

## Community Investments Vol. 11, Issue 2

### Hot Tips: Q & A

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Each year, Community Investments conducts an informal poll of our readership to identify CRA issues that continue to cause headaches among even the most seasoned CRA and compliance officers. This year we asked industry experts Jeanine Catalano and Carol Cordova to respond to those issues, and to share with us their five most frequently asked questions. Here's how they responded:

#### **Jeanine's Top Five**

##### **1. Community Development Loans**

Can a loan be both a community development loan and a small business loan? Alternatively, can a loan be both a community development loan and a HMDA loan?

The revised CRA regulation brought a welcome dose of clarity to this issue. It has become abundantly clear that a bank's lending results rule the day.. . or should we say "make the rating." And, because of the focus on lending and results, there is a clamoring for additional clarity with respect to community development loans. Understandably, banks want as much credit as possible for as many loans as possible.

The questions about community development loans generally boil down to two things: What qualifies? And, how do you report them? This presents a

challenge to banks for several reasons. One is that in order for a loan to meet the CRA definition of a community development loan, it must meet three tests, not just one. The three tests are: 1) purpose, 2) lack of double-counting, and 3) location benefited. More specifically, to meet the definition of "community development," the loan must:

- a) have as its primary purpose community development as defined in the regulation;
- b) except for wholesale and limited purpose banks, the loan may NOT have been reported or collected by the bank (or its affiliate) for consideration as a home mortgage, small business, small farm, or consumer loan, as defined in the regulation, unless it is a multi-family dwelling loan; and,
- c) the loan must benefit the bank's assessment area(s) or a broader statewide or regional area that includes the bank's assessment area(s).

Knowing that a loan that has as its primary purpose community development is not enough information to determine whether or not it qualifies.

Note that there is a general prohibition against double-counting. For example, a loan defined as a small business loan per the CRA regulation may have as its primary purpose community development. However, because that loan would be captured and reported on the bank's small business loan register, it would not qualify as a community development loan. The same would be true of any loan that has as its primary purpose community development, but is reported as a HMDA loan, small farm loan or consumer loan (assuming the bank opts to have its consumer loans considered for CRA purposes.)

There is one key exception to this rule. Multi-family loans, which have as their primary purpose community development, may be reported on both the HMDA-LAR and the community development register. The illustration on the following page may be helpful in sharing this information with others in the bank.

Finally, it is essential that the definitions of home mortgage, small business, small farm, and consumer loans be those specified in the regulation, regardless of internal bank classifications.

## **2. Internal Self Assessments**

Should self-assessments be conducted? If so, how often, and to whom should the results be reported?

Bankers should conduct regular self-assessments of their performance under the CRA for several reasons:

- a) to determine whether the bank is meeting its CRA goals;
- b) to determine if different strategies should be employed; and,
- c) to prepare for the bank's next CRA examination.

The best way to conduct a self-assessment is to use the interagency examination procedures applicable to your bank. Other useful references include the regulation itself, the May 1999 CRA Interagency Q&A, performance evaluations of other banks, and aggregate HMDA data.

Self-assessments should be conducted at least quarterly. The results should be in writing and should summarize the bank's strengths, weaknesses and recommendations for improvement. The written report should be presented to senior management of the bank and/or the bank's management and board committees responsible for performance under the regulation.

### **3. Internet Banking**

What are the current CRA issues relative to Internet banking?

Internet banking is defined here as any and all banking products and services offered through the Internet, whether by specialized Internet banks or traditional banks with Internet Web sites. The following issues could raise red flags where CRA is concerned: a) consistency of credit criteria, b) data collection, c) assessment area, and d) accessibility.

#### Consistency of Credit Criteria

Many banks offer relaxed underwriting and/ or special loan products for low- and moderate-income borrowers or for those borrowers in low- or moderate-income areas. When a bank solicits and/or processes applications on the Internet, it should make sure that these products are available to all potential borrowers; that the applicants are aware of these products; and that the appropriate credit underwriting is applied.

#### Data Collection

Loans made over the Internet may be CRA-reportable loans (HMDA, small business, small farm, community development and consumer loans, depending on the bank). As such, data collection and reporting requirements do apply. When a bank makes loans over the Internet, it should have in place a process by which the required data is requested, collected, verified, and reported.

#### Assessment Area

One of the great benefits of transacting business over the Internet is that a customer can do so from anywhere. It is entirely possible that new customers from outside of the bank's assessment area may become borrowers through this channel. Lending outside of a bank's assessment area, including lending through the Internet should be monitored to

determine whether the bank continues to make a substantial portion of its loans within its delineated assessment area(s).

#### Accessibility

There may be a "digital divide" within a bank's community if low-or moderate-income people have significantly less access to the Internet. Less accessibility may be due to lower rates of computer ownership, limited access to public-use computers, or fewer connection opportunities. Should such a divide exist, a bank's distribution of lending to low- and moderate-income people may be reduced as its Internet lending increases. Information about accessibility should be understood as part of a bank's performance context. In addition, a bank may want to explore opportunities to increase accessibility in low- and moderate-income areas and for low- and moderate-income people.

#### **4. The Service Test and TA**

What information is needed to support technical assistance provided by bank directors, officers and employees as a community development service? In the early years of CRA, it was common for many activities in which bank employees participated to be considered favorably by the examiners. The early regulation did not define "community development services." As a result, definitions varied widely. Greater clarity was provided in the new CRA regulation, and subsequent Interagency Qs & As offered examples of community development services, including the provision of technical assistance.

After you have determined that a service qualifies as technical assistance, it will be helpful to examiners to note the following:

- a) the name of the director/officer/employee providing the assistance;
- b) the person's title at the bank;

- c) the nature of the person's work at the bank, even if you think it's obvious by the title;
- d) the name of the organization for which the technical assistance was provided;
- e) the organization's mission;
- f) the geographic area in which the organization operates;
- g) a quantifiable determination that the organization serves primarily low- and moderate- income people;
- h) the nature of the technical assistance provided by bank director/officer/employee; and,
- i) how the director/officer/employee's work at the bank relates to the technical assistance provided.

While gathering all this information may seem like a lot of work, it does make this aspect of the examination go faster and more easily.

### **5. Other Information That Supports Performance**

What are examples of "other information" a bank might present to examiners that would reflect positively on the bank's CRA lending performance?

Although not required, banks may find it useful to provide information about CRA lending performance above and beyond HMDA and CRA data. For example, some small business loans may have community development as their primary purpose. Identifying and tallying such loans would help a bank and its examiners better understand the nature of the small business lending performed by the bank. Another example would include data about loans made under affordable mortgage programs, such as those sponsored by cities or counties, that allow borrowers to have incomes above what was considered to be low or moderate at the last census, conducted in 1990. Relying strictly on LAR data, loans made under such programs may not be noted as loans to low- and moderate-income people.

Another example of information that may reflect positively on a bank's lending performance is the volume of loans made for the purpose of revitalizing and stabilizing a specific geographic area. In order to support these types of loans, a bank may want to:

- a. identify and target the area which is in need of revitalization and stabilization; and,
- b. provide data and information, perhaps from a city planning department or a local Consolidated Plan, which shows:
  - o why the area needs improvement;
  - o who believes the improvement is needed; and,
  - o what the city or others are doing to participate in the revitalization and stabilization effort.

Finally, if a bank is making community development loans with more than one type of community development purpose, the bank may want to note that in its files. For example, a loan whose primary purpose is increasing affordable housing may also help to stabilize an area. If so, the loan file should reflect this.

## **Carol's Top Five**

### **1. Small Business Loans**

Are small business loans secured by residential real estate always excluded from the small business loan definition?

No, not always. Loans reported as small business loans consist of the following:

- a. loans with original amounts of \$1 million or less that have been reported in Schedule RC, part I, item I(e) (column B on the

FFIEC 031), "loans secured by non-farm, nonresidential properties" (in domestic offices); and

- b. loans with original amounts of \$1 million or less that have been reported in Schedule RC-C, part I, item 4, "commercial and industrial loans," on the FFIEC 034; item 4(a), "commercial and industrial loans to U.S. addresses" on the FFIEC 032 and 033; and item 4(a), column B, "commercial and industrial loans to U.S. addresses" in domestic offices, on the FFIEC 031.

Loans secured by non-farm, nonresidential properties include loans secured by real estate as evidenced by mortgages on business and industrial properties, hotels, motels, churches, hospitals, educational and charitable institutions, dormitories, clubs, lodges, association buildings, homes for aged persons and orphans, golf courses, recreational facilities, and similar properties. Thus, any loan secured by residential properties would not be included within this definition.

Commercial and industrial loans that qualify as small business loans include those to sole proprietorships, partnerships, corporations, and other business enterprises, whether secured (other than by real estate) or unsecured, single-payment or installment. This category also includes loans to individuals for commercial, industrial and professional purposes, but not for investment or other personal expenditures.

Loans for commercial, industrial and professional purposes to mining, oil- and gas-producing, quarrying companies, manufacturing companies of all kinds, and insurance agents qualify, as do loans for the purpose of financing capital expenditures and current operations. Loans to business enterprises guaranteed by the Small Business Administration and dealer financing lines also qualify.



The Call Report instructions specifically provide that financial institutions must exclude from commercial and industrial loans, loans secured by real estate, even if for commercial and industrial purposes, as reported in Schedule RC-C, part I, item 1. Thus, it is necessary to look at the definition of "loans secured by real estate." According to the Call Report instructions, loans secured by real estate include all loans (other than those to states and political subdivisions in the U.S.), regardless of the purpose and regardless of whether originated by the bank or purchased from others, that are secured by real estate as evidenced by mortgages, deeds of trust, land contracts, or other instruments, whether first or junior liens (e.g. equity loans or second mortgages) on real estate. Examples of loans secured by real estate include: loans secured by residential properties that are guaranteed by the Farmers Home Administration (FmHA) and extended, collected, and serviced by a party other than the FmHA; loans secured by properties and guaranteed by governmental entities in foreign countries; and, participations in pools of Federal Housing Administration FHA Title I home improvement loans that are secured by liens (generally, junior liens) on residential properties.

The glossary to the Call Report instructions adds more clarification. Loans secured by real estate are loans predicated upon a security interest in real property. A loan predicated upon a security interest in real property is a loan secured wholly or substantially by a lien on real property for which the lien is central to the extension of the credit. That is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien on real property. All loans satisfying the criteria above are to be reported as loans secured by real estate (Schedule RC-C, part I, item I), regardless of whether secured by first or junior liens, regardless of the department within the bank or the bank's subsidiary that made the loans, regardless of how the loans are categorized in the bank's records, and regardless of the purposes of the financing. Only in transactions where a lien on real property has been taken as collateral solely through an abundance of

caution, and where the terms, as a consequence, have not been made more favorable than they would have been in the absence of the lien, would the loans not be considered secured by real estate and not be classifiable as loans secured by real estate in the Call Report.

Therefore, if a bank makes a small business loan and takes a lien on a principal's residential real estate as an abundance of caution, and the terms of the loan are not made more favorable because of the lien, the loan would fall out of the definition of loans secured by real estate. Consequently, the loan would meet the definition of a "commercial and industrial loan," and thus would qualify as a small business loan under CRA.

## **2. Qualified Investments**

Are investments or grants to minority or "Section 504" non-profit organizations considered qualified investments under CRA?

Not necessarily. To have an investment considered as a qualified investment, an institution needs to look beyond the non-profit designation or classification of the organization in which it invests. The organization must meet one of the four criteria of community development, by providing:

- a. affordable housing (including multi-family rental housing) for low- or moderate-income individuals;
- b. community services targeted to low- or moderate-income individuals;
- c. activities that promote economic development by financing small businesses or farms; and/or,
- d. activities that revitalize or stabilize low- or moderate-income geographies.

To find out if the organization meets one or more of these criteria, an institution may want to interview or survey the organization regarding its community development efforts (as defined in the CRA).

### **3. Affordable Housing**

Under the community development definition, what does "affordable housing" mean?

According to the CRA Interagency Questions and Answers issued May 3, 1999, the concept of "affordable housing" for low- and moderate-income individuals depends on whether low- or moderate-income individuals benefit, or are likely to benefit, from the housing. According to the regulatory agencies, an institution should not receive community development credit for a project that exclusively or predominately houses families that are not low- or moderate-income simply because the rents or housing prices are set according to a particular formula that relates the cost of ownership, rental or borrowing to the income levels in the area. Therefore, for an existing project to meet the definition of affordable housing, an institution must look at the actual incomes of the individuals residing in the units. It cannot merely look to the rents those individuals are paying.

However, for projects that do not yet have occupants, and for which the income of the potential occupants is not known in advance, an institution may look at such things as demographic, economic, and market data to determine the likelihood that the housing will "primarily" accommodate low- or moderate-income individuals. For example, an institution may consider the following:

- median rents of the assessment area and the project;
- median home values of either the assessment area, or specific low- or moderate-income geographies;

- the low- or moderate-income population in the area of the project; or,
- the past performance record of the organizations undertaking the project.
- In addition, it will weigh in the institution's favor if the project's express, bona fide intent is community development. This could be evidenced in the project's prospectus, loan proposal or community action plan.

#### 4. **Peer Analysis**

How can a financial institution determine who its peers are? And, where can peer data be obtained?

One way of measuring performance is to view the institution's performance against the performance of other similarly situated institutions-or peers. There are many methods of determining an institution's peers. For example, asset size, number and location of branches, similar credit products, and similar assessment areas are common ways of making such determinations. Another way to determine this is through the FDIC's deposit/market-share analysis. Information on branch deposit market-share for FDIC-insured institutions can be obtained at a state, county, city and bank holding company level and can be found at <http://www.fdic.gov>.

After an institution has determined its peers, it is important to evaluate its peers' CRA performance by reviewing the public section of their last CRA exam and their record of home mortgage, small business and small farm lending activity from their CRA and HMDA disclosure statements. For home mortgage data, the HMDA disclosure statement can be obtained from the peer institution or from the FFIEC's Web site at <http://www.ffiec.gov>. For small business and small farm data, the CRA disclosure statements also can be retrieved from the peer institution or the FFIEC's Web site. Also, all reporting institutions were sent a CD-ROM entitled "1997 CRA Aggregate &

Disclosure Software" (Version 1.10), which has disclosure and aggregate statements from all reporting institutions nationwide for 1997. Additional copies of this program can be ordered through the FFIEC's CRA assistance line at (202) 872-7584. The public section of a peer's CRA performance evaluation can be requested from the institution or its regulatory agency. In fact, the FDIC and the OCC post their public evaluations for both large and small institutions in a downloadable format on their Web sites. The FDIC's evaluations can be found at <http://www.fdic.gov> and the OCC's at <http://www.occ.treas/cra/electric.htm>.

### **Analyzing Deposit Data**

Should a financial institution geocode and map its deposits?

Though not a requirement under CRA, it is a good idea for a large retail institution to geocode and map its deposits for two reasons. First, under the Service Test, an institution can determine how effective its deposit services are in reaching customers in its assessment area, especially in low- and moderate-income areas. Second, if there are gaps in the assessment area that are not penetrated by loans, and there are the same gaps in the institution's deposit activity, the institution could reasonably explain that these are areas that it cannot effectively reach. That is, while the institution is not able to penetrate the area in the way of loans, it also is not draining the community of deposits, which is arguably consistent with the stated intent of CRA.

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### **About the Authors**

Jeanine Catalano has more than two decades of financial institution experience, including particular expertise in fair lending and compliance with the Community Reinvestment Act. After beginning her career as a banker, Ms. Catalano moved to the regulatory side of banking and worked at the Office of the Comptroller of the Currency, the Federal Reserve Board in

Washington, DC., and the Federal Home Loan Bank of San Francisco. Ms. Catalano entered the consulting field after leaving the Office of Thrift Supervision in 1990. Prior to becoming an independent consultant in 1998, she worked for The Secura Group and KPMG Peat Marwick. As a consultant, she has served a wide variety of institutions, both small and large, helping them to deal with all aspects of fair lending and CRA.

Carol A. Cordova specializes in establishing training and auditing programs, maintaining current and active compliance programs, and creating various reporting tools to manage compliance within the ever-changing regulatory landscape. Ms. Cordova has over 15 years of compliance experience, especially in CRA. She is vice president and compliance manager of Bankers' Compliance Group, Inc.