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Current Insights on the CRA Investment Test

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Once again, banks and regulators are focusing on The Community Reinvestment Act (CRA); the FDIC announced in January that it is considering the first changes to CRA rules in nearly a decade. One consideration being discussed is raising to $500 million the asset size threshold of banks to qualify for streamlined small bank exam procedures[1]. Bank trade associations are continuing their push to limit the scope of CRA. For example, America's Community Bankers has proposed raising the large bank cutoff to $1 billion[2], while the Independent Community Bankers of America has advocated eliminating the investment test altogether and applying small bank exam procedures to banks with total assets up to $2 billion[3].

Community activists, on the other hand, have been vocal about keeping as many banks as possible subject to existing CRA criteria. In fact, they are focused on expanding the CRA's scope to encompass non-bank institutions such as mortgage banks and credit unions.

Background

The Community Reinvestment Act (CRA) was enacted by Congress in 1977 encouraging banks and thrifts to help meet the credit needs of the communities in which they operate. Federal regulators assess an institution's track record when evaluating bank mergers, acquisitions, branch openings and charter applications. The potential of regulators to deny applications based on CRA considerations gives the act teeth. The first example of this came in 1989, when a Continental Illinois merger application was denied on CRA grounds[4].

CRA has provided impetus for banks to open new branches, provide expanded services, and most significantly, to adopt more flexible credit underwriting standards. As a result, segments of local economies and populations which typically went underserved experienced a significant increase in penetration by banks lending to low- and moderate-income (LMI) neighborhoods and borrowers.

The 1990s marked a turning point for CRA, with regulators placing renewed emphasis on the law as part of a trend toward stricter consumer compliance oversight. Taking effect in 1997, exam procedures were overhauled, dividing banks into large and small bank categories. An institution is considered a "large bank" if its total assets exceed $250 million for two consecutive calendar years, as measured by December 31st Call Report data. A bank first crossing the $250 million threshold on December 31, 2003 for example, becomes subject to large bank exam procedures, if on December 31, 2004 total assets continue to exceed $250 million. Also, all banks, regardless of asset size, are considered large if they are owned by a holding company with total assets of $1 billion or more during two consecutive calendar years. While the streamlined small bank procedures have attracted little attention, the large bank exam procedures still cause confusion and controversy several years after their enactment.

Three Criteria Facing Large Banks

CRA examinations are conducted by the four federal agencies responsible for supervising depository institutions: the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS). These exams focus on three main criteria, each of which has its own test:

> **Lending Test-** This test measures an institution's CRA performance by a variety of loan-related activity. This includes home mortgage originations and purchases, small business, farm and community development loans outstanding, and (at the institution's option) consumer loans or other loan distribution data. The test focuses on the geographic distribution of loans, the distribution of loans based on borrower characteristics, the record of community development lending, and the use of innovative or flexible lending practices. It weighs the importance of each lending category relative to the institution's overall business.
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> **Investment Test-** Regulators evaluate the dollar amount of qualified investments which address affordable housing or other community development needs and benefit low or moderate income individuals, businesses, or farms. Focus is placed on banks meeting the credit needs of their assessment areas through qualified investments and grants that benefit the assessment area. If limited opportunities exist within the assessment area, regulators may permit a broadening of the geographic area. Consideration is given to the innovativeness or complexity of investments, the responsiveness of investments to credit and community development needs, and the degree to which the investments are not routinely provided by private investors.
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> **Service Test-** This test evaluates an institution's branch locations, accessibility to low to moderate income areas, and the availability of credit and other services offered.

Based on the exam results, the regulators formulate an overall rating and individual ratings for each of these three categories. Ratings of outstanding, high satisfactory, low satisfactory, needs to improve, and substantial noncompliance are assigned. Of the three tests, the investment test is the least understood, perhaps because lending and service activities are the purpose of traditional banking activity and prior to the 1997 changes, examiners didn't routinely look to the investment portfolio for evidence of CRA commitment.

The CRA Investment Test - Recent Experience

When evaluating a CRA investment, bankers generally have two questions: *Will the investment be given exam credit*, and *Will it earn a competitive return*? Investments that satisfy both needs are generally given strong consideration. When the new guidelines were first introduced, examiners themselves were unfamiliar with the intricacies and application of the investment test; as a result they tended to be more lenient. The subsequent completion of thousands of large bank exams has helped to solidify standards. These factors have led to two observations based on our conversations with the banking community:

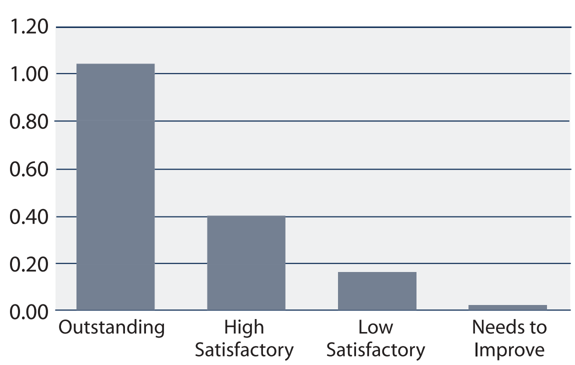
- Examiners are more particular about what they consider to be qualified investments.
- The amount of CRA-eligible investments required to attain satisfactory or outstanding ratings appears to be escalating.

Typically, examiners do not provide guidance on the level of investments that will garner outstanding or satisfactory ratings. Our view is that regulatory agencies are reluctant to be held to hard and fast standards. Specific guidelines for the investment test are unavailable; however, general levels can be interpolated by looking at recent exam data.

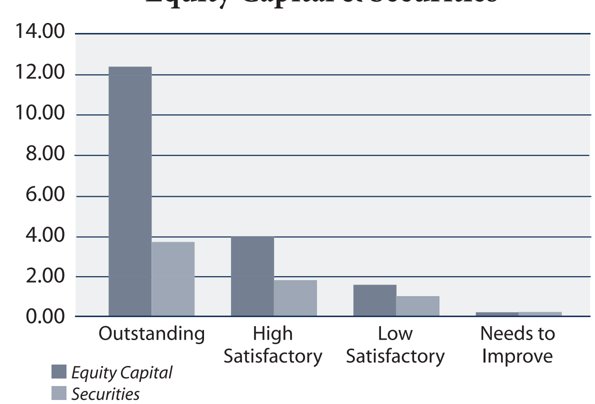
Milestone analyzed the 40 most recent "large bank" examinations during calendar year 2003, drawing upon the 10 most recent performance evaluations from each regulator, balanced geographically. Banks between $250 million and $1.5 billion were selected as representative of typical community banks. Observing the characteristics of this sample allows us to provide our clients meaningful insight in evaluating their own CRA programs. Though methods vary between various regulators and regions, performance evaluations routinely compare the level of qualified investments to total investments, total securities, and total equity capital.

QUALIFIED CRA INVESTMENTS AS A % OF			
	ASSETS	CAPITAL	SECURITIES
Outstanding	1.18	13.44	4.14
High Satisfactory	0.53	4.89	2.69
Low Satisfactory	0.23	2.61	1.49
Needs to Improve	0.01	0.11	0.10

CRA Investment as a % of Asset Size



CRA Investment as a % of Equity Capital & Securities



In evaluating this sample group, some discernable differences become evident in the levels of investment that result in these four main examination categories as seen above. Exam philosophies differ between individual regulators and geographic regions. We recommend that CRA officers acquire the most recent large bank reviews for banks in their state from the appropriate regulator's website. This approach can be insightful in formulating an effective CRA strategy.

There are no surefire CRA investments; all are subject to examiner interpretation. Unfortunately, many banks have purchased securities assuming they will meet the investment test's qualifications, finding otherwise during their bank's examination. With any CRA related investments under consideration, prospectuses and private offering memoranda have to be scrutinized to ensure the investment's primary purpose is meeting the needs of LMI borrowers or serving LMI geographies. Bankers must keep in mind that the definition of low to moderate income as defined in the prospectus may differ from those contained within the CRA regulations, the standard for investment test consideration.

A Traditional Solution: CRA-Targeted Passthroughs

Soon after the new exam procedures were implemented in 1997, the banking community required a readily available investment that satisfied the investment test's objectives. CRA-eligible mortgage backed securities (MBS) effectively satisfied investors and regulators alike. Securitized by Freddie Mac, Fannie Mae, and Ginnie Mae, these passthrough securities are comprised of loans to LMI borrowers or within specific LMI geographical regions.

In order to qualify for eligibility, loans within the pool must be LMI loans within the specific geographic area in which the bank conducts business, typically in communities where the bank has branches. LMI is defined as 80 percent or less of median income within a region. For example, in 2003 the Cincinnati, Ohio Metropolitan Area had a median income of $64,000. Borrowers with an annual income at or below 50 percent of this figure are considered low income borrowers, while those with incomes between 50 and 80 percent are considered moderate income borrowers.

If the targeted area is difficult to find, a broader geographic area may have to be encompassed, or the underlying loans may be aggregated over time to create the pool. Due to the regulatory concept of "performance context", if a bank has limited CRA investment opportunities in its own area, it can expand out to a broader geographic area which includes its assessment area. Statewide MBSs were once routinely accepted by examiners. However, Milestone's recent conversations with banking clients have revealed that some examiners are now giving credit only for mortgages actually within the bank's specific assessment area.

One source Milestone has found to reliably provide CRA-eligible MBSs is HanoverTrade. HanoverTrade is a high-caliber capital markets firm focused on, among other things, securitizing and pooling LMI loans into passthrough securities. Hanover's methodology targets specific geographic areas outlined by Milestone's banking clients. These areas are identified by focusing on the MSAs, counties, cities, or census tracts where the bank conducts business. Hanover purchases mortgages from mortgage banking companies, pools them, and delivers a customized agency passthrough. CRA targeted pools have several advantages in fulfilling the CRA investment credit:

Widespread Acceptance- when the investment test was introduced there were few CRA investment alternatives so CRA-targeted MBSs became very popular with investors and examiners. In the ensuing years, they have become a standard CRA investment.

Reduced Prepayment Risk of Underlying Loans—CRA passthroughs tend to insulate investors somewhat from prepay risk compared with traditional MBS. Their borrowers are generally less mobile than conventional borrowers. Given their income levels, they also tend to have greater difficulty refinancing during market rate declines.

Liquidity- Fannie Mae, Freddie Mac, and Ginnie Mae CRA eligible securities are very liquid and can be quickly traded at posted spreads. Regaining CRA premiums paid, however, may be difficult due to the geographic specificity of these tailored securities.

Geographic Specificity- MBSs obtained through HanoverTrade are tailored to the specific assessment of the area bank.

Despite their widespread popularity, CRA-targeted MBSs also have some drawbacks:

Expense- Premiums for forming targeted pools tend to be considerably higher than purchasing generic passthrough securities. This is especially evident in geographic regions where there is considerable concentration of large banks but limited CRA mortgage production, e.g., Delaware and Utah.

Declining Balances –With all passthrough pools, principal balances progressively decline. Frequently principal balances are substantially reduced by the time of an examination; unfortunately only existing principal balances are counted. As a result, investing in CRA pools becomes a moving target, forcing banks to spend time maintaining a desired investment level.

Small Pool Size Concentrates Prepayment Risk- While underlying loans in a particular CRA pool tend to pay more slowly, passthroughs bought at a premium can reduce the expected yield, sometimes substantially. As a result, the refinancing of just a few mortgages within a pool can have a profound impact on yield, especially on premium purchases.

CRA-Focused Mutual Funds

Examiners give leadership credit and accord higher marks to progressive CRA solutions. CRA-specific municipal investments and specialized mutual funds, which focus on tax credits, small business investment companies, and affordable housing may also meet regulators' expectations. However, caution must be taken when evaluating these investments as they may expose investors to credit risk, result in reduced liquidity, or have a protracted period before a meaningful return on the investment is realized.

One particular mutual fund we feel offers banks an attractive solution to the challenges of the CRA investment test is the Access Capital Strategies Community Investment Fund (Access Capital). Formed in 1997, this fund is the industry's longest operating pure-play CRA investment fund. With over $300 million in assets and more than 100 investors in 37 states, the fund has experienced significant growth as an increasing number of banks have become investors. In addition to many community banks which have just crossed over the "large bank" threshold, some of the largest money center banks have invested in the fund as well.

The fund organizers felt that bank management teams could benefit from having their CRA investments professionally managed, saving the bankers time while earning an attractive return. This fund invests only in agency or AAA-quality securities that meet the definition of "qualified investment" as outlined in the regulation.

The fund holds three advantages over other investment vehicles: geographic specificity, a steady investment balance, and solid historical returns.

Geographic Specificity

Financial institutions investing in the fund can target fund investments specific to their assessment areas. Banks are able to designate a target region with pinpoint accuracy, whether by state, MSA, county, city, census tract, zip code or any combination thereof. The fund manager sources CRA-qualified securities in that exact area to support each bank's investment by interfacing with the nation's largest producers of CRA investments, including Fannie Mae, Freddie Mac, Countrywide, Washington Mutual, ABN Amro, and NatCity, among others.

Investing in this fund holds a key advantage over statewide targeted MBS pools, since every invested dollar sits in the bank's designated assessment area. From Washington, D.C. to Guam, the fund has always found sufficient investments to satisfy bank demand. Management produces loan-level detail reports which capture all HMDA information, showing exactly where funds are put to work in an institution's assessment area.

Fannie Mae is an investor in Access Capital Strategies, LLC, the fund's manager. Management works closely with Fannie Mae to identify attractive investment opportunities in different regions that represent housing-related economic development. As an equity security, a bank's invested principal in the fund remains constant year over year, although interest rate and market changes will cause fluctuations in net asset value.

Steady Investment Balance

The Access Capital fund offers another key advantage to investors, as the fund manager automatically reinvests any principal amortizations and prepayments, so a bank is always fully invested in its assessment area. As loans are paid off, new securities are purchased to support the bank's investment. Unlike individual pools, investment balances do not diminish over time. As principal balances are reinvested, a bank's original investment ends up supporting an entirely new portfolio of community development loans. This "dynamic credit" concept has been validated by several banks, which have received full credit for their fund investments at multiple CRA exams.

Returns

As the table below indicates, the fund has performed admirably throughout its five year history, demonstrating that CRA compliance need not come at the expense of healthy financial returns. For many investors, the fund was the best-performing component of their investment portfolio throughout 2003. As a result, several banks invested in additional shares.

Access Capital Strategies Community Investment Fund Data as of December 31, 2003	
Last Month End SEC Current Yield	5.60%
Trailing 12 Month Dividend Yield	5.70%
Total Return (3 years annualized)	5.98%
Total Return (5 years annualized)	6.14%
Total Return (since inception June 1998 annualized)	6.00%

The fund's performance is not solely based on the coupon and yield of the underlying securities. Like all mutual funds backed by MBSs, the fund experiences net-asset value fluctuations with changes in market rates. Changes in share price can be significant. Investors should anticipate performance to be hindered should the underlying securities experience a market value decline.

Other Considerations

The fund pays a monthly dividend which can be issued in cash or invested in additional shares. Investors receive financial statements (audits, 10Ks) and specific reports on CRA-related aspects of investments made on their behalf in their targeted areas. Regulators from each federal banking agency have given investors credit for fund investments; evidence is available in the form of 30+ performance evaluations. Due to its agency / AAA credit quality requirement, an investment in the fund is carried at a 20 percent risk weighting.

No single product serves as a "magic bullet" to satisfy the investment test. Examiners like to see a variety of investments, both debt and equity vehicles, as well as grants to qualifying organizations. Because the invested balance of the Access Capital fund remains steady from exam to exam, we consider it an excellent baseline investment with which to anchor a sound CRA program, while allowing bank management to minimize the time spent on CRA investing.

The Future of the Investment Test

When the regulators overhauled CRA in 1995, they agreed to revisit its rules every seven years. The challenge presented by all banking legislation is that a single law must apply with equal effectiveness to all of the nation's 9,200 banks and thrifts; it is a daunting task. Invariably there are groups of banks and other parties that feel that the law unfairly impacts them, inflating the cost of compliance and negatively affecting their competitive edge.

Much has been made of the "CRA tax" whereby institutions are forced into paying above-market levels for CRA product just to satisfy investment test standards. On the other hand, CRA investments command a market premium because the originators of CRA-eligible mortgages themselves are paid above-market rates. This, in turn, provides incentive to banks to continue serving the needs of LMI individuals and areas. There is little doubt that supply and demand forces are at work in the marketplace; a finite amount of CRA-qualified product is produced in any given time period, and the level is often insufficient to meet the needs of all the institutions subject to CRA.

One genuine dilemma is the continual search for investments that will be considered "innovative and complex" as defined in the law. This ambiguous phrase defies definition. Regulators are seen as constantly raising the bar on the types and amounts of CRA investments that are needed to pass muster on examinations. For any bank there will be a finite number of investments that will meet the criteria set forth in the regulation, and bankers fear that a "what have you done for me lately" attitude on behalf of the regulators will impact their ability to continue to receive strong marks on the investment test.

While they may yearn for a legislative change, the reality is that banks are subject to the regulation as it stands today. Recognizing the political forces at play and the long term nature of revising already-enacted legislation, bankers should continue to advocate change, but must remain focused on proven and effective CRA investment solutions.

Milestone Advisors' Balance Sheet Strategies Team

Milestone Merchant Partners has offices in Washington, D.C., and Miami, Florida. Its financial advisory subsidiary, Milestone Advisors, LLC, is a licensed broker-dealer located in Short Hills, New Jersey. Milestone's Balance Sheet Strategies Team places considerable emphasis in working with financial institutions, advising them on profitably managing their income through effective balance sheet management. Our strategists have had extensive experience within the banking industry, advising financial institutions on a broad variety of financial challenges. To learn more about Milestone, visit the website at www.milestonecap.com. Should you have any questions regarding the strategies outlined in this discussion, please contact any of Milestone's Team members.

[1] Linder, Craig. "In Focus: CRA Plan to Lighten Bank Load; Activist Fight is Likely." American Banker, January 20, 2004.

[2] Lockyer, Sarah. "Waiting for Changes in CRA? Better Not Hold Your Breath." American Banker, November 25, 2002.

[3] Taylor, John. "Eliminating the CRA Investment Test Would Drain Billions from Communities." American Banker, October 25, 2002.

[4] Thomas, Kenneth. "CRA at 25: Reforming an Almost Perfect Law." American Banker, December 13, 2002.

Portions of the "Background" section were adapted from the OCC and FFIEC websites.

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