is required under the regulation.

**II. Marketing and Types of Credit Offered and Extended Assessment Factor B**

This file contains sample marketing and advertising materials and background information on the bank's special loan programs.

*Under the new exam procedures, is an examiner going to want to see any of this information and if so, how and where?*

Although an examiner will not ask to see marketing materials or sample advertisements, this information could be helpful in extreme situations when, for example, a bank needs to refute allegations of redlining. Proof of marketing efforts might help in countering such charges. Any information regarding special loan programs will be particularly useful when examiners consider the institution's flexibility and/or innovation under the lending test.

**Assessment Factor I**
HMDA data, marketing research, and loans to nonprofits have been documented in this file.

*How should this information be reported under the new procedures?*

HMDA data will continue to be reported in the same manner and format in which they are currently reported. The data will then be incorporated by examiners into the five performance criteria of the lending test which are, in brief: 1) geographic distribution of loans by income level; 2) geographic distribution of loans by borrower characteristics; 3) responsiveness to credit needs within assessment area; 4) innovative or flexible lending practices; and 5) community development lending activities.

*How strict are deadlines on community development and small business/farm reporting?*

The deadlines are as strict as those for HMDA reporting. In addition to using the data for generating a disclosure statement for the reporting bank's public file, the data will be aggregated with other financial institution data to prepare reports that will assist examiners in developing a performance context.

*What will the turn-around time be for receiving this information back from our regulator?*

The regulators' goal is to have a turn-around time of 90 days or less in keeping with the same turn-around schedule for the HMDA data.

*Will the examiner want to see organizational background information about loans made through consortia?*

Organizational background is useful information, particularly if an employee of the institution performs a technical function for the consortium (e.g., sits on the loan committee or performs an administrative function). This technical assistance could be used to augment the bank's performance under the service test.

*Is it true that financial institutions can receive "double credit" for consortia lending?*

There are provisions for double credit which can occur in several different ways. For example, suppose a financial institution's commitment to a consortium loan pool produces loans for the development of low- and moderate-income multifamily housing. The institution would be able to count its pro rata share of these loans under both the mortgage and the community development lending aspects of the lending test. Also, should an institution make an equity investment *and* a loan pool commitment to a CDC or consortium lender, it would receive consideration for its share of the loan pool under the lending test as well as consideration for the equity investment under the investment test.

In another possible scenario, assume an institution invests $1 million in a community development bank ("CDB") that has a total capitalization of $10 million. The CDB holds assets of $30 million, with $12 million in qualified investments and $18 million in community development loans.

The investing institution could choose to have its $1 million investment considered solely under the investment test. Alternatively, if it requested consideration under *both* the lending and investment tests, the amount attributed to the investment test would equal the product of the bank's investment in the CDB and the percentage of the CDB's asset portfolio comprised of qualified investments.

The amount attributed to the lending test would equal the product of the investing institution's pro rata share of community development loans originated by the CDB during the period under review and the percentage of the CDB's asset portfolio comprised of community development loans.
In this example (illustrated below), qualified investments comprise 40% of the CDB's total assets ($1 million of total assets of $30 million), so the investing institution would receive consideration for 40% of its total $1 million investment in the CDB, or $400,000, under the investment test. It is assumed that the remainder of the institution's investment has been used to fund community development loans in an amount equal to its pro rata share of loans originated by the CDB. Since the bank has supplied 10% of the capital of the CDB, this provides the basis for determining, under the lending test, its pro rata share (10%) of community development loans made by the CDB. Assuming the CDB's $18 million in loans were originated during the period under review and benefitted the institution's assessment area (or a broader statewide or regional area that includes the bank's assessment area), the institution's pro rata share of these loans would be $1.8 million. However, because community development loans comprise only 60% of the CDB's asset portfolio, the bank would receive consideration for only 60% of its pro rata share of community development loans, or $1.08 million, under the lending test. In summary, the bank's $1 million investment would be evaluated as a $400,000 investment under the investment test plus $1,080,000 in loans under the lending test. Keep in mind that the investing institution must provide examiners with the necessary information to

calculate the appropriate breakdown should it choose to have its investment evaluated under both the investment and the lending tests.

**Assessment Factor J**
FHA, SBA, and other government program information is contained in this file.

*Under the new regulation, will the examiner want to know if we participate in these programs and, if so, what information will the examiner find useful?*

Information about whether an institution participates in government sponsored programs will be useful to the extent that the program allows the bank to offer flexible or innovative credit terms since these are criteria of the lending test.

*Is this information relevant within the development of a performance context?*

It very well could be relevant. For example, assume that through community contacts examiners identify a need for small business loans with flexible terms that are typically available through the SBA loan program. If the financial institution is not an SBA lender, but offers a small business credit product of its own with similar terms, then the fact that it is a non-SBA lender becomes moot. If the bank does *not* have its own small business product, however, the SBA enhancements may help make the loans more flexible--which in turn helps the institution receive favorable consideration under the lending test.

**III. Geographic Distribution and Record of Opening and Closing Offices**

**Assessment Factor E**

This file contains maps, census tract lists, and data about credit applications, approvals, and denials.

*Under the new procedures, what methods of documenting geographic distribution of loans are recommended? How far back should data be collected?*

There are a variety of software programs currently available that will prepare a geographic distribution analysis. The main thing to remember is that examiners will conduct their geographic distribution analysis based on either census tracts or, in the case of non-MSAs, block number areas. Their analysis will be based on the loan data (which would include the census tract location, if appropriate) collected by the bank since January 1, 1996.

*Should these data still include applications, approvals, and denials?*

The data for the lending test should include only originated or purchased loans. The only exceptions are HMDA loans for which the reporting requirements are unchanged.

**Assessment Factor G**
This file contains information about branch openings and closings, as well as services provided.

*Since the new regulation stipulates that this information be included in the public file, does it also need to be documented anywhere else?*

Examiners will consider branch openings and closings, and the services provided as part of the performance criteria for retail banking services under the service test.

*Is it important for a bank's CRA officer to have input on branch openings/closings? Why or why not?*

Usually, it is a financial institution's directorate, senior management, and branch administrator who make the decision about opening or closing a branch. However, input from the CRA officer should be carefully considered since the impact on the low- or moderate-income people within the community is an element of any branch opening or closing application made to a regulator.

**IV. Discrimination and Other Illegal Practices**

**Assessment Factors D and F**
These files contain the institution's fair lending information.

*What methods will the examiner use under the new regulations to assess fair lending activities?*

Unlike the old procedures, the new CRA procedures have no specific criteria concerning fair lending except that the financial institution's assessment area cannot arbitrarily exclude low- or moderate-income geographies and may not reflect illegal discrimination. However, if examiners determine, during an institution's fair lending examination, that substantive fair lending issues exist (e.g., redlining or the discouragement of applications), the institution may expect to see a bottom-line reduction in its overall CRA rating.

*What information related to assessment factors D and F should be contained in the new CRA files and where?*

The issues covered under the old assessment factors D and F have been firmly transferred to the fair lending examination. However, if during a CRA examination an examiner interprets the lack of loan penetration in a given geography as redlining, any information the institution could supply that would demonstrate why an anomaly exists (e.g., the tract is predominately farmland, is occupied by an airport or college campus, etc.) could help in refuting the allegation. That is an extreme example of why it is beneficial for financial institutions to assist examiners in the development of the performance context. Few people should know the institution's assessment area as well as the institution's staff.

**V. Community Development**

**Assessment Factor H**
This file contains outreach information, volunteer activities, and community development investment information.

*How should these activities be divided among lending, service, and investment, and what information is needed for each?*

Community development investment information should be categorized under the investment test unless the bank is willing to provide the additional lending test information (as previously described under assessment factor I) for consideration under both the lending and the investment tests. Volunteer activities may be counted under the community development services portion of the service test provided such activities meet the necessary qualifications. Footnote #2 of the preamble to the regulation as printed in the *Federal Register* on May 4, 1995, provides a list of qualified community development service examples.

*What's your advice for how to measure and/or quantify service test activity?*

There's no science to this process, but it does rely heavily upon the performance context. Carefully analyze the institution's capacity and opportunity to provide community development services and remember that the service/assistance provided must relate to the provision of financial services. For further guidance, refer to the list of qualified community development services in the preamble of the CRA regulation. In polling a large multi-layered financial institution to ascertain who provides what community development service to whom, it is most effective to start at the top of the hierarchy with the Board of Directors and end with senior management. If the bank decides there is still an insufficient record of community development services, it could then tap down another management layer. However, at this point, the effectiveness in providing community development services may be rather weak and indicative of a larger problem in the bank's performance under the service test.

*How can an institution determine if its levels of lending, service, and investment are "adequate?"*

The key components to this answer are performance context and self-analysis. During the course of business, financial institutions commonly gather information on each other, the demographics of their service area(s), and opportunities for lending and investment. All of these play a role in the development of a performance context. Whether it is done consciously or not, institutions are constantly developing and maintaining a performance context. It is this contextual framework that allows bank management to know when to implement changes to bank policy or to engage, within the scope if its capacity, in a given activity.

With an established performance context, an institution may then conduct a self-analysis. The collection of loan data is already a requirement. Also, large institutions should ideally have begun gathering information about CRA qualified investments and services. Armed with this information, banks should reasonably be able to conduct a self-analysis. Moreover, it is essential that periodic self-analyses are conducted so that adjustments in the institution's CRA efforts may be made wherever appropriate and before they become subject to criticism from an examiner.

**Assessment Factor K**
This file contains information about the bank's financial condition and size.

*Under the new procedures is there consideration given for a "large" institution's size, legal impediments, and financial condition?*

Absolutely! This is directly part of the performance context criteria.

*What information should be provided, and in what form?*

Examiners develop this portion of the performance context by reviewing the financial institution's consolidated report of condition, any outstanding supervisory actions, and internal regulator reports that help examiners to identify peer institutions. If bank management is aware of some limitation that affects the institution, it should share that information with examiners. Don't always assume that the examiners know about al the limitations that might affect a performance context.

**Assessment Factor L**
This file contains all the data that didn't quite fit the other files, particularly about outreach, community needs, and potential new projects and partners.

*Under the new procedures, what consideration will be given for withdrawn credit proposals that consumed significant time and resources and, if any consideration is given, where will it appear?*

Consideration under the service test will be given to financial institutions that initiate long-term credit proposals such as the creation of a CDC or a low-income multi-family housing development project, only to have the proposal unravel after a substantial investment of time and resources. Realistically, a bank should invest at least a couple of months and substantial staff resources into such a proposal before it can expect to receive any credit for withdrawn proposals.

**How The Double Credit Calculation Works...**

| | |
|---|---|
| CDB Total Capitalization | $10 million |
| CDB Total Assets | $30 million |
| - qualified investments | $12 million (=40% total assets) |
| - CD loans | $18 million (=60% total loan portfolio) |
| Financial Institution Investment | $1 million<br>(=10% of total capitalization) |
| Investment Test Consideration | $400,000 |
| *Bank receives consideration for 40% of initial $1 million investment which reflects CDB's 40% ratio in qualified investments.* | |
| Lending Test Consideration | $1,080,000 |
| *Bank receives consideration for 10% of $18 million in CDB's CD loans, which totals $1.8 million. That $1.8 million is then multiplied by 60% (a reflection of CDB's 60% ratio in CD loans) to obtain the correct credit of $1.08 million.* | |
| Total Investment & Lending Test Consideration | $1,480,000 |

**CRA Transition Check List**

- Reorganize CRA files
- Change lobby CRA notices
- Recreate public files
- Gather peer data
- Re-evaluate assessment area
- Write performance context
- Gather community development lending data
- Gather small business/farm data
- Determine whether to collect consumer loan data
- Ensure that community development investments meet the definition
- for such investments
- Establish open lines of communication with your bank's CFO and educate him/her about qualfied CRA investments
- Identify what services, both retail and community development, are offered by the bank