COMMUNITY REINVESTMENT ACT

CRA - YOU ARE GROWING

SO WHATS NEXT? WE DISCUSS WHAT SMALL AND INTERMEDIATE BANKS NEED TO KNOW

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RADD LLC.
RISK ADVISORY, DIRECTION AND DELIVERY

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Why was the Community Reinvestment Act created?

CRA was created to require regulatory agencies to encourage financial institutions to help address the credit needs of low and moderate-income neighborhoods through lending and community development activities. In addition, federal regulatory agencies are required to assess the effectiveness of each banks' obligations to their target community.

How does CRA affect my institution?

The regulatory agencies developed a rating system in assessing the CRA performance of banks. The bank's CRA record is reviewed when considering applications for expansion, including mergers and acquisitions. Maintaining a satisfactory or better CRA evaluation will result in less frequent CRA exams.

This blog will discuss at a high level the expectations of growing from a bank that has been evaluated as a "Small" institution to an "Intermediate Small Institution."

Progression and an increase in the bottom line are always the goals for financial institutions. But with an increase in assets comes more responsibility.

As a community bank's assets increase over time, its classification under the Community Reinvestment Act (CRA) can change. Small banks (SBs) can increase in size and become intermediate small banks (ISBs) and, therefore, subject to new requirements. ISBs must complete more CRA examinations, including a lending test and a community development test.

ISB classification is more complex than just the lending test that SBs must complete, which focuses on retail activities. This change doesn't need to become a stressful ordeal for a financial institution or its employees. However, banks need to prepare themselves with the appropriate information for the transition.

What is the Community Reinvestment Act (CRA)?

CRA was created to require the Federal Reserve and other federal banking regulators to encourage financial institutions to help meet the credit needs of the communities involved.
The three federal banking regulatory agencies responsible for the CRA are:

- Federal Deposit Insurance Corporation (FDIC)
- Federal Reserve Board (FRB)
- Office of the Comptroller of the Currency (OCC)

Together, these agencies supervise financial institutions that have applied or been accepted to be part of the Federal Reserve System for CRA compliance.

SB and ISB Asset Threshold

Small banks are defined as having less than $330 million in assets for two prior years (2022). The threshold is updated and announced every year in January. Intermediate small banks are defined as having assets of at least $330 million for two prior years and less than $1.322 billion in assets for the two previous years.

Two years is used to measure the assets as assets can easily fluctuate over or under the threshold within a given year. Measuring these assets after two years determines if the institution is considered an SB, ISB, or large bank. It is essential to determine each institution's size to help set the examination procedures for that bank's CRA evaluation.

A recommendation for SBs approaching the threshold is to familiarize themselves with the ISB requirements before going up a class rather than waiting until they pass the threshold.

CRA Expectations for SBs VS ISBs

The CRA generally classifies an institution based on its asset size to determine which CRA performance criteria and tests should be used for the evaluation.
The lending test used reviews the following criteria:

- net loan-to-deposit ratio
- percentage of lending-related activities located inside the institution's assessment areas
- geographic distribution of loans
- record of lending to borrowers of different income levels
- record of lending to businesses of different sizes
- record of taking action
- response to written complaints about the institution's performance

The lending products evaluated under the lending test can vary based on the institution's major product lines. These products might include residential loans, small business loans, and consumer loans. The SB and ISB evaluation difference is that the ISB also includes the community development test. The CD test measures how involved an institution is in community development activities.

Examiners will review the volume, mix, and qualitative aspects of the community development loans, qualified investments, and community development services.
The CD test evaluates the following:

- the quantity and amount of community development loans
- the quantity and amount of qualified investments
- the extent of community development services provided
- effectiveness of community development loans, qualified investments, and community development services for development needs and opportunities

The CD test mainly focuses on determining if an institution fully understands and responds to community development needs. Well-established ISBs are most likely already in a good position for this evaluation. However, new ISBs or SBs likely to become ISBs should evaluate their current position in community development for improvement opportunities. This includes making community development loans, making more qualified investments, and providing effective community development services in the area. The regulatory agencies that complete a CRA exam tend to expect ISBs to be engaged in community development loans, qualified investments, and community development services. These services should be consistent with the institution's capacity and operations strategy.

To qualify for a community development activity, the relevant services must be purposed for community development needs. In addition, ensuring this activity can be deemed a community development activity includes that the majority or a sizable percentage of the dollars or beneficiaries are associated with community development in mind.

An example would be an activity targeting low or moderate-income households such as economic development, revitalizing or stabilizing the community, designating disaster areas, or underserved communities. All of the funds used to help any of these activities could be eligible for CRA consideration.

Evaluating an ISB's CRA performance involves a review of the volume of its community development activity and its responsiveness to those activities to community development needs. The community development test was created with flexibility in mind. It allows financial institutions to allocate resources based on their capacity, strategy, development needs, and opportunities. It is important to note as different communities have different needs.CRA agencies acknowledge that smaller ISBs don't have the resources as larger banks and factor in qualitative components such as the innovation and complexity of the development activity.

If your institution is unsure what activities qualify, it should contact the CRA evaluation's regulatory agency or contact RADD for assistance.

FDIC defines a Construction loan as " an extension of credit for the purposes of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development" which is considered acceptable collateral where a lender has a perfected security interest. Community development under CRA is inclusive of activities that promote the construction and financial restructuring of affordable housing (single-family residences, multi-family housing rentals) for low or moderate-income individuals and families inside the identified assessment areas. New construction must promote housing stability for low or moderate-income renters especially if they are experiencing financial hardship. This would be inclusive of the COVID-19 emergency. New construction for the benefit of individuals facing or experiencing homelessness or domestic violence situations is considered CRA qualified. Lastly, Construction loans must meet Supervisory Loan-to-Value Limits (Maximum of 80% LTV for commercial, multi-family, and other non-residential property types. Max 85% for 1-4 family residential units).

For additional information on construction loan qualifications for CRA please reference the CRA illustrative List of Qualifying Activities bellow:

CRA Illustrative List of Qualifying Activities (occ.gov)

How to Prepare for the CRA

A) The financial institution must have a plan of action that includes proper documentation and an analysis of its lending history to complete the lending and community development tests. Once a plan is in place, financial institutions need to ensure the board of directors and employees understand what needs to be done. In addition, pertinent staff should understand the community development and lending opportunities within their evaluation area.

B) Outreach from the marketing department can be analyzed to find the community's development activities such as loans, investments, and services. Even the smallest of efforts should be documented.

C) Reporting of activities. Many SBs and ISBs already engage in community development activities, but if they are unable to provide accurate information concerning the activity to CRA examiners, the activities could be missed during the exam.

The institution being examined should create an effective procedure or process for capturing information about the community development activities to ensure they are reviewed for the CRA consideration. Once the information is routinely collected, the institution's CRA team will be available for future CRA exams. Lastly, software (Ncontracts) that tracks the bank's existing loans and investments could also be helpful to aid in recording community development activity.

Financial institutions should check their lending and community activities from the past five years. Banks must have a thorough understanding of what has been completed over those five years, as well as an understanding of what their expected outcomes were. For example, suppose a bank's main goal was to increase the number of business loans they board over the five years. In that case, they need to review how many loans were written during that period and compare it to prior years or other financial institutions in similar locations for comparison. If there has been an increase in lending activities, gather information on products and services that have contributed.

D) Self-assessments by the institution help to understand and monitor the aspects of the CRA-related performance of the institution to prepare for future evaluations. They can provide a great starting point to identify strengths, weaknesses, opportunities, and threats to the institution's development strategy.

The following information should be included in self-assessments:

- economic conditions
- demographic shifts
- bank products
- business strategy
- bank capacity and limitations
- marketing efforts
- board involvement in the community
- volunteer activity - although not required but tells a good story

How to Pass the CRA Evaluation

A clear understanding of the rating system allows prospective ISBs to prepare and improve their CRA programs to respond to community needs and opportunities better. To secure a satisfactory or outstanding evaluation, an ISB will be required to evaluate the needs of the pertinent community and engage in development activities that respond to those needs within the institution's resource limits.

ISB banks should create an effective strategy to disperse resources using community development loans, investments, and services. ISBs will benefit further by utilizing:

- community outreach to gauge the community's needs
- training personnel for effective resource allocation
- systems to track community development performance
- self-assessments to measure the effectiveness

An ISB's community development performance must demonstrate exceptional responsiveness to the community development demands of its assessment region. This can be done through community development loans, qualified investments, and services compared to the ISB's resources capacity and the community's needs.

To receive an overall satisfactory rating for the CRA evaluation, an ISB is required to score satisfactory scores for the lending test and the community development evaluation. If the institution receives a "needs improvement" on either evaluation, its overall score will result in a "needs improvement."

Public CRA Responsibilities

Besides considering the institution's community development and lending activities, public responsibilities under the CRA are required.

- Pertinent institutions must maintain and update a public file containing its CRA performance, include a copy of the most recent evaluation, and disclose CRA and HMDA data reports.
- A public notice must also be posted in the institution's lobby containing the availability information for the public file and provide consumers with contacts at the bank and FDIC to comment on the bank's CRA performance.
- A system must be in place to respond to consumer complaints at the institution. Any complaints about the bank's CRA evaluation must be kept in the public file but include the institution's response to the complaints.

Conclusion

ISB CRA evaluations can seem scary to a prospective institution, but proper steps can be taken to ensure the highest rating possible. Financial institutions tend to be already involved in community development activities and need to ensure they correctly record that activity and the responsiveness from the targeted community. Preparation and training by existing and prospective ISBs can put them in an excellent position for a CRA examination.

If you have any specific questions or issues with the CRA exam, the best place to start should contact the regulatory agency conducting the exam or RADD LLC.

Thank you. RADD LLC can assist with any CRA needs. Our services include (but are not limited to):

- Review of Program
- Update Policies and Procedures
- Staff Training
- Perform quarterly risk assessment
- Evaluation or data scrub of loans
- Qualification of services
- Preparation of Performance Context

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