CRA & CDFIs

The Community Reinvestment Act and Community Development Financial Institutions

Qualified Investments, Community Development Lending, and Lessons from the New CRA Performance Evaluations

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by

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Introduction

The Community Reinvestment Act (CRA) has been a key tool in the redevelopment of lower-income and minority communities since its passage in 1977. It has also been a primary motivator of banks' involvement with community development financial institutions (CDFIs).

CDFIs rely critically on banks for capital and other resources. Banks, in turn, rely on CDFIs to help them reach underserved segments of their communities. Each side brings resources to this partnership.[1] CDFIs bring knowledge of local and distressed markets, expertise in community development finance, and philanthropic and government resources to bear on the problems faced by economically distressed communities and individuals. Banks bring the resources of scale, as well as the ability to tap secondary markets and a broader network of financial services.

In order for CDFIs to maximize the bank resources to which they have access, they must recognize the power and utility of CRA. In particular, they must understand how CRA regulations can be used to garner investment, debt, and operating support from banks and thrifts.

In recent years, the regulations which implement CRA have undergone substantial revisions, in part, so that the law would reward institutions based more on performance and outcomes rather than on promise and process. The "new" regulations, adopted in 1995 and put into effect for larger banks in mid-1997, shifted evaluation toward the examination of actual lending, investment, and service performance in lower-income communities.

For banks with more than $250 million in assets, or whose parent has more than $1 billion is assets, the new regulations call for CRA ratings to be derived from three component tests: the lending test; the investment test; and the service test. Banks that are involved with and invest in CDFIs and other community development organizations can receive credit in all three components of the CRA component tests. But it is the investment test and, to a lesser degree, the community development portion of the lending test that are most relevant to CDFI-bank relationships.

This report has a dual purpose. First, it is intended to inform CDFIs about the investment and community development lending portions of the CRA evaluation process. The goal here is to assist CDFIs in becoming more proactive in utilizing CRA to expand and improve their access to capital and resources from CRA-regulated financial institutions. Second, in examining the results of recent CRA performance evaluations conducted under the new regulations, the report draws out ongoing CRA policy issues that have implications for CDFIs and improving access to credit and capital in lower-income communities.

In general, the results of CRA examinations following the implementation of the new regulations are somewhat promising. Overall, performance evaluations now rely more on actual lending, investment, and service results than on financial institutions' less substantive descriptions of outreach and effort. It is true that regulators appear to remain quite generous in their awarding of CRA ratings, especially among the relatively larger institutions, so that very few institutions receive a grade below that of Satisfactory. Some improvements, however, have been made. Over the last year or so, the awarding of Outstanding ratings has declined significantly. Most relevant here, perhaps, is the fact that examiners have not been as generous in granting investment test scores as they have in grading the lending and service tests, which should encourage banks and thrifts to do more in this area, including becoming more active investors in CDFIs.

After describing the structure of the new CRA evaluations and some basic reasoning on how the new exams may influence bank-CDFI relationships, this report presents some information on how regulators are rating banks on the investment test – the part of CRA that is the most directly relevant to CDFIs. Then, observations regarding the evaluation of community development lending and investments based on a sample of recent CRA exams are presented, together with lessons for CDFI practice and CRA policy implications.

CRA Reform and the New Regulations

CRA places an affirmative obligation on banks and thrifts to meet the credit needs of their community. Depository financial institutions are evaluated approximately every two years for their compliance with the law, and these evaluations are made public.

Historically, CRA has been a critical tool in improving access to credit and promoting development in lower-income communities. But the vigor with which federal banking regulators have applied the law has varied. While many community development advocates remain concerned that CRA is inadequately enforced and that continuing bank consolidation has lead to a growing amount of economic and political power among a smaller number of larger financial institutions, some improvements in the implementation of CRA have occurred. The primary improvement has been a change in the evaluation of bank CRA performance from concentrating on process (e.g., marketing, documenting contacts, etc.) to focusing on outcomes (loans to lower-income communities, bank branch locations, etc.).

This change came about in the early 1990s after a growing number of voices argued that CRA, as it was being implemented and enforced, was not resulting in sufficient improvements in reinvestment performance. As a response, in 1993, federal banking regulators proposed major revisions to CRA rules that focused more on results.

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[1]See *Partners in Community Building: Mainstream and Community Development Financial Institutions*, by Valjean McLenighan and Kathy Tholin, Woodstock Institute, 1997 for more discussion of bank-CDFI partnerships. Also see Appendix III for additional Institute publications on CDFIs.

In April 1995, after 18 months of comment and debate, the four federal banking regulators -- the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) -- released new CRA regulations. The new rules replaced the 12 assessment factors in the previous regulations with an outcome-based evaluation system. This system is intended to assess how well institutions serve their communities based on lending, investments, and financial services, rather than on how well they conduct needs assessments and document community outreach.

While a shift from process to outcomes was the primary goal of the regulatory changes, there was also some attention given to "easing the regulatory burden" of banks, especially for smaller institutions. As a result, a two-tier evaluation system was established, with banks classified as "small" having more limited evaluation procedures than "large" institutions. Large banks, which include many relatively small institutions, are those with assets over $250 million or owned by a holding company with assets of more than $1 billion.

CRA evaluations for large banks consist of three component tests: the lending, investment, and service tests. Wholesale or limited purpose banks, such as credit card banks, are evaluated based on a special community development test. Small banks are examined according to a less rigorous procedure which focuses on loan-to-deposit levels and other simple measures. Small banks are not evaluated for community development lending or investments, although they may choose to have such activity considered in order to improve their ratings. This report focuses on large banks because they account for an increasingly large proportion of all bank assets, because there is a regulatory expectation for them to be more active in community development lending and investments, and because they have more capacity to engage in extensive levels of such activity.

CRA reform also resulted in the regulatory agencies regularly publishing a list of banks that will be evaluated for CRA in the upcoming quarter.[2] This allows community organizations, CDFIs and others to comment on a bank's CRA performance at the time of the CRA evaluation. This is a key change and provides an improved opportunity for community development organizations to influence a bank's CRA rating and performance.

All institutions receive an overall, or composite, rating of "Outstanding," "Satisfactory," "Needs to Improve," or "Substantial Noncompliance". The rating is substantiated in a report written by a bank examiner called a "performance evaluation" or PE. PEs are made public after they are completed and the bank has an opportunity to contest the rating. The composite rating is derived from three component tests: lending; investments; and services.

[2]Such schedules are published on the world wide web pages of the regulators as well as via hard copy. See Appendix II for more information.

CDFIs and the Lending Test

The lending test is an evaluation of a bank's lending activities, including the amount of lending and the distribution of loans by location and income of borrower. This part of the PE is the most heavily weighted portion of the examination in the calculation of the overall CRA rating. It focuses primarily on conventional, direct lending to households and small businesses. Home mortgages, small businesses, small farms, and community development lending are considered. Consumer lending is also considered if a bank chooses or if consumer lending constitutes a substantial majority of the bank's business. Regulators examine the bank's lending performance according to the following criteria:

1. Lending activity -- the number and dollar amount of loans.

2. Geographic distribution -- whether the loans are within the bank's assessment area and the proportion of loans in low- and moderate-income census tracts.

3. Borrower characteristics -- the income of homebuyers (comparing the number of loans to low-, moderate-, middle-, and upper-income individuals within the assessment area) and the number of loans to small businesses/farms with less than $1 million in annual revenues.

4. Community development lending -- additional loans whose primary purpose is community development.[3]

5. The use of innovative or flexible lending practices.

Community development lending is the part of the lending test that is most directly relevant to CDFIs. It includes loans that serve community development purposes and do not qualify as mortgage, small business, small farm, or consumer loans.[4] The loans must benefit the bank's assessment area or a broader area that includes the bank's assessment area. Examples of community development lending include loans for

[3]The definition of "community development" is a technical one and according to CRA regulations includes: (1) affordable housing (including multifamily rental housing) for low- or moderate-income individuals; (2) community services targeted to low- or moderate-income individuals; (3) activities that promote economic development by financing businesses or farms that meet U.S. Small Business Administration size eligibility standards [contained in 13 CFR 121.802(a)(2) and (3)] or have gross annual revenues of $1 million or less; or (4) activities that revitalize or stabilize low- or moderate-income geographies. Clarifications of these rules are contained in the regulatory agencies' "Questions and Answers" documents, which are available on an interagency world wide web site (www.ffiec.gov/cra/info). While many of what are considered community development activities are limited to those that benefit low- and moderate-income places or people, the formal definition includes some activities that are not necessarily so focused, including many Small Business Administration activities, for example. The consideration of activities that do not clearly benefit low- and moderate-income places or people as community development remains a point of controversy among regulators and community reinvestment activists.

[4]Loans for multifamily buildings (5 or more units) may be counted both as housing loans and as community development loans.

affordable housing, daycare, education, and other social services. Also included is debt provided to CDFIs for increasing lending capacity. (See examples on page 6.)

CDFIs and the Investment Test

The second element of the PE is the investment test, an assessment of the bank's record of helping to meet the credit needs of its community through investments. The investment test is the test that is most directly relevant to CDFIs, although not all investments are made in CDFIs. This is a new category in which the regulators delineate which types of investments are considered in evaluating a bank's CRA record. These "qualified investments" must benefit the institution's assessment area or a broader area including its assessment area, and they must be for the purpose of community development, as defined in the regulations. Investment activity is judged for innovation, complexity, and responsiveness to community development needs as well as quantity. CRA-qualified investments include investments, deposits, membership shares, grants, and in-kind contributions in or to:

Examples of Community Development Lending to CDFIs

Under CRA, community development lending can include a wide variety of activities. Examples from recent PEs of community development loans benefiting CDFIs include:

- A thrift in Albany, New York provided a five-year term loan to a local CDFI for making loans to women and minority-owned businesses and firms in low-income areas.

- Together with a group of other financial institutions, a commercial bank in Milwaukee, Wisconsin made a loan to a CDFI enabling it to purchase and rehabilitate single-family homes for low-income families.

- A Chicago bank provided a line of credit as bridge financing for a CDFI financing multifamily rehab projects to provide affordable rental units for low- and moderate-income families.

- Financial intermediaries such as CDFIs (see examples on page 7);

- Non-profits serving community development needs, such as homeowner-ship counseling; commercial development in low-income areas, etc.; and

- Other nonprofit organizations serving low- and moderate-income individuals in the bank's assessment area.

CDFIs and the Service Test

The service test is aimed primarily at examining a bank's retail banking services. Examiners consider the distribution of branches among low-, moderate-, middle- and upper-income areas, and the institution's branch openings and closings, especially those affecting low- to moderate-income areas or individuals. Also taken into account are alternative systems of service delivery (ATMs, bank-by-phone, loan production offices) and the range of services offered.

Examples of Qualified Investments in CDFIs

Among other activities, qualified investments include investments in and grants to CDFIs. Examples from recent PEs of investments in CDFIs include:

- A Chicago bank invested $2 million in a community development bank. Together with other investments, this capital injection enabled the CDFI to purchase another bank and expand their operations and service area.

- A bank made $300,000 in equity-equivalent investments in two local CDFIs, one making microloans to very small businesses, focusing on minority-owned firms and businesses in lower-income areas, and the other providing real estate financing for nonprofit organizations serving low-income constituencies.

- A New Orleans bank invested $250,000 in a for-profit CDFI focusing on business and industrial development in the city.

The new regulations also require an examination of an institution's community development services. These are services which promote credit availability, small business development, or affordable housing, or which provide technical assistance in the financial services field to organizations, including CDFIs, working to meet the credit needs of low- to moderate-income communities or individuals. Also included are seminars and bank-at-school programs aimed at providing financial literacy and education to lower-income households.

The Composite CRA Rating

The overall, or composite, CRA rating is derived from the three component test scores. An institution may receive any of five possible scores on each component test: Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, or Substantial Noncompliance. Table I indicates how points are assigned for different component scores. These component scores are then summed to arrive at a composite score that corresponds to an overall rating. A composite score of 20 or more yields an Outstanding rating; 11-19 yields a Satisfactory; 5-10 yields a Needs to Improve; and 0-4 yields a Substantial Noncompliance. In addition, to give additional emphasis to the lending test, an institution must receive at least a Low Satisfactory on the lending test to attain an overall Satisfactory rating.

Examples of Community Development Services Supporting CDFIs

While CDFIs are likely to benefit most from the community development lending and qualified investment portions of CRA regulations, banks may receive community development service credit for a variety of services that they provide to CDFIs. Most of these involve the voluntary contribution of bank staff time for serving on committees and boards in which bank staff provide assistance on financial and development issues:

- In Milwaukee, a bank provided staff to a variety of CDFIs and other organizations working on small business and housing development. Staff often serve on loan committees.

- A Chicago bank took a leadership role in addressing the need for supermarkets in lower-income neighborhoods. In addition to working with local community organizations and the public sector on identifying potential locations, the bank worked with a CDFI to structure a financing offer for a particular project.

This scheme also means that any institution receiving an Outstanding on the lending test is assured an overall Satisfactory, even if it receives Substantial Noncompliance on the other two components.

Table I
Numerical Equivalents of Component Test Ratings

Component Test Rating	Lending	Investment	Service
Outstanding	12	6	6
High Satisfactory	9	4	4
Low Satisfactory	6	3	3
Needs to Improve	3	1	1
Substantial Noncompliance	0	0	0

The Strategic Plan Option

As an alternative to the conventional large bank examination process, an institution may choose to be evaluated under the "strategic plan" option of the CRA regulations. The strategic plan option allows institutions to define their own community reinvestment objectives for lending, investments, and services, in a multi-year plan. Regulators give relatively little guidance to banks regarding what the plans should contain or what the nature or scale of the objectives should look like.[5] Moreover, banks may ask to be regulated based on their strategic plan only if they receive a Satisfactory or Outstanding rating, and are able to revert to the conventional evaluation if they do not meet their basic goals.

[5]The FDIC has produced *Community Reinvestment Act: Guide to Developing the Strategic Plan*. This document includes some general information on what a strategic plan should contain. It does not specify how goals should be derived.

A bank pursuing the strategic plan option must publish notice in a newspaper that it is formulating a plan and must give the public the opportunity to comment on the plan prior to submitting it for regulator approval. (Although regulators can review a plan for responsiveness to public comments, banks are not necessarily obliged to incorporate changes to the plan recommended in such comments.) Once the plan is approved, regulators have much less discretion in determining the bank's rating than in the case of conventional regulation. For strategic plan banks, the key intervention point for community development organizations is during the plan's comment period. Because plans can cover a period as long as 5 years, the opportunity to comment on a plan is an important one.

Wholesale and Limited Purpose Banks

The new regulations allow a financial institution to apply to its regulator to be designated either as a "wholesale" or "limited-purpose" bank. These types of institutions are regulated differently than conventional, full-service banks or thrifts. Wholesale banks are those that are not in the business of routinely extending home mortgage, small business, small farm, or consumer loans to retail customers. A bank serving only large businesses, for example, might apply to be classified as a wholesale bank. Limited-purpose banks are those that offer only a narrow product line, such as credit card or motor vehicle loans, to a regional or broader market.[6]

Wholesale or limited-purpose banks are regulated according to a "community development" test, which consists of an evaluation of an institution's community development lending, qualified investments, and community development services. These banks are not evaluated for direct residential or small business lending activities. Thus, investments and community develop-ment lending are especially important activities to such institutions.

CDFIs, Community Development Lending, and the Investment Test

CDFIs and other intermediaries may benefit directly from both community development loans and CRA-qualified investments. It is important to understand the difference between these two classifications of CRA activity, how examiners treat these activities, and how such treatment may affect banks' propensity to provide capital to CDFIs.

In preparing PEs, bank examiners consider community development lending as a subpart of the lending test, while considering qualified investments under the investment test. A bank may contribute debt to an affordable housing loan pool, for

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[6]Lists of wholesale and limited purpose banks are generally available on the regulatory agencies web sites, which are listed in Appendix II.

example, thereby garnering community development lending credit. Alternatively, an institution may make an equity-equivalent investment (see description on page 11) or purchase stock in a CDFI and receive investment test credit. A bank's choice of community development loans or investments may depend, in part, on how it expects CRA examiners will view such activity in the context of the bank's overall CRA performance.

Community development lending is evaluated based partly on whether the bank makes a relatively high or low level of such loans. The regulations do not specify how such a determination is to be made. In the lending test, the regulations call for a general assessment of whether the bank is "responsive to the credit needs of low-income individuals and geographies" and whether it makes extensive use of innovative and/or flexible lending practices.

In the investment test, banks are to be judged for the level of their activity, whether they are responsive to credit and community development needs, and whether they make extensive use of innovative and/or complex investments.

In order to improve its CRA rating, a bank may have an incentive to focus more or less on community development lending and/or investments. Overall, it is important to keep in mind the relatively greater weight given to the lending test, and the requirement to achieve a Low Satisfactory on the lending test to achieve an overall Satisfactory rating. Most important to the lending test grade is the magnitude and distribution of direct, conventional lending. At the same time, investments and community development lending can be important to a bank's CRA ratings, especially at the margin.

Equity-Equivalent Investments

Because nonprofit CDFIs cannot legally issue stock, the "equity" needed to support their lending activity has generally come from capital grants. These grants provide the permanent capital that is used to leverage debt to build the total lending base of the fund. The availability of grants, although still very important, is clearly limited, and the industry needs new ways to raise patient, affordable capital.

In the mid-1990s, the National Association of Community Development Loan Funds (now the National Community Capital Association, or NCCA) developed a product that enables CDFIs to receive equity-like, or equity-equivalent, funds from banks that would act much like an equity investment in a private-sector firm would. Because equity-equivalent investments are heavily subordinated, CDFIs can leverage such funds with senior debt to build their lending capacity. Other characteristics of NCCA's product include: that the bank book it as an investment following generally accepted accounting principles; that it is a general obligation of the CDFI; that its payment cannot be accelerated by the bank; and that it has an initial ten year "tenor" (or term) that is annually rolled over to a new ten year tenor.

NCCA approached the Office of the Comptroller of the Currency (OCC) seeking clarification on how such investments might be treated under the new CRA regulations. Subject to several conditions on the nature of the investment, the OCC agreed that the equity-equivalent instrument could be counted under the investment test. Alternatively, if the bank desired, it could choose to claim, under the lending test, a pro rata share of the CDFI's lending based on the bank's share of the CDFI's total "equity".

The OCC's conditions for counting the equity-equivalent product as an investment include: that the instrument is fully subordinated to the claims of all debtors; that they are designed to raise funds for the issuer; and that they have an indeterminate term.

As CDFIs seek to identify banks and thrifts to approach for investments or community development loans, they should consider a few general implications of the component test structure:

- A bank hoping for an Outstanding overall rating (which many larger banks do) needs to do very well on the lending test (due to its disproportionate weight in the calculation of the composite rating) and generally must perform adequately on the investment test. Moreover, due to uncertainties over exactly how examiners will judge its performance on the component tests, banks striving for Outstanding ratings usually try to score well on the investment test.

- Banks with poor lending records, or who do little lending of any kind, might also try to be more active in investments than banks with stronger conventional lending records. The investment test score can help to secure a satisfactory composite rating. Such banks may also try to use community development loans to improve their lending test score.

- At the same time, unless the currently large proportion (98 percent) of institutions receiving Satisfactory or Outstanding ratings declines substantially, banks content with Satisfactory ratings may have little incentive to invest at high levels.

- If a bank's conventional lending performance is strong (e.g., the bank is an active lender and serves lower-income communities well relative to higher-income communities), then community development lending may be relatively less important to the bank's CRA rating. It may receive a high lending test score regardless.

- Conversely, if its conventional lending performance is not very strong, a bank may be more interested in community development lending in order to boost its lending test score, since this score is very important to the composite rating.

- Wholesale and limited-purpose banks, which are not evaluated for conventional lending, should be expected to do more community development lending and investments than similarly sized full-service institutions. CDFIs should be particularly aware of such banks that have assessment areas containing all or part of their market. Lists of such banks are generally available on regulatory agencies world wide web sites (see Appendix II).

Investment Test Scores

As of July 1, 1997, the new CRA regulations were applied to all large bank evaluations. To identify how examiners have been rating banks and thrifts on the various component tests, data were collected from the four regulatory agencies on the component and composite CRA ratings of institutions evaluated from July, 1997 through July, 1998.[7] Table II shows the combined results of the large bank PEs completed and made public during this period.

Composite ratings remain high. Fewer than 2 percent of institutions received Needs to Improve or Substantial Noncompliance ratings, although Outstanding ratings are significantly lower than in earlier periods. (See Appendix I.)

For the purposes of this report, the key observation about Table II is that investment test scores are markedly lower than scores for lending or services. Only about 4 percent of institutions received an Outstanding score, with another 21 percent receiving a High Satisfactory. In the lending test, 12 percent of institutions received an Outstanding and another 64 percent received a High Satisfactory. Similarly, more than 12 percent of institutions received an Outstanding for services and another 57 percent received a High Satisfactory. Also worth noting is the fact that more than 14 percent of institutions received Needs to Improve or Substantial Noncompliance investment test scores, much higher than for either the lending or service test.

These results present both an opportunity and a threat to CDFIs. First, the low investment test scores may encourage banks and thrifts to make more investments, which should increase capital flows to CDFIs. However, the overall high composite ratings suggest that, unless a bank strives for an outstanding rating, investments may not be very important to the bank from a CRA perspective, since the bulk of institutions with weak (Low Satisfactory or below) investment test ratings are receiving Satisfactory or better composite ratings.

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[7]The FDIC was only able to provide data, with component scores broken out, for PEs initiated and made public from January through July, 1998. Other regulators provided data for large bank PEs conducted and made public during the entire period. The data include some PEs initiated shortly before July 1, 1997 but still conducted according to the new regulations.

Table II. Component and Composite CRA Ratings for Banks and Thrifts Evaluated under the Large Bank CRA Regulations July, 1997 - July, 1998*

Component Test Ratings

	Out-standing	High Satisfactory	Low Satisfactory	Needs to Improve	Substantial Non-compliance	Total
Lending Test	44	237	84	2	1	368
	12.0%	64.4%	22.8%	0.5%	0.3%	100.0%
Investment Test	16	77	223	42	10	368
	4.3%	20.9%	60.6%	11.4%	2.7%	100.0%
Service Test	46	210	106	4	2	368
	12.5%	57.1%	28.8%	1.1%	0.5%	100.0%

Composite CRA Ratings

Outstanding	Satisfactory	Needs to Improve	Substantial Noncompliance	Total
38	323	6	1	368
10.3%	87.8%	1.6%	0.3%	100.0%

***Note:** Includes performance evaluations from all four regulatory agencies dated and made public from July 1, 1997 through July 30, 1998, except for FDIC institutions, which only include those from January, 1998.

The Relationship Between Investment Activity and Investment Test Scores

Qualified investments can include a broad and complex set of activities, ranging from deposits in insured depositories to equity investments in real estate projects that may entail some significant financial risk. Equity or equity-equivalent investments in CDFIs and grants to community development organizations or to nonprofits serving low- and moderate-income individuals are also included. Because the values (either to the bank or the recipient) of these different types of investments are not necessarily equivalent to their face value, simply summing up total dollars of investment committed is not a strong measure of qualified investment effort. At the same time, bank investment levels vary widely, and comparing total dollars of investments to the asset size of the bank may provide some sense of whether examiners are generally rewarding banks making higher levels of investments with higher investment test scores.

To shed some light on this issue, data collected by the Community Affairs Department of the Federal Reserve Bank of San Fransisco can be examined. The Bank collected 30 conventional large bank PEs (conducted by all four regulatory agencies) for banks and thrifts located in the Federal Reserve's nine-state western district and reported investment totals and bank assets for each. Twenty-six of the PEs included investment totals, while four had no such figures. Table III shows that, generally, banks and thrifts receiving higher investment test ratings did have higher investment-per-asset ratios. The average investment-per-asset ratio increased significantly, for example, in going from the Low Satisfactory to the High Satisfactory rating.

However, a closer look at these data reveals some possible inconsistencies. While institutions receiving Needs to Improve ratings did have a somewhat lower average investment-per-asset ratio than banks receiving a Low Satisfactory, the table also shows that five of the Low Satisfactory institutions had ratios of less than $0.10 in qualified investments per $1,000 in assets. Yet three of the six institutions receiving Needs to Improve scores had ratios exceeding this level. Similarly, four of the Low Satisfactory institutions had relatively high investment-asset ratios, in the $1.00-$4.99 per $1,000 category. Again, these figures must be interpreted with caution since they group all sorts of investments together.[8] Nonetheless, they raise some concern over the extent to which examiners are employing consistent rationale in evaluating the investment levels of institutions.

Table III. Investment per Asset Ratios for Sample of Large Bank Performance Evaluations

		Dollars of Investment per $1,000 in Assets					
Investment Test Rating	**Number of PEs**	**<$0.10**	**$0.10-0.49**	**$0.50-0.99**	**$1.00-4.99**	**$5.0+**	**Average**
Substantial Noncompliance	0	N/A	N/A	N/A	N/A	N/A	N/A
Needs to Improve	6	3	2	1	0	0	$0.22
Low Satisfactory	14	5	5	0	4	0	$0.73
High Satisfactory	5	0	0	0	3	2	$4.37
Outstanding	1	0	0	0	0	1	$11.00

Source of Data: *Qualified Investments, A Summary of Investment Test Results: Qualified Investments Under the Revised CRA,* Federal Reserve Bank of San Francisco, Community Affairs Unit, April, 1998.

Lessons from the New PEs: Implications for CDFI Practice and CRA Policy

In order to provide information on how examiners are evaluating community development lending and investment activity, the PEs of 12 large banks and thrifts were examined in detail. A small number of evaluations was chosen so that attention

[8]See pages 19-22 for additional discussion of the evaluation of the nature as well as magnitude of investments, including discussions of complexity and innovation and responsiveness to need.

could be focused on the types of institutions that were likely to be most relevant to CDFIs. The intent here was to perform an in-depth qualitative examination of the PEs and not a statistical analysis.

These PEs were conducted between July 1, 1997 and June 30, 1998. They include 11 full-service institutions and one limited-purpose bank located throughout the country. One of the institutions was evaluated under the strategic plan option. The institutions chosen are relatively large, even among banks classified by regulators as large, because bigger institutions represent a disproportionate amount of bank assets and because such banks have a greater capacity to make substantial amounts of community development loans and investments than do smaller banks. They range in size from $2.1 billion to more than $200 billion in assets, with three having assets of more than $20 billion and two having assets of less than $4 billion. The four regulators are equally represented in the sample, each accounting for three of the PEs.

Identifying common characteristics and issues presented in these PEs will help CDFIs utilize CRA to garner investment capital from regulated financial institutions. Examining the PEs also suggests implications for CRA policy that will encourage banks to meet their communities' investment and community development lending needs. Therefore, a set of observations on the PEs are presented together with implications for CDFI action as well as CRA policy:

It is important to keep in mind that, although the new regulations were finalized in 1995, these rules left many important details to be resolved by the regulatory agencies. Thus, the "new" CRA evaluation process continues to evolve as the agencies have recently completed their first full year of large bank PEs under the new rules (which became mandatory in July, 1997). Some of the CRA policy implications described below are likely to touch on matters being discussed internally by the agencies as they continue to review and modify their large bank procedures.

❖ ***Examiners have substantial discretion in conducting PEs, especially in the evaluation of community development lending and investments***. Much of this discretion is appropriate. Different institutions operate in different markets and under different constraints. One bank may make few community development loans because CDFIs and other intermediaries in its area are more in need of investments, while an institution in another market may be responding to a stronger need for community development lending. At the same time, there appears to be room for more consistency among the exams in how community development lending and investments are measured, how adequate levels of lending or investment are determined, and whether an activity is considered innovative or complex. Moreover, examiners tend to present little information to substantiate their evaluation of these activities. Out of the 12 PEs, only 3 (all from the same regulator) made any explicit attempt to measure investment activity relative to bank size. Even among these three PEs, two different measures were used.

⇒ **Implications for CDFIs:** CDFI industry leaders and individual CDFIs should strengthen relationships with high-level regulatory officials and with the CRA examiners who evaluate banks serving their area. This will enable CDFIs to understand examiners' expectations of banks (e.g., level of investments, etc.). Perhaps more importantly, examiners can learn from CDFIs about what investments are innovative or complex and whether an activity is responsive to community needs. CDFIs can influence examiners' expectations and their evaluation of bank investment and community development lending performance. (See the insert on page 18 on Building Relationships with Bank Regulators.)

⇒ **Implications for CRA Policy:** Better and more consistent methods of evaluating community development lending and qualified investments are needed. Both flow and stock measures of community development lending and investment should be utilized more regularly and consistently, and such measures should be clearly detailed in the PEs. That is, outstanding investments/loans as well as commitments should be detailed for each year since the previous PE.

❖ ***Shortcomings in consistency in the evaluation of community development lending and investments stems, in substantial part, from a lack of comprehensive data on such activities by all banks and thrifts.*** For residential and small business lending, there exist relatively good data that can be used to compare a bank to the rest of the market. While regulators now collect data from all large banks on community development lending, the data quality is suspect, and there is no such data set for investments. While data on such activities may not fully capture important differences in types of investments or loans, the use of basic comparisons will provide some sense of whether an institution's level of effort is reasonable.

**Building Relationships with Bank Regulators:
The Chicago CRA Coalition**

The Chicago CRA Coalition is a coalition of organizations, including some CDFIs, working to increase community reinvestment in low- and moderate-income neighborhoods and households in the Chicago area. It has negotiated CRA agreements with large and medium-sized big banks covering lending, investment, and service issues. The Coalition, which is convened by the Woodstock Institute and includes the Chicago Association of Neighborhood Development Organizations, the Chicago Rehab Network, and the Chicago Community Loan Fund, among many others, also deals with CRA policy issues.

Members of the Coalition meet quarterly with staff from the four bank regulators to discuss CRA regulation trends, community development and credit needs, and new issues in community development. Both community affairs personnel and bank examiners attend regularly. These meetings allow community development groups to understand how examiners evaluate banks and thrifts under CRA and provide them with an opportunity to educate examiners on community development topics. For example, discussions have concerned the definition of complex and innovative investment activities and what CDFIs currently view as innovative. Of primary concern are issues regarding financial institutions' responsiveness to community development and credit needs, as well as the nature of such needs.

The most important goal of the Coalition's meetings with regulators is to build direct relationships between examiners and community development groups. These relationships provide both groups with additional resources with which to pursue their respective missions.

While not all regions are in close physical proximity to bank examiners and regulator staff, it is important to create opportunities to build stronger relationships with agency personnel. CDFIs can take advantage of times when regulators are in their area to get to know examiners and community affairs staff. Either independently or in coalition with other community development organizations, CDFIs should invite agency staff to visit their area and discuss community development and credit needs issues.

⇒ **Implications for CDFIs:** CDFIs, either directly or in partnership with other community development organizations, can collect data on local banks' investment activities from PEs and prepare their own comparative analysis. Investment and community development lending data can be evaluated and the results distributed to the public. This may encourage banks to increase their activities in these areas. CDFIs should encourage regulatory agencies to provide detailed, consistent data on banks operating in their markets that will allow for comparison of similar activities over similar periods of time.

⇒ **Implications for CRA Policy:** The regulatory agencies should develop a more comprehensive and consistent set of data on community development lending and investments for all banks, with breakouts at the metropolitan and statewide levels. Qualified community development grants should be recorded separately under investments. Such data should be used to compare banks to their peers in a market. Because large investments and community development loans may occur in a lumpy fashion, the number and amount of outstandings as well as annual commitments should be evaluated by all agencies and reported in the PEs. Ideally, the data set should include bank size (assets), tier 1 capital, net income, and related bank capacity measures. These data can be used in providing broad measures of bank investment and community development lending activity.

❖ ***Notwithstanding the previous point, quantitative measures, alone, will not provide sufficient information for the evaluation of community development lending and investments.*** This is due to the substantial variability in the form of these activities. Investments, for example, can include insured deposits in a community development or minority bank, the purchase of revenue bonds with a community development purpose, an equity investment in a neighborhood commercial development project (through a bank CDC, for example), or an equity-equivalent investment in a microenterprise loan fund. Some of these investments entail essentially no risk or complexity, while the others involve significant risk or complexity. Moreover, investments vary significantly in their rates of return to the banks, making some projects much easier to find investors for than others.

The regulations call for examiners to assess the complexity and innovation of investments. However, the PEs reviewed generally provide little discussion of the nature of investments or community development loans and do not substantiate the classifications of activities as complex or innovative. Moreover, some PEs considered certain types of investments (e.g., low-income housing tax credits) complex and innovative while others did not. (It is difficult to argue that such tax credits are complex or innovative since they have been used frequently by corporations of all types for more than a decade and provide relatively high rates of return.) In one PE, an investment in a venture capital fund was classified as complex and innovative, but equity-equivalent investments in local CDFIs were not, even though few such investments had been made at the time anywhere in the country.

⇒ **Implications for CDFIs:** CDFIs and community development groups should comment to banks and regulatory agencies on the nature as well as the magnitude of banks' investment and community development lending. CDFIs, for example, can explain what opportunities a bank could have financed but did not. For conventionally regulated banks, CDFIs and others have their greatest opportunity to comment on and influence bank activity when a bank is undergoing its CRA evaluation or when it is applying to acquire or merge with another financial institution. For institutions choosing to go the strategic plan route, it is critical to provide comments to the bank before the plan is finalized. Of course, such discussions are most effective if continued through ongoing relationships.

⇒ **Implications for CRA Policy:** Regulators continue to struggle with characterizing and differentiating investments according to their nature, complexity, innovation, and responsiveness to need. This task is inherently difficult. However, it is important for examiners to develop and apply consistent distinctions between different types of investments and community development loans. (For example, a market-rate investment in an untargeted small business investment company should not be considered equivalent to a similarly sized, below-market rate investment in a CDFI that makes loans for hard-to-finance projects in low-income communities.) The nature and variety of such activities may be at least as important as their total dollar amount.

❖ ***The failure to address responsiveness to credit and community development needs is the most noticeable shortcoming in the PEs.*** Rarely is there any discussion of what types of investments or community development loans are needed in the community. Occasional vague comments are provided, such as "…discussions with community representatives … stating that the bank meets the credit needs of the communities they serve, and that the bank is involved strategically in a significant number of community development initiatives." Often, not even such broad statements are included in the PEs. The result is that examiners focus on a relatively abstract notion of complexity and innovation, without considering what the needs are for various types of investments or community development loans.

For example, a community's greatest need may be for grants to community development corporations or CDFIs to provide operating support or permanent equity capital. Since grants are unlikely to be deemed complex or innovative and tend to be small in face value relative to investments, however, banks may receive little credit for such activity, even if this is where there is a very large need. PEs generally do not discuss the need for different types of investments or community development loans and, when they do, provide little substantive basis for their assessments. Of the twelve PEs, only one contained a significant, detailed discussion of need, and this covered only one segment of the banks' activities.

⇒ **Implications for CDFIs:** CDFIs are competing with other potential recipients of investments and community development loans. They must show examiners and regulatory agencies how they fulfill critical financing gaps and serve the broader community. They must also articulate the needs of CDFIs that banks should help meet. CDFIs must distinguish investment in themselves from other forms of qualified investments and make the case that such investments are responsive to community development needs and have a high level of impact on lower-income communities and individuals.

⇒ **Implications for CRA Policy:** Regulators must fundamentally address the issue of need in evaluating investments and community development loans. Currently, for example, an investment in a small business investment company (SBIC) that does not target its investments to minority firms or firms in distressed areas and that provides a rate of return exceeding 20 percent would receive as much credit, dollar-for-dollar, as an equity-equivalent investment in a microloan fund targeting minority firms and that would not provide a similar rate of return. Since the former investment recipient is already subsidized (via the SBA) and is generally able to raise funds on the open market, it seems clear that the need for investment in the microloan fund is greater and that such an investment should be given greater weight on a dollar-by-dollar basis.

A more fundamental policy recommendation is to modify existing regulatory practice and not count investments in activities that do not target communities or individuals in need. That is, investments in SBICs or other entities that do not target low- and moderate-income individuals or distressed communities should not be considered qualified investments.

Conclusion

The new CRA regulations are a key opportunity for CDFIs to access additional resources and to develop stronger, long-term relationships with conventional financial institutions. CRA is a critical tool in increasing the scale and impact of CDFIs' activities.

At the same time, bank regulators must examine more closely their role in the continued development of the CDFI industry and its crucial and complementary role to bank lending and services in lower-income communities. Without understanding the needs and opportunities of this critical sector of community development movement, the agencies will miss a key opportunity to help remedy structural failures in the financial services industry as it relates to lower-income communities and families.

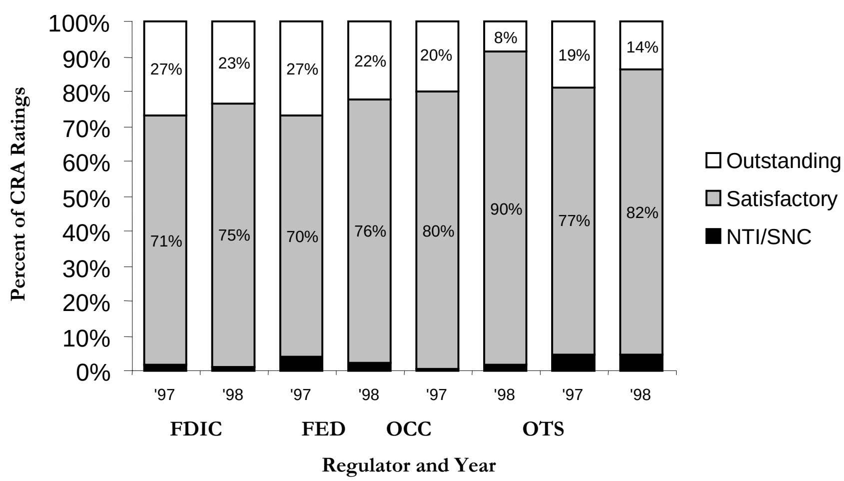
To take full advantage of CRA, CDFIs must understand the basic mechanics of the law and its regulations, develop strong relationships with bank regulators, and put CRA policy high on their agendas. With the continuing consolidation of the financial services industry, the entrance of banks into a broader set of industries, and the persistent problems of the un- and under-banked, CDFIs need to understand, utilize, and work to improve this powerful tool.

Appendix I. Recent Trends in Public Evaluation Grades

Community reinvestment advocates supported CRA reform in large part because they believed that a shift to performance-based regulations would help reduce substantial "grade inflation" in CRA ratings that reached very high levels beginning in the late 1980s.[9] While the results from those banks which voluntarily chose to be regulated under the new regulations (from mid-1996 to mid-1997) did not suggest that the new regulations were having such an impact, more recent trends in CRA grades are somewhat more promising in this regard, at least in terms of reducing the proportion of Outstanding ratings.

Figure 1 shows that, for each of the four regulatory agencies, the proportion of institutions receiving an outstanding rating dropped significantly from 1997 to the first half of 1998. Overall, the proportion of Outstanding ratings dropped from 24.3 percent to 18.6 percent over this period. The largest drop occurred at the Office of the Comptroller of the Currency (from 20 percent Outstandings to 8 percent). At the lower end of the rating spectrum, ratings results have not changed significantly. Overall, the proportion of Needs to Improve (NTI) and Substantial Noncompliance (SNC) ratings remained steady at only 2 percent of ratings.

Figure 1. CRA Rating Results for Banks Examined in 1997 and the First Half of 1998



Note: 1998 includes exams from January through June only.
Source: CRA ratings compiled by *Inside Mortgage Compliance*, July 13, 1998.

Appendix II. CRA Resources for CDFIs

Federal Banking Regulators:

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[9]See *Is CRA Reform for Real? Analyzing the Ratings of Large Banks Opting for Evaluation Under the New CRA Regulations* by Daniel Immergluck (Woodstock Institute, 1997) for a more detailed discussion of CRA grade inflation.

The four federal banking and thrift regulators are key resources for CRA information on a particular bank or thrift. It is important for CDFIs to be familiar with regulator policies and practices and to develop relationships with the examiners conducting PEs in communities. Each agency also has community affairs or community development staff in regional offices. Developing relationships with regulator staff will enable CDFIs to educate examiners on local community development and credit needs and on what is currently innovative in bank-CDFI relationships. Some agency web sites contain important policy materials, including key interagency interpretive letters on CRA regulations and the interagency "Q&A," which provide important details on how CRA regulations are applied. The web sites generally allow for search of an institution's CRA rating and, in some cases, allow for the full exam to be downloaded. They also contain public notices, including schedules of upcoming CRA evaluations and applications received from banks intending to merge.

The **Federal Financial Institutions Examination Council** (www.ffiec.gov) is an interagency council that coordinates various activities of the four regulators.

Office of the Comptroller of the Currency (www.occ.treas.gov)

Board of Governors of the Federal Reserve System (www.bog.frb.fed.us)

(The regional Federal Reserve Banks also provide information through their web sites and publications. Regional banks web sites are linked via the main site above.)

Federal Deposit Insurance Corporation (www.fdic.gov)

Office of Thrift Supervision (www.ots.treas.gov)

National Community Capital Association (www.communitycapital.org)

NCCA developed the equity-equivalent investment instrument to provide a new vehicle for CDFIs to attract long-term, patient capital. NCCA is a membership organization of community development loan funds that provides a variety of related services to members and banks.

National Community Reinvestment Coalition (www.ncrc.org)

NCRC is a national coalition of community reinvestment advocates, including some CDFIs. Members work together to develop and further common policy objectives.

Woodstock Institute (www.woodstockinst.org/)

Woodstock Institute has done a wide variety of research, policy, and public education work on CRA and CDFIs.

Appendix III. Additional Woodstock Institute Publications on CDFIs

A diverse range of community development financial institutions (CDFIs) have been created over the past two decades to address the need for access to financial services and development credit in disadvantaged communities. Woodstock Institute has supported community development financial institutions with a series of publications examining the roles and activities of these institutions, the issues they face, and the types of support and policy needed to sustain their growth.

The CDFI series includes nine publications and a reinvestment strategies paper:

The Community Reinvestment Act and Community Development Financial Institutions (1998)

Credit to the Community: The Role of CDCUs in Community Development (1997)

Partners in Community Building: Mainstream and Community Development Financial Institutions (1997)

Credit Unions and Communities: Breaking New Ground in Affordable Mortgage Lending (1996)

Banking on Communities: Community Development Banks in the United States (1995)

Community Development Financial Institutions: Investing in People and Communities (1994)

Lenders of First Resort: Community Development Loan Funds (1991)

The Business of Self-Sufficiency: Microcredit in the United States (1991)

Banking Services for the Poor: Community Development Credit Unions (1991)

Reinvestment Strategies: State Governments Use Public Deposits to Strengthen Community Development Financial Institutions (1994) (Free)

==================OrderForm================

Community Development Financial Institutions-- Indicate choice of publication(s)

___CRA and CDFI	**___Banking on Communities**
___Credit to the Community	**___Business of Self Sufficiency**
___Partners in Community Building	**___Banking Services for the Poor**
___CDFIs	**___Credit Unions and Communities**
___Lenders of First Resort	**___CDFI Series (all 9 publications)**

Nonprofit/Government: $12 each. Set of 9: $80. For-Profit: $25 each, Set of 9: $160. Send check or money order to: **Woodstock Institute, 407 S. Dearborn, Suite 550, Chicago, IL 60605**

Name____

Organization____

Address________________________________ Tax Exempt #_________________

City____________________ State_____Zip _____________Phone _____________

For more information call 312-427-8070 or email woodstck@wwa.com or visit our web site at http://www.nonprofit.net/woodstock/

Woodstock Institute

Woodstock Institute a Chicago nonprofit incorporated in 1973, works locally and nationally to promote community reinvestment and economic development in lower-income and minority communities. It works with community organizations, financial institutions, foundations, government agencies, and others to promote its goals.

The Institute engages in applied research, policy analysis, technical assistance, public education, and program design and evaluation. Its areas of expertise include: CRA and Fair Lending policies, financial and insurance services, small business lending, community development financial institutions, and economic development strategies including local employment programs.