DirectorCorps Strong Board. Strong Bank.

www.bankdirector.com

WOLTERS KLUWER FINANCIAL SERVICES

CRA Comes to Life

WHITE PAPER

Wolters Kluwer
Financial Services

Edward B. Kramer
is executive vice president, regulatory programs at Wolters Kluwer Financial Services. Prior to this position, Kramer was deputy superintendent of banks in charge of the Consumer Services Division of the New York State Banking Department, which is responsible for performing consumer compliance and fair lending examinations and administering the Community Reinvestment Act.

Christina Nejezchleb Speh
is director of new markets and compliance strategy for enterprise risk compliance at Wolters Kluwer Financial Services. Speh helps financial institutions minimize regulatory and operational risks through the use of improved enterprise risk management processes, policies and procedures as well as the use of technology.

Executive Summary

The Community Reinvestment Act (CRA) requires that every insured depository institution meet the needs of its entire community. It also requires the periodic evaluation of depository institutions' records in helping meet the credit needs of their communities. Proactively monitoring CRA performance is important for several reasons. The record is taken into account when considering an institution's application for deposit facilities, meaning it will directly impact any contemplated acquisitions and/or branch openings. Additionally, the record will be regularly examined by the federal agencies that are responsible for supervising depository institutions and a rating will be assigned. Since the results of the exam and the rating are available to the public—customers, competitors and community groups—an institution's CRA performance can impact its reputation. Banks must understand the characteristics of their assessment area and regularly monitor their performance to ensure the equal credit extension throughout their entire customer base.

This paper will explain the purpose and requirements of CRA and how as a board member, you can provide oversight regarding your institution's CRA obligation.

Regulatory Overview

Understanding and taking responsibility for a bank's compliance with laws and regulations is a requirement demanded by regulators, who are insisting that boards be fully engaged in the oversight of compliance, including the CRA.

The CRA is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations. It was enacted in 1977 by Congress and is implemented by regulation that specifically states the regulation must be "consistent with safe and sound banking operations." This regulation does not require you to make loans that do not meet standard lending requirements, nor does it require you to give money away.

The CRA was created in response to a practice, initially found in Chicago and Atlanta institutions, termed "redlining." The name originates from the practice of lenders drawing red lines around neighborhoods that met certain demographic criteria. These same lenders would refuse to lend even if an individual from within a red-lined neighborhood met a bank's underwriting guidelines. This led to disinvestment in whole neighborhoods, and Chicago-area and Atlanta-area lenders were not alone in this practice. Because of this, the CRA requires the periodic evaluation of insured depository institutions' records in helping meet the credit needs of their communities. Those records are taken into account when the regulatory agency is considering an institution's application for deposit facilities, including mergers and acquisitions.

Federal Reserve Board Regulation BB implements the CRA. In addition to the above requirements, Reg BB addresses a variety of related matters, including the collection, maintenance and reporting of data about an institution's performance in meeting the credit needs of its community and an institution's public disclosure of materials evaluating or commenting on its performance. The other three federal bank and thrift regulatory agencies have promulgated very similar regulations to Reg BB.

The CRA examinations are conducted by the federal agencies (not the newly formed CFPB) that are responsible for supervising depository institutions. If a BHC has several charters, it will receive several CRA evaluations, one for each bank charter.

What Do Regulators Look for?

Regulators will give your institution an overall CRA rating of one of the following:

- Substantial Noncompliance
- Need to Improve
- Satisfactory
- Outstanding

Most banks receive scores of satisfactory or outstanding.

Read It!

The performance evaluation of a bank's CRA examination is a public document; it is posted online by the regulatory agencies, and it must be readily available to the public from the bank itself. Read it! Your competitors read it, the community groups in your area read it, and, lastly, government officials read it.

Breaking Down the Score

There are no hard and fast rules or ratios that translate into these scores. When writing the regulations the agencies were very concerned about the CRA being perceived or implemented as a credit or capital allocation regulation. This was handled by introducing the concept of "performance context." The performance context should provide the story or the "context" that surrounds the institution's performance, which ultimately explains why your bank received the CRA score that it did. Therefore, it is possible that two banks of different sizes with different strategies in the same area might receive different CRA ratings for what seems, at face value, to be similar performance.

Performance context best translated is your bank's picture: your market realities, your competitors, your customers, your strategy and your banking expertise. This is something that your institution's CRA officer should own, write and prepare for the regulatory agencies. We recommend that the board review, provide insight and understand the performance context. Your knowledge of the bank's market will help create a more robust performance context for the CRA officer and ultimately the bank's examiners.

The Assessment Area

The CRA rating is based on your performance in the assessment area. There are detailed rules around how to draw an assessment area in the regulation. The assessment area needs to include all branches, be drawn based on census tracts, and be no larger than a Metropolitan Statistical Area (census defined city lines) or a combination of counties within a non-Metropolitan Statistical Area. Boards are typically asked to approve the bank's assessment area and any changes made to it. When approving an assessment area or change thereto it is important to understand:

- Why is the assessment area changing
- What your performance will look like with the new assessment area
- Whether there any program changes needed based on the new assessment area changes (new loan officers, community group associations, etc.)
- Whether a map of the assessment area may make it appear that low- or moderate-income geographies or minority neighborhoods are being avoided.

Low and Moderate Income (LMI): The Census Bureau stratifies individual income and geographic income (census tracts). The stratification is: low, moderate, middle and upper income. They are calculated using the most recent census information. The CRA is most concerned with your ability to lend and provide services equitably across these income bands. Your CRA performance evaluation will focus on your bank's performance based on these categories.

Many people wrongly assume that all LMI individuals are homeless, below the poverty level, unemployed or can't afford to buy homes. Although these individuals may be LMI, in many assessment areas the following jobs titles are often LMI: fire fighters, school teachers, bank tellers, branch managers, loan processors, or office administration. We recommend that your CRA officer provide you with information on typical job titles for LMI individuals in your bank's assessment area. This helps provide some context as to whom your special CRA programs are supporting.

Board Involvement in Understanding CRA Performance

CRA is a complex law, and the requirements for compliance are numerous. Many outside directors have limited knowledge of the CRA and monitoring a bank's compliance with it can be difficult. But technology has afforded new opportunities for visualizing data through the use of digital dashboard reporting. Whether it's a bank's lending levels in low- and moderate-income neighborhoods, its distribution of branches, or its participation in community development loans, technology-enabled performance dashboards provide an easier-to-understand visual illustration of a bank's progress in reaching its goals. Specifically they provide the following:

- High level, brief overview of complete CRA performance
- Individual visual indicators for each benchmark of CRA's components (i.e., lending, investments and services)
- Geographic granularity by entire lending footprint, state or assessment area

It is increasingly important that compliance officers provide the appropriate views of performance to the board as well as executives, lines of business and other stakeholders. This will help board members understand regulatory requirements and recommendations for reporting, including:

- Key Performance and Risk Indicators (KPIs and KRIs)
- Comparisons against industry-standard or institution-specific goals

Presenting information in a clear and digestible format is essential, with special emphasis on how best to explain the regulatory changes, and how they impact an organization's operations. Technology can provide a comprehensive, at-a-glance perspective of a bank's compliance with the laws and regulations.

The Tests

Since there is no one-size-fits-all for "helping to meet your communities' credit needs" and bank strategies, the regulators created several different tests.

• Large Bank: Contains the lending, investment and services test.

• Small Bank and Intermediate Small Bank: Focuses on the loan to deposit ratio; percentage of loans in your assessment area; performance in lending to individuals of different income levels; performance in lending to geographies of all income levels; and your institution's response to any complaints.

• Wholesale/Limited Purpose: Focuses on community development activities.

• Strategic Plan: Very limited use by banks, but enables a bank to develop its own CRA plan.

We are going to discuss the two most common tests, the large bank and the small bank tests, in more detail in this document.

Small and Intermediate Small Bank Test

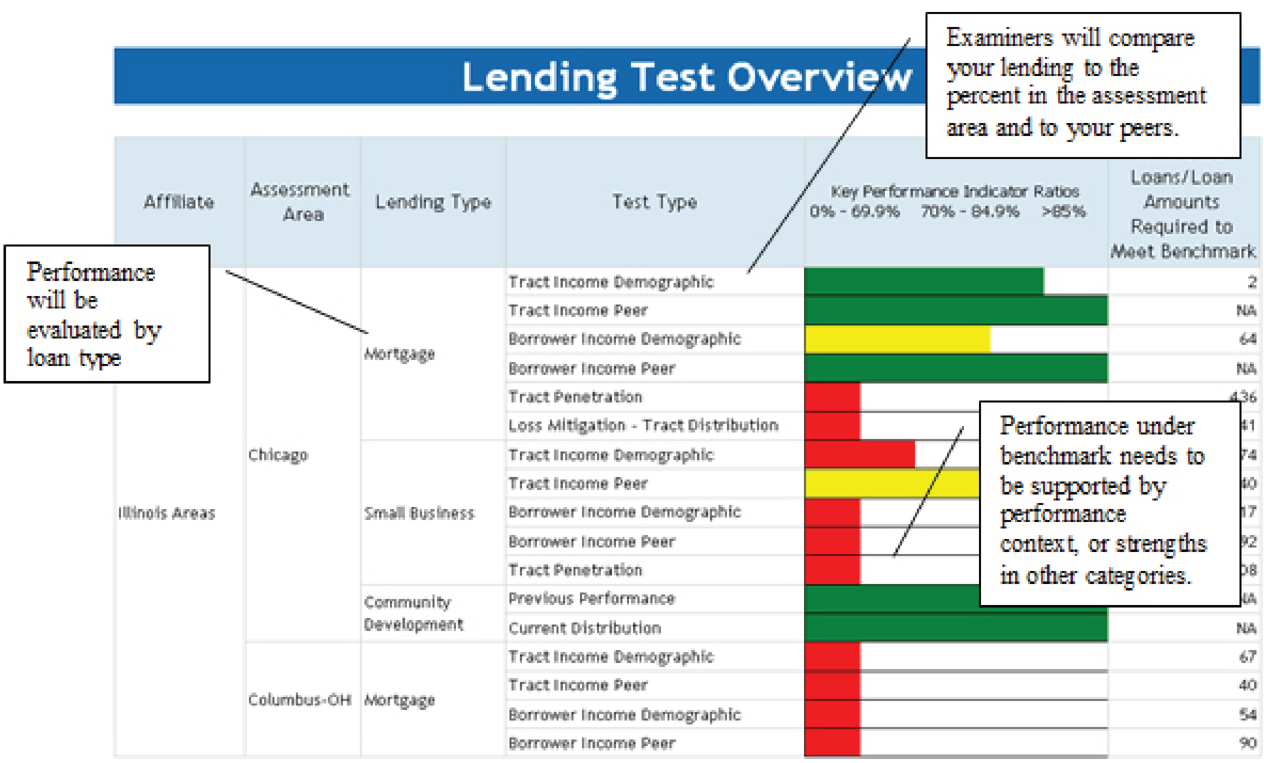
If your bank is under approximately $1 billion in assets you will fall under the small or intermediate small bank CRA test.

Under the small bank test, examiners focus on whether you are lending, whether you are lending in your community and, finally, if you are meeting needs across all income levels of borrowers and all income geographies. Specifically, examiners will evaluate the following:

• Loan-to-Deposit Ratio: This ratio helps the examiners understand if you are lending. They will compare you to your competitors in your market.

• Lending In versus Out of Your Assessment Area: This ratio helps examiners understand the percentage of lending that is being made within your assessment area. If there is a majority of lending out of the assessment area, the examiners will want to understand why.

• Performance in lending (or other services) to individuals of different income levels (specifically low- and moderate income):This is also evaluated in the large bank test.



• Performance in lending to geographies of different incomes: This is also evaluated in the large bank test.

In addition, to the above lending evaluation, an intermediate small bank will also have their community development loans investments and services evaluated in a community development test. Both tests need to be "satisfactory" to receive an overall satisfactory rating. More details on the community development activities are discussed in the large bank test.

Large Bank Test

Once your bank has reached approximately $1 billion in assets for two consecutive years, your institution will be evaluated under the large bank test. This test differs from the small bank test in that it excludes the loan-to-deposit test and adds a separate investment and services test.

Lending Test

As outlined above, this test evaluates performance in lending (or other services) to individuals of different income levels (specifically low- and moderate-income) and performance in lending to geographies of different incomes.

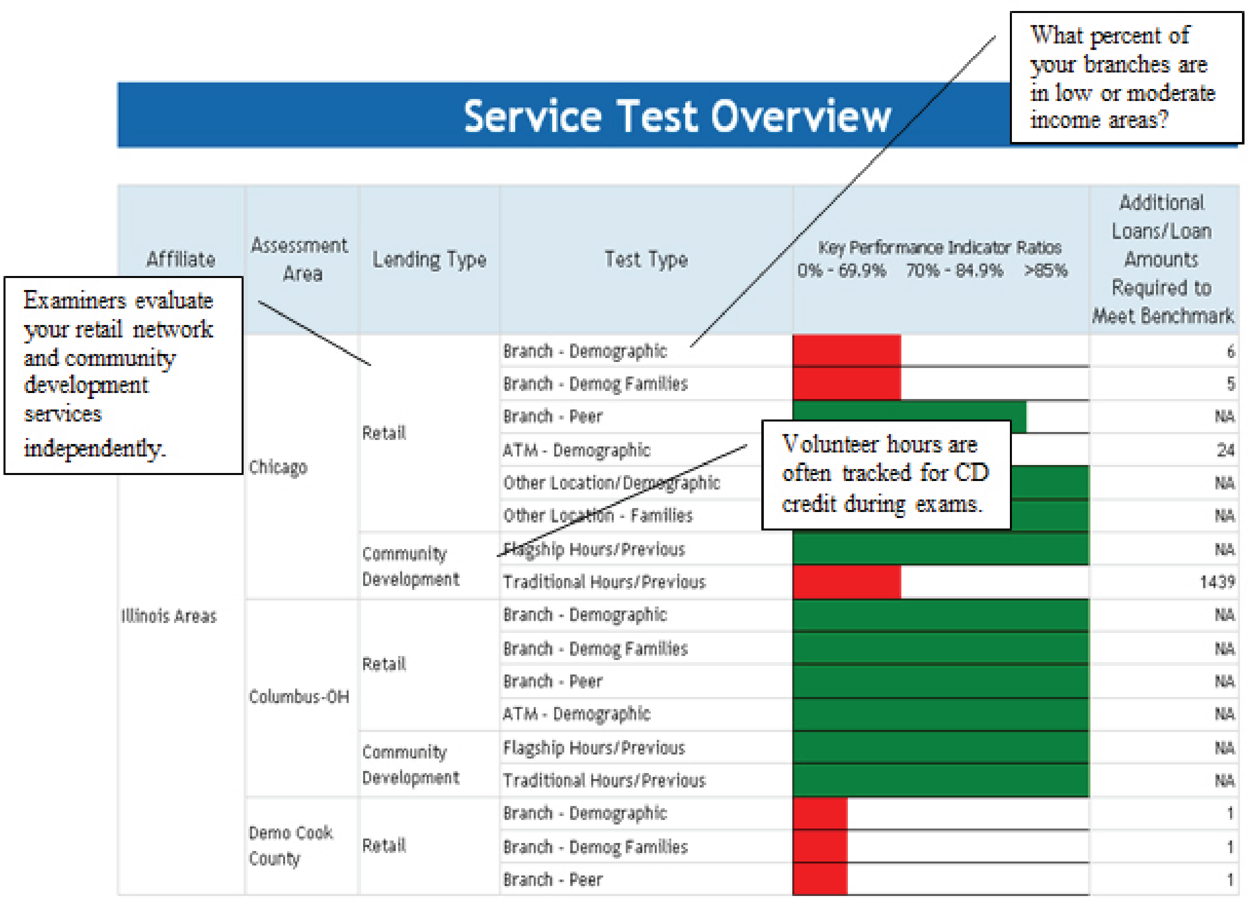
• Performance under benchmark needs to be supported by performance context, or strengths in other categories.

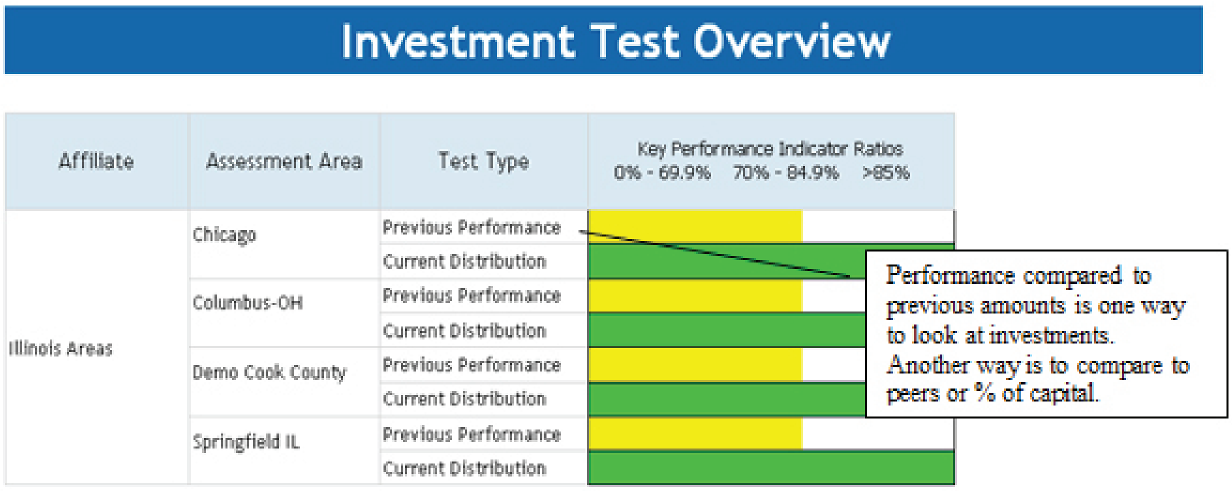
• Performance will be evaluated by loan type

• Examiners will compare your lending to the percent in the assessment area and to your peers.

Services Test

The services test evaluates the effectiveness of your retail services (branch network and deposit products) in reaching your entire assessment area, including low-to-moderate-income areas and people, and the innovativeness and responsiveness of your





community development services. It is harder to encapsulate your services performance in numbers. However, there are a few ratios that are of interest that are shown below. In addition, your CRA officer will document volunteer hours that meet the strict definitions in the regulation. They will also document special programs such as literacy programs or senior programs that also target low- or moderate-income individuals or geographies.

- Volunteer hours are often tracked for CD credit during exams.
- What percent of your branches are in low or moderate income areas?
- Examiners evaluate your retail network and community development services independently.

Investment Test

The investment test evaluates a bank's record of meeting its assessment areas' credit needs through qualified investments. All investments need to meet the strict definition in the regulation. Grants to qualified groups and/or projects are also considered under the investment test. It is important to note that grants are not required under CRA or to receive a satisfactory investment test rating. However, many small banks find it to be good criteria to manage their standard community-based grants.

- Performance compared to previous amounts is one way to look at investments. Another way is to compare investments to peers or to look at them as a percentage of capital.

Conclusions and Questions to Ask Your Bank

Demonstrating compliance with the CRA is critical to ensuring a smooth exam process and advancing a bank's future growth strategy. Board members and senior management must have insight on how all business lines are impacting lending, investments, branch openings and closings, and service activities. And since CRA performance is regularly evaluated, an institution must be able to explain how performance reflects economic changes as well as the institution's earnings, liquidity, products, staff changes, etc. Staying on top of CRA performance and things that may affect it are critical to making any necessary adjustments to lending strategy. The following questions will help you oversee your institution's CRA obligations:

- Can you provide your last CRA performance evaluation for board review? How does your performance compare to your competitors?
- Does your assessment area reflect your pattern of lending? Are there areas within your assessment area that you just do not lend in? Why? Is this explained in your performance context?
- Do you have any questions regarding the market and the business environment in your assessment area that the board can help you explain in the performance context?
- If you look at a map, is there any minority or low- to moderate-income geographies that appear to be specifically excluded from your assessment area? Why? What is your explanation? Do you have any data to back this up?
- What CRA test are you under?

Small Bank and Intermediate Small Bank

- Are you lending? How does this differ from your competitors or other similarly situated institutions? Based on the market and economic issues, is this acceptable?
- Are you lending in your assessment area? If there is a substantial amount of lending outside of the assessment area, is it related to a non-branch strategy? What is the impact for CRA?
- Is your lending distributed across LMI geographies and to LMI individuals? Are there certain types of loans where you do a better or worse job? What strategies are you employing to reach typically underserved communities?
- What is the impact to your rating if we do not have any LMI geographies?

Large Bank

- Are you lending in your assessment area? If there is a substantial amount of lending outside of the assessment area, is it related to a non-branch strategy? What is the impact for CRA?
- Is your lending distributed across LMI geographies and to LMI individuals? Are there certain types of loans where you do a better or worse job? What strategies are you employing to reach typically underserved communities? How does your lending compare to demographics and your peers?
- Are your branch network and retail services offered equally throughout your community?
- What community development lending, investments, and services are you involved in? What impact are large institutions having on your ability to be involved in the community development market?

Data Accuracy

- Do you have the appropriate resources to efficiently produce accurate data that is evaluated under the CRA? Where can your processes be shored up to ensure accurate data collection and therefore, accurate analysis and reports to the board?