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Small Banks Respond: How We Prepared and Fared Under the New CRA Exam Procedures

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Many small financial institutions have been examined under new CRA rules that became effective in early 1996. The following is a report from two of those institutions, Cache Valley Bank (Logan, Utah) and Mid-Peninsula Bank (Palo Alto, California). The Fed's roving CRA reporter, Shawn Elliott, asked the two banks how they prepared for those examinations and whether the preparation was useful. We would like to thank Dennis Durfee, Vice President and Compliance Officer of Cache Valley Bank and Susan Black, Executive Vice President and CRA Officer of Mid-Peninsula Bank for their candid responses to our questions. Also included is commentary by Gilberto Cooper and Millie Castillo, examiners-in-charge of the CRA/consumer compliance examinations for those institutions.

Hundreds of small banks have yet to be examined under the new regulation. If your bank is one of them, read on... we think you'll find the honest opinions and examination preparation tips most helpful.

Q. In preparing the performance context for your institution, examiners looked at peer group data. Did bank management define the banks peer group? If not, why not? If so, did management include credit unions and finance companies in the peer group? Did management share peer group information with the examiners? If so, was this a helpful exercise?

Cache Valley Bank: Management compiled two different peer group comparisons in preparation for the bank's safety and soundness examination. The first comparison was taken from the Uniform Bank Performance Report (UBPR) and the second was comprised of information from three local financial institutions, including a credit union. During the compliance examination, the analysis was reviewed by examiners; we are unsure what benefit this analysis provided to the compliance examination process.

Cache Valley Examiner: As part of the pre-examination preparation, the financial data of similarly situated banks was reviewed to help develop the performance context for the bank's CRA examination. This peer review included banks of similar asset size, structure, and with similar market characteristics. Cache Valley Bank management had performed a similar review using banks located in Utah. Discussion with management regarding the results of its peer analysis and management's insights regarding the local banking market (i.e., market concentrations and niches, competition for deposits) was helpful to our staff in developing the context within which the bank operates.

Mid-Peninsula Bank: Mid-Peninsula Bank defines its peer group as commercial banks located in the Bay Area with a focus on business banking. The peer group does not include finance companies and credit unions. Management tracks and compares the banks performance to that of the peer group; these comparisons were not discussed with the examiners. Examiners used a broader approach and identified a state-wide peer group utilizing the UBPR.

Mid-Peninsula Examiner: As part of the pre-examination procedures, the UBPR was reviewed to gauge the bank's performance against its peers. To develop the bank's performance context accurately, we also reviewed other financial data produced by the Fed; this data was more relevant since it

included local banks that are similarly situated based on asset size, location and number of branches.

Q. What factors did management consider when developing the banks assessment area? Although not required, did the bank conduct any kind of geographic analysis of loan distribution in its efforts to define its assessment area? If so, were a majority of those loans located within the anticipated assessment area?

Cache Valley Bank: In establishing the assessment area, the bank has historically determined the geographic area that we can logically expect to serve based on customer convenience. Over the past several compliance examinations, examiners have questioned the bank's ability to serve some of the outlying areas included in our delineation, and, as a result, the bank has "pulled in" its boundaries. During the most recent compliance examination, however, the assessment area was not questioned and management was not obliged to make any adjustments.

Bank management used a zip code listing of loans to analyze loan location and determined that 92% of our loans were made within the Assessment Area. This analysis was informal and somewhat rough, as the system uses mailing addresses, which does not necessarily reflect the location of the loan. The analysis did give us some confidence that the proportion of loans made within the assessment area is reasonable.

Cache Valley Examiner: The results of the bank's analysis were confirmed by the examiners' analysis which was based on block numbering areas (BNAs) designated by the Census Bureau. BNA information is often more useful than zip code information because it includes demographic data such as income, number of households and population size which are helpful in determining the bank's penetration into areas of various income levels.

Mid-Peninsula Bank: The bank's delineated community was previously defined as those communities within a seven mile radius of our three offices. To meet the requirements of the new regulation, which indicates that an institution's assessment area must include whole census tracts or BNAs, we expanded our service area to include whole census tracts within each city we serve. The philosophy of Mid-Peninsula Bank is to serve the businesses in the communities in which we are located. As a result, the majority of our loans are within close proximity. Geographic analysis and mapping of the bank's loan portfolio confirmed that over 70% of our loans were within the assessment area.

Q. If loan data were collected and analyzed, did bank management identify any "conspicuous gaps" in lending patterns? If so, how were these addressed?

Cache Valley Bank: No analysis of loan data was conducted prior to the examination. Management was not aware of any lending gaps that may have existed.

Cache Valley Examiner: Lending gaps were identified during the examiners' geographic analysis of a statistical sample of the banks commercial loans, but were later determined to be reasonable. The examiners' analysis of the sample found that no loans were extended in the one low-income BNA within the bank's assessment area. Upon review, however, it was determined that this BNA is sparsely populated and located in a national forest. Overall, the bank's distribution of loans by BNA income level was considered reasonable.

Mid-Peninsula Bank: Loan data is collected, analyzed and mapped semi-annually. The only conspicuous gaps identified were in areas with limited business lending opportunities (i.e., residential census tracts, the airport, a correctional facility, a university campus, etc.). This information was

discussed with the examiners and included in the report of examination. It was very helpful to have identified and analyzed this information prior to the examination.

Mid-Peninsula Examiner: Bank examiners noted several conspicuous gaps in reviewing loan data, which resulted in further research and clarification by bank management. The bank substantiated the cause of these lending patterns, which were due primarily to the bank's focus on business lending and justifiable low level of penetration in residential neighborhoods.

Q. What percentage of the banks loans and, as appropriate, other lending-related activities did management expect to be originated within the bank's assessment area to reasonably meet standards? Did (or does) the bank engage in other lending-related activities? Can you provide examples?

Cache Valley Bank: We intend for a high percentage of loans to be made within the bank's assessment area, and, as a small community bank, we believe it is necessary to originate loans in the local market. These loans strengthen the local economy, help create jobs and strengthen the banks customer base.

Cache Valley Examiner: The examiners' analysis of the statistical loan sample confirmed that the majority of the bank's credit extensions were within the banks assessment area.

Mid-Peninsula Bank: The bank attempts to maintain at least 70% of its loans within the assessment area. A geographic analysis of our total loan portfolio confirmed that 71% of all loans fall within this area. We also participate in a loan consortium, Lenders for Community Development (LCD), and lend through LCD's two loan pools--one for affordable housing and one for micro-lending to small businesses. Lenders for Community Development has just expanded its operating area from Santa Clara County

and East Palo Alto to include all of San Mateo County. We believe this will enhance our ability to provide additional loans within our assessment area going forward.

Mid-Peninsula Examiner: The examiners' analysis of the geographic distribution of small business loans indicated that an exceptional portion of the bank's credit extensions were made within the assessment area.

Q. Does management believe that the bank's loan-to-deposit ratio is reasonable? Did bank management advise examiners of other factors such as sales to the secondary market and/or seasonal fluctuations which have an impact on the loan-to-deposit ratio? What specific economic data does the bank regularly receive/collect in this regard?

Cache Valley Bank: Management's goal is to maintain a loan-to-deposit ratio in the 70%-85% range. Compliance examiners determined this range to be "satisfactory" while safety and soundness examiners have argued that the ratio is substantially above the peer group level. The bank operates in a market that is experiencing a strong, growing economy. Loan demand has been good, creating a very competitive deposit market and producing higher than average loan-to-deposit ratios. Management monitors loan and deposit growth closely. The bank has not experienced substantial seasonal fluctuations which would impact the loan-to-deposit ratios; however, loans are routinely sold to the secondary market out of economic necessity.

Cache Valley Examiner: The examiners' review of deposit data for Cache County revealed that branch banks have a sizeable majority of the area's deposits. As a result, smaller banks face stiff competition for deposits. Accordingly, a contributing factor to Cache Valley Banks high loan-to-deposit ratio is the tough competition for deposits within its assessment area.

Mid-Peninsula Bank: The bank's loan-to-deposit ratio was 64% at the end of 1995, 69% by the end of February 1996 and averaged 64% over the last two years. While a higher loan-to-deposit ratio is desirable, management believes the existing ratio is reasonable.

Mid-Peninsula Examiner: Comparison of the bank's loan-to-deposit ratio to its peers indicated that the ratio is satisfactory. During discussions with bank management, it was agreed that given the bank's financial capacity, the ratio could be increased.

Q. Did management conduct any analysis of the income level of borrowers or size of small businesses prior to the bank's CRA examination? If so, was this analysis useful? How did the bank's analysis compare to that of the examiners?

Cache Valley Bank: The bank has not conducted an analysis of the income level of borrowers or the revenue size of small business borrowers. The bank's community is a rural area dominated by small businesses. According to 1990 census data, all of the bank's assessment area falls in the low-to-moderate income category with only one part, a sparsely populated National Forest, designated as low income. During the compliance examination, and in follow-up correspondence, the examiners suggested that the bank may want to capture borrower income and business revenue data for all of our lending activity.

Cache Valley Examiner: While management did not review the income level of its borrowers, examiners collected information regarding the revenue size of the bank's business borrowers as represented by the statistical loan sample. This information was used to determine the bank's CRA performance in lending to small businesses, defined as those with annual revenue of less than \$1 million. In this regard, the bank's level of lending to such businesses met the standards for satisfactory performance.

Mid-Peninsula Bank: As a business lender, revenue is analyzed as part of the credit decision and monitored by an account officer. The bank has not separately tracked this information for compliance purposes. The examiners obtained this information directly from credit files during the course of the examination.

Mid-Peninsula Examiner: During the examination, examiners collected information on business revenue size, since Mid-Peninsula Bank is primarily a small business lender. A review and analysis of the data indicated that the bank's record of lending to businesses of different sizes was outstanding.

Q. Did management consider pursuing an outstanding rating? What factors did management use in reaching this decision?

Cache Valley Bank: Management's goal is to maintain a satisfactory CRA rating. In a small institution, management's time is critical, and the effort required to reach an outstanding rating does not always equal the reward. We believe that time and effort spent on other bank functions pays greater dividends in the day-to-day operation of the bank. Our philosophy is: "If we take care of our customers and manage the bank on sound principals, we will, by necessity, serve the community--and a reasonable CRA rating should follow."

Cache Valley Examiner: A bank's performance under the CRA must be managed, as must any regulatory aspect of a bank's operation. Management's CRA strategy should be revisited periodically to ensure that the needs of both the bank and its assessment area are being met. In particular, bank management must ensure that given its present resources, performance with CRA is at its best.

Mid-Peninsula Bank: Mid-Peninsula Bank received an outstanding rating in the two previous CRA exams. The CRA program is an integral part of our business plan and we are committed to continuing this tradition of excellence. Preparing for the examination was challenging since many areas of the revised regulation appear to be open to interpretation. To be considered for an outstanding rating, we prepared information regarding the bank's qualified investments and services which was not required under the small institution examination procedures. The examiners were very helpful in providing clarification and suggestions about the revised regulations.

Mid-Peninsula Examiner: Since the bank has received an outstanding CRA rating for the past two examinations, we were asked to evaluate the bank's performance with consideration for an outstanding rating. Under the revised rules, there are two methods by which a bank can merit outstanding performance. First, the institution must meet the requirements for a satisfactory rating under the five performance criteria and materially exceed the standards in one or more of the criteria. Second, at the institution's option, the examiners will evaluate its investments and services. Consequently, strong performance in investments and services can potentially raise a "satisfactory" CRA rating to "outstanding." However, this activity cannot raise a "needs to improve" rating to a "satisfactory" rating.

Examiners determined that the bank met standards for satisfactory performance in all five performance criteria, and exceeded standards in the category of geographic distribution of loans. The bank's investments and services were then evaluated to ascertain whether an outstanding rating was warranted. Examiners determined that the bank's investments were innovative and complex, and that the bank's commitment and dedication to Lenders for Community Development (LCD) and Community Bank of the Bay (CBB) greatly enhanced the banks ability to maintain an outstanding rating. Moreover, management was commended for allocating sufficient resources to ensure that the local community credit needs were met.