

Assessing the Impact of CRA on Community Development Lending for Affordable Housing and Small Business in Appalachia

Introduction

The Community Reinvestment Act (CRA) of 1977 imposes upon banks and thrifts an affirmative and continuing obligation to meet the credit needs of communities in which they are chartered, including low- and moderate-income communities. Four federal financial supervisory agencies enforce CRA and conduct periodic CRA exams about once every two or three years for banks with assets above \$250 million. CRA exams assess the level of loans, investments, and services banks with assets above \$250 million provide to low- and moderate-income communities.¹⁸ Banks receive CRA ratings for their overall performance as well as their performance in each state and multi-state metropolitan statistical area (MSA) in which they have branches. Banks and thrifts have strong incentives to increase their levels of lending, investing, and services to low- and moderate-income communities. Low CRA ratings can result in negative publicity and/or delay bank applications for federal agency approval to merge with another institution or open additional bank branches.

This chapter will assess the impacts CRA has had on increasing certain types of lending and investing for affordable housing and small business by banks located in Appalachian counties. The chapter will use CRA exams of banks headquartered in Appalachia during the time period of 2001 through 2004 to document levels of financing for affordable housing and small business development. So far the report has been devoted to examining access to lending for individual small businesses. In this chapter, the report scrutinizes the level of community development financing. Community development lending and investing provides the financing that builds the infrastructure and support systems of small

¹⁸ As of September 2005, the CRA exam structure was different for mid-size banks with assets between \$250 million and \$1 billion and for large banks with assets above \$1 billion. The exams for these two types of banks, however, had the same test structure (separate lending, investment, and services tests) during the time period examined by this report. Below, the chapter describes the test structure in more detail. This chapter looked at the most recent CRA exams of banks headquartered in Appalachia; the great majority of exams were conducted during 2001 through 2004. Only about 1 percent of the exams were conducted during 2005.

businesses. For example, community development financing would support the development of small business incubators and Rural Business Investment Corporations (RBICs). This chapter therefore rounds out the analysis of serving the credit and capital needs of small businesses. The chapter supplements the previous analysis of lending to individual small businesses with an analysis of financing the necessary infrastructure and support systems of small business development.

CRA exams for banks with assets greater than \$250 million include sections that assess a bank's level of community development lending and investments. Community development lending and investing include financing for low- and moderate-income rental and homeowner units as well as for small business incubators and equity vehicles for small businesses. The purpose of comparing levels of financing affordable housing and small business is to provide the Appalachian Regional Commission with a new and unique database of bank financing for these important needs.

This exercise also seeks to reveal the levels at which banks finance affordable housing and small business and whether a relatively small amount of financing for one of these activities suggests that more bank financing is required. The chapter will also assess if CRA has influenced banks to increase their level of bank branching in Appalachian counties. Finally, the CRA regulations have recently changed. The chapter will contain a brief description of the new CRA regulations for mid-size banks with assets between \$250 million to \$1 billion and offer insights into whether the new regulations and exams will impact the level of community development lending and investing.

Description of Sample Size of Banks and Thrifts

NCRC selected banks in Appalachia that had greater than \$250 million in assets as of year-end 2004, as listed by databases available on the Federal Financial Institutions Examination Council (<http://www.ffiec.gov>) web page. Banks and thrifts with assets above \$250 million in assets have more comprehensive CRA exams that scrutinize their lending, investment, and service activities. In particular, NCRC was interested in the community development

lending and investment activities of these banks. At the end of 2004, 227 banks and thrifts located in Appalachian counties had assets of more than \$250 million. NCRC was able to find the CRA exams for 220 of these institutions. In the seven remaining cases, the CRA exams could not be tracked down due to a number of possibilities including changes in charter types, the age of the institution (new or de novo banks may not have been examined yet), or mergers and acquisitions making it difficult to track name changes to the institutions.

At the time of their most recent CRA exam, 78 of the 220 banks had less than \$250 million in assets and were examined by regulators using the “small bank” CRA exam. The small bank CRA exam focuses on lending activities. The remaining 142 banks were examined using the “large bank” examination that encompasses lending, investments, and services. The banks with assets less than \$250 million at the time of their CRA exam were still included in the NCRC database and analysis.¹⁹ Specifically, these banks were included in the examination of bank branching patterns, but were not included in the part of the analysis that considered the levels of community development lending and investing.

Four federal supervisory agencies conduct CRA exams. The Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board (FRB) conduct CRA exams for institutions chartered by state governments. The Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS) perform CRA exams for institutions chartered by the federal government.

¹⁹ NCRC thought it was important to capture the banks that had assets over \$250 million at year end 2004, but had assets less than that amount in their most recent CRA exam. The next CRA exams of these institutions will be more comprehensive. In addition, their branching patterns could still be assessed. Finally, the small bank CRA exam provides “bonus” points if small banks engage in community development lending and investing. We wanted to see how often small banks in Appalachia took advantage of the bonus point option and engaged in community development and lending.

The regulatory agency break down for banks in the sample is as follows:

	All Banks	Small Banks	Large Banks
FDIC	51.8%	57.7%	48.6%
FRB	15.0%	9.0%	18.3%
OCC	25.5%	25.6%	24.4%
OTS	7.7%	7.7%	7.7%
Sample Size	220	78	142

The majority of banks and thrifts in our sample were state-chartered institutions as the FDIC and FRB examined 51.8 percent and 15 percent of the institutions, respectively. The OCC examined a quarter of the banks. Only 7.7 percent of the lenders were federally chartered thrifts that were examined by the OTS.

The great majority of CRA exams in the NCRC sample were relatively recent. More than 90 percent of the CRA exams for the large bank sample were from 2002, 2003, and 2004 (23.2%, 36.6% and 31.7%, respectively). CRA Exams from 2001 and earlier made up 7% of the sample, and exams from 2005 accounted for 1.4%.

Bank Location by State, Metropolitan Area and County

Appalachian counties in Pennsylvania accounted for 42 institutions in the sample or almost 30 percent of the sample. Appalachian counties in Alabama had 20 banks or 14 percent of the lenders in the sample and Appalachian counties in Tennessee had 10 institutions or 7 percent of the lenders in the sample.

Of the sample of large banks, the break-down by state is as follows:

	Count	Percentage
AL	20	14.1%
GA	14	9.9%
KY	5	3.5%
MD	4	2.8%
MS	6	4.2%
NC	8	5.6%
NY	8	5.6%
OH	9	6.3%

PA	42	29.6%
SC	2	1.4%
TN	10	7.0%
VA	7	4.9%
WV	7	4.9%
Total	142	100%

Slightly more than half of the banks and thrifts with assets above \$250 million as of year end 2004 were located in metropolitan statistical areas (MSAs) in Appalachia. One hundred seventeen banks were located in MSAs and 103 banks were located in non-metropolitan counties in Appalachia (see Appendix Table 36a). The asset sizes of the banks located in MSAs were considerably larger; banks located in the MSAs had combined assets of \$420.6 billion versus \$73.3 billion for assets of banks located in non-metropolitan counties (see Appendix Table 36c). Only 11 banks with combined assets of \$4.3 billion were headquartered in distressed counties in Appalachia.

Banks headquartered in Appalachia represent a significant financial resource for responding to credit and capital needs of small businesses, but planning needs to be undertaken to leverage increased amounts of bank financing delivered equitably throughout the region. The imbalance of considerably more bank assets in MSAs is not surprising, but can perhaps be mitigated by CRA assessment area procedures. It is unlikely, for example, that the 117 banks located in metropolitan areas have declared only metropolitan areas as their official CRA assessment areas in which they undergo CRA exams. Many of these banks may also have non-metropolitan areas designated as assessment areas. ARC officials and local economic development officials may want to undertake a targeted review of CRA exams of MSA-located banks to ensure that non-metropolitan counties are included as assessment areas, especially counties designated as distressed counties.

The other phenomena regarding asset sizes that is important for planning purposes is the relatively “small” size of banks located in Appalachia. The average asset value of banks and thrifts in the NCRC sample located in Appalachian counties as of year end 2004 was \$2.2 billion but the median asset size was \$364 million (see Appendix Table 36a and Appendix Table 36b). In other words, a large number of banks and thrift fell into the asset category of \$250 million to \$1 billion, an asset category considered to be “intermediate”

small banks by the federal financial supervisory agencies. Intermediate small banks may have more difficulties undertaking large-scale community development financing projects such as significant Low-Income Housing Tax Credit deals or high volumes of equity investments in small businesses. These banks, however, may be receptive to a consortia approach or investing in CDFIs or Revolving Loan Funds to benefit a specific area within Appalachia in cases in which large scale financing is needed.

The Level of Community Development Investment and Lending for Affordable Housing and Small Business

Banks and thrifts in NCRC's sample (located in Appalachian counties and with assets of more than \$250 million as of year end 2004) made about \$3.53 billion and \$1.9 billion in community development lending and investing, respectively, during a time period of approximately once every 2.5 years (which was the average time period evaluated by CRA exams in the sample) (see Appendix Table 37c).²⁰ In other words, lenders in the NCRC sample made about \$5.43 billion in community development lending and investing every 2.5 years.²¹ This figure of more than \$5 billion represents a significant financial resource for economic development in Appalachia. It is all the more impressive when considering it does not include dollar totals of loans to individual small businesses and homeowners. Instead, the \$5 billion reflects the amount available for community development projects such as large scale housing developments or small business incubators that benefit neighborhoods or even entire rural counties in Appalachia.

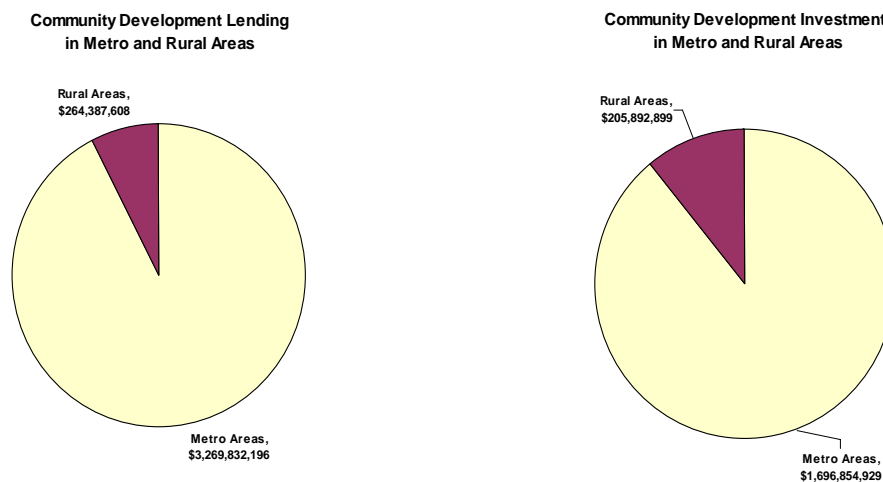
Banks located in metropolitan areas made considerably higher levels of total community development loans and investments than banks located in non-metropolitan areas in Appalachia. Banks located in metropolitan areas issued a total of \$3.27 billion in

²⁰ The average time period for which CRA data on lending and investments was considered on the exams in the NCRC sample was 30.8 months. This average number of months for large bank CRA exams was 32.7 months, and the average for small banks was 26.8 months. The median values were 32 and 24 months, respectively. The prior period investments have been subtracted from the total community development lending and investment totals.

²¹ This total does not include outstanding investments and loans from previous time periods not made during the most recent CRA exam cycle. The total prior period investments include \$16 million for community development lending and \$215 million in community development investing.

community development loans on their most recent CRA exams while banks located in non-metropolitan areas made a total of \$264 million in community development loans (see Appendix Table 37c and Figure 16). Likewise, banks located in metropolitan areas made a total of \$1.7 billion in community development investments and banks in non-metropolitan counties issued \$206 million in community development investments. This does not necessarily translate into much fewer community development loans and investments for non-metropolitan areas since banks located in metropolitan areas most likely have included non-metropolitan counties as part of their assessment areas or geographical areas scrutinized on their CRA exams. But even after taking into account the non-MSA assessment areas of MSA headquartered banks, non-MSA areas most likely receive considerably less bank community development lending and investing.

Figure 16



Source: Appendix Table 37 c. Total Values – row *CD Lending* and *CD Investment* and columns *Rural Areas* and *Metro Areas*

It is also likely the case that the total community development investment and lending disparities among banks headquartered in metropolitan and non-metropolitan areas are being driven by a few very large banks. The median community development lending and investment figures still showed that banks headquartered in metropolitan areas issued higher levels of community development financing but the differences narrowed considerably. Banks located in metropolitan areas issued a median community

development lending level of \$1.811 million as opposed to the \$1.585 million made by banks located in non-metropolitan counties (see Appendix Table 37b). Banks headquartered in metropolitan areas issued a median level of \$1.461 in investments while banks in rural counties made a median level of \$848,000 in investments.

NCRC attempted to break down the total community development lending and investing figures into sub-totals for housing and small business development. This endeavor was more successful for community development investing as opposed to lending. CRA exams vary in the level of specific detail they provide on community development financing. Some exams provide much detail on every community development project financed by banks while others reveal only total amounts of community development lending or investing. For whatever reason, the level of detail was greater for community development investments than lending (perhaps because investments were considered under a separate test for banks with assets greater than \$250 million while community development lending was considered as part of a lending test). The total amount of community development lending for all banks in the NCRC sample was \$3.53 billion with \$3.1 billion that could not be classified as supporting housing or small businesses (see Appendix Table 37c). In contrast, most of the investment dollars could be classified as either supporting affordable housing or small businesses. The total amount of community development investment was \$1.9 billion with \$707 million that could not be classified as supporting affordable housing or small businesses.

Considering the amount of community development lending and investments that could be classified suggests that the level of bank community development financing supporting affordable housing is higher than that for small businesses. In total, all banks and thrifts in NCRC's sample made \$297 million in community development loans that financed affordable housing versus \$117 million in community development loans for small businesses in Appalachia (see Appendix Table 37c and Figure 17).

Figure 17



Source: Appendix Table 37 c. Total Values – rows *CD Lending (Housing and Small Business)* and *CD Investment (Housing and Small Business)* and column *All Banks*

Similarly, banks and thrifts in NCRC’s sample issued \$807 million in investments for affordable housing as opposed to \$174 million in investments for small businesses in Appalachia during the time period of the most recent CRA exams for the banks and thrifts in NCRC’s sample. Examining average or median community development loan and investment levels per bank for affordable housing and small businesses yielded similar disparities in favor of affordable housing. This analysis is not intended to suggest that community development financing levels for affordable housing should go down so that levels for small businesses can go up. Instead, it suggests that banks could be encouraged to increase their overall levels of community development financing and small business development.

Examples of Small Business Financing

Some examples of innovative community development financing illustrate that CRA has motivated important financing for small business development and expansion in Appalachia. For instance, Union State Bank in Alabama with \$257 million in assets made a construction loan of \$1,800,100 for a childcare facility in a moderate income area. The day care provided its services to all citizens in the area; however, it offered a discounted rate to low- income individuals. The CRA exam for United Bank in Parkersburg, West Virginia stated that this bank maintained a \$2.2 million equity investment in a small

business investment company (SBIC). The SBIC focused on businesses located throughout West Virginia. Finally, S&T Bank, a Pennsylvania-based bank with \$2.2 billion in assets, invested almost \$300,000 in a federal preservation tax credit project, according to its CRA exam. The project involved an investment in a commercial office building in a moderate-income census tract.

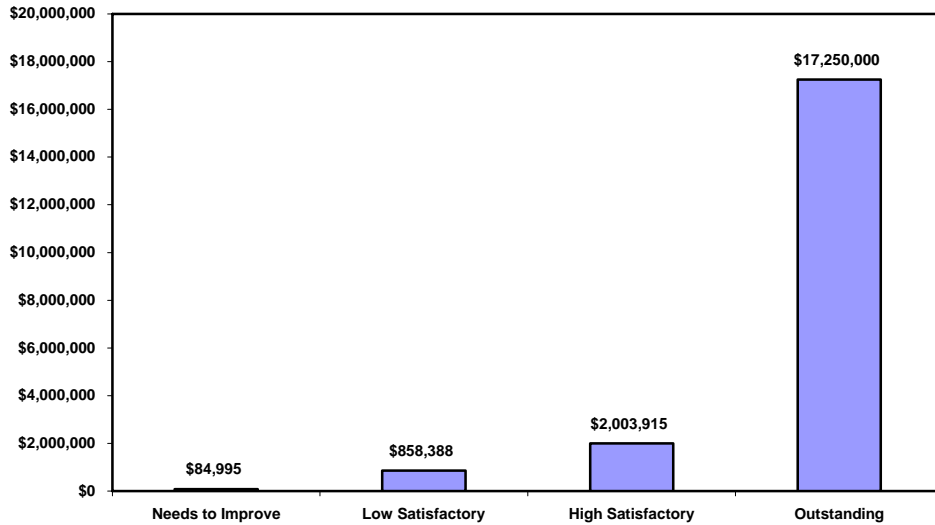
Relationships Among CRA Ratings, Community Development Investment and Lending Levels

NCRC's sample revealed that banks with higher ratings or grades on their investment and lending tests had higher levels of community development investments and lending. While this finding would appear to be intuitive, it is nevertheless important since it indicates that if banks are encouraged to perform well on their CRA exams, then the level of community development financing will increase in Appalachia. Banks can receive one of five ratings on their lending or investment tests: Outstanding, High Satisfactory, Low Satisfactory, Needs to Improve, and Substantial Noncompliance.

Substantial differences in investment levels were present for Appalachian banks with various ratings on their investment test. The median community development investment level for the 20 banks with Outstanding ratings was \$17.3 million and was \$2 million for the 41 banks with a High Satisfactory ratings on their Investment Test (see Appendix Table 38b and Figure 18). Median investment levels drop precipitously for banks with lower ratings. The 62 banks with Low Satisfactory ratings had median investment levels of \$858,388 and the 18 banks with Needs-to-Improve ratings had median investment levels of just \$84,994.

Figure 18

Median Community Development Investments by CRA Rating



Source: Appendix Table 38 b. Median Values – row *CD Investment*

Banks with various ratings also had significantly different ratios of community development investment to assets. Banks with Outstanding ratings on the Investment Test had average ratios of community development to assets of .84% (see Appendix Table 38a). In other words, the average dollar amount of community development investments was less than 1 percent of bank assets or .84% of bank assets. Banks with High Satisfactory ratings had ratios of community development investment to assets of .56%. Banks with the lowest ratings had much lower ratios.

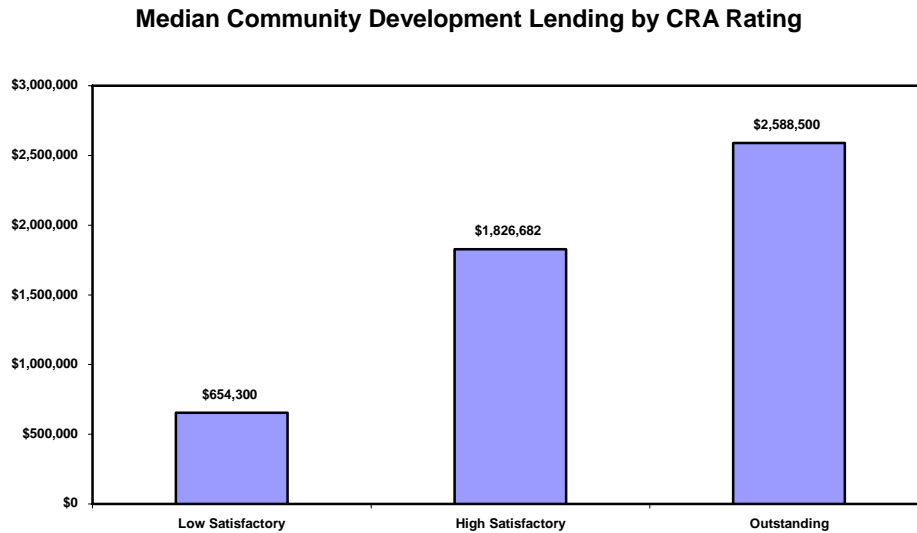
The differences among the mean community development investments to assets ratio were statistically significant for a number of the ratings categories. The difference between .56% for banks with High Satisfactory ratings and .22% for banks with Low Satisfactory ratings was statistically significant (see Appendix Table 38a). The difference between .22% for banks with Low Satisfactory ratings and .07% for banks with Needs-to-Improve ratings was also statistically significant. Interestingly, only the differences between banks with Outstanding and High Satisfactory ratings were not statistically significant.

A sensible objective is to motivate as many Appalachian headquartered banks as possible to strive for a High Satisfactory or Outstanding ratings on their investment tests since banks with these ratings were making statistically significant higher dollar number of investments in Appalachia than banks with lower ratings. Many banks desire higher ratings on CRA exams to enhance their public reputation and demonstrate solid CRA performance to the public and their regulatory agencies.²² If stakeholders (nonprofit organizations, public agencies, CDFIs, and others) present enticing opportunities, partnerships, and/or programs for increasing levels of investments, a number of banks will seize these opportunities as a means of bolstering their CRA ratings and increasing their level of profitable community development investments.

The community development lending levels were also substantially different for banks with various ratings on the lending test. Banks with Outstanding ratings on the lending test had a median community development lending level of \$2.6 million (see Appendix Table 39b). Just going down one notch in the ratings to High Satisfactory resulted in considerably less community development lending. Banks with High Satisfactory ratings on the lending test had a median community development lending level of \$1.8 million, about \$700,000 less than banks with Outstanding ratings. The difference was even more dramatic between banks with High Satisfactory and Low Satisfactory ratings. The median community development lending dollar amount of banks with Low Satisfactory ratings was \$654,300, about one quarter the amount of banks with High Satisfactory ratings (see Appendix Table 39b and Figure 19).

²² The federal regulatory agencies consider CRA performance and ratings when banks submit applications to merge and open branches. Solid CRA performance, consistent CRA performance on all the component tests, and high ratings increase the chances of expeditious approval of bank applications.

Figure 19



Source: Appendix Table 39 b. Median Values – row *CD Lending*

The community development lending to asset ratios were substantially different for banks with various ratings on the lending test but they were not statistically significant. The community development lending to asset ratios were .96%, .54% and .33% for banks with Outstanding, High Satisfactory, and Low Satisfactory ratings on the lending test, respectively (see Appendix Table 39a). One possible reason for the lack of statistical significance is that the lending test includes a number of other components besides community development lending. In contrast, the investment test is solely focused on community development investing. Despite the lack of statistical significance, the absolute dollar amounts and ratios for community development lending differed greatly among banks with various ratings on the lending test. Again, the objective should be to motivate banks to achieve High Satisfactory and Outstanding ratings on the lending test in order to maximize the amount of community development lending in Appalachia.

Lastly, small bank CRA exams did not provide much of an impetus for banks to engage in community development lending and investing. As stated above, small banks with assets under \$250 million can receive bonus points for community development financing. Only two small banks out of 78 small banks in the sample had information on community

development investments included on their CRA exam. Seven small banks in the sample had information on community development lending included on their CRA exam.

The Level of Bank Branches in Appalachia

CRA exams include an analysis of bank branching patterns as a component of the CRA service test. The service test includes the number and percent of branches by income level of census tract. The branching data in this chapter differed from the branching data presented in other chapters in that the data here were from CRA exams whereas the branching data in the other chapters were from the FDIC web page.²³ The objective in this section of the chapter was to describe branching patterns in detail for banks of various asset sizes and to assess if CRA service test ratings reflected differences in branch penetration in low- and moderate-income areas. Since branches had a significantly positive impact on the level of lending as discussed in the regression chapter, it is important to see if CRA exams are motivating banks to place more branches in low- and moderate-income areas.

The CRA exam data suggested overall differences in branching by category of counties and confirmed the analysis above that showed a relative shortfall of branches in NonMSA counties. The CRA exam sample included 7,662 branches; 7,244 branches were owned by large banks while small banks controlled 418 branches (see Appendix Table 36c). Almost 1,500 branches were located in low- and moderate-income census tracts. Banks headquartered in MSAs had 5,956 branches while banks located in NonMSAs had just 1,706 branches.²⁴ Interestingly, the median number of branches was 10 branches located in both MSA and NonMSA counties. The reason for the disparities was the larger banks with higher average assets in MSA areas. The average number of branches in the two county categories was quite different: 54 for MSA counties and 17 for NonMSA counties.

²³ The previous data on branching from the FDIC was from <http://www2.fdic.gov/sod/index.asp> and <http://www2.fdic.gov/sdi/index.asp>.

²⁴ The differences in distressed and non-distressed counties are not discussed because a small sample, just 8 banks, were headquartered in distressed counties. The CRA exam data for branching in distressed counties is contained in the tables.

Banks with Low Satisfactory ratings on the service test did not place branches in proportion to the portion of census tracts that were low- and moderate-income (LMI) in Appalachian counties. Overall, the banks with different ratings did not differ that much in the average percent of branches they placed in LMI census tracts. Banks with Outstanding ratings on the service test located 19.4 percent of their branches in LMI tracts while the branch distribution in LMI tracts was 19.2 percent and 16.7 percent, respectively, for banks with High Satisfactory and Low Satisfactory ratings, respectively (see Appendix Table 40a).

The variations in performance became apparent when calculating the difference in the percent of branches in LMI tracts and the percent of tracts that were LMI. For banks with Low Satisfactory ratings, the portion of branches in LMI tracts was 5.9 percentage points less than the portion of tracts that were LMI (see Appendix Table 40a). In contrast, for banks with Outstanding and High Satisfactory ratings, there was no difference in the percentages of branches in LMI tracts and the percentages of tracts that were LMI. Interestingly, the differences on this measure for banks with High Satisfactory and Low Satisfactory were not statistically significant. Just as was found on the lending test, the differences in performance on this measure may not be statistically significant because the service test includes a number of components. However, the differences appear to be substantial, and point to the desirability of motivating banks to score well on the service test.

The Future in CRA Performance

The federal banking agencies recently changed the CRA exam format for mid-size banks with assets between \$250 to \$1 billion in assets (the change occurred after the time period in this study).²⁵ Instead of a separate lending, investment and service test, the new mid-size

²⁵ The federal banking agencies changed the CRA regulation in August of 2005 and then adopted new Questions and Answers on the CRA regulation in March of 2006. See the Federal Register, Vol. 70, No. 147, August 2, 2005, pp.44256-44270, and the Federal Register on Friday, March 10, 2006 Volume 71, No. 47, page 12424. The Office of Thrift Supervision (OTS) made different changes to its CRA regulation over several months starting in the summer of 2004. This report does not discuss the OTS changes because of the

bank exam will include a lending test and a community development test. The community development test will assess community development lending, investments and services. The new exam format raises a series of questions including whether the tests will be as rigorous and whether levels of community development lending and investing will increase or decrease in Appalachia.

The new exam for mid-size banks is highly significant for Appalachia. The great majority of banks located in Appalachia were mid-size banks in NCRC's sample. Mid-size banks with assets between \$250 million to \$1 billion totaled 136 banks in Appalachia while banks with assets above \$1 billion dollars totaled just 40 banks. Small banks with assets less than \$250 million were 44 of the Appalachian banks. Since the great majority of Appalachian banks now have new CRA exams, it is important that the exams remain rigorous.

Because NCRC found substantial differences in community development lending and investment levels and branching levels for banks and thrifts with different ratings, it appears that the current three tests of the large bank exam are effective in identifying quantitative differences in performance and awarding banks ratings that reflect these differences. Nationally and especially in Appalachia, the regulatory agencies must ensure that the new mid-size bank exam format is as effective as the previous large bank exam in motivating and rewarding mid-size banks and thrifts to offer community development loans, investments, and services.

A vital element of migrating to the new exams is to establish expectations that banks must be expected to maintain and improve upon their overall level of community development (CD) investing and lending. Federal agencies should make clear, for example, that banks will receive lower ratings if they dramatically decrease their combined levels of CD lending and investing in the first round of the new CRA exams. The preamble to the new CRA regulations for mid-size banks included a quote stating that the federal banking agencies "do not intend to suggest that a bank may simply ignore one or more categories of

small number of federally chartered thrifts in Appalachia and because there is a possibility that the OTS may be changing its CRA regulations again.

community development or arbitrarily decrease the level of such activities.” This guideline, reinforced recently in the Interagency Question and Answer document, must be implemented in a manner that ensures that community development lending and investing do not decrease, especially in a region like Appalachia that depends on mid-size banks.

The new community development test for mid-size banks does not have an explicit criterion for bank branching. It is not clear, for example, if the new exams will carefully scrutinize the number and percent of bank branches in LMI census tracts. Since substantial differences of bank branching in LMI tracts exist for banks with different CRA ratings, it is critically important that the new tests also have rigorous measuring mechanisms for assessing bank branching in LMI communities. The new Question and Answer document states that “the presence of branches located in low- and moderate-income geographies will help to demonstrate the availability of banking services to low- and moderate-income individuals.”²⁶ This is the closet that the regulatory agencies will come for a specific branching criterion on the new mid-size bank exam. It is an improvement over earlier language. Hopefully, it will be interpreted to mean that mid-size banks will still be assessed by the number and percent of branches in low- and moderate-income areas.

The report found that banks located in metropolitan areas had much higher levels of community development financing than banks located in non-metropolitan areas. The regulatory agencies also amended the CRA regulations to provide CRA points for community development financing in rural middle-income census tracts located in distressed and underserved counties. It is possible that community development financing may increase in non-metropolitan and distressed counties as a result of these newly eligible census tracts.

Community development financing directed to middle-income tracts in distressed rural counties may indeed be beneficial but must be considered in the overall economic context of the rural community. On the one hand, a county may be quite distressed economically and have high poverty rates, meaning that a middle-income tract still has low absolute

²⁶ Federal Register citation, March 2006 on the Interagency Question and Answers, op. cit.

income levels. In rural areas, CRA defines income levels based on a statewide median income for rural counties. This means that middle-income as defined as 80 to 120% of area median income could still be low in absolute terms. In cases in which middle-income represents low absolute income levels, community development directed to middle-income census tracts benefits these particular tracts and could have beneficial effects in surrounding low- and moderate-income tracts.

On the other hand, a middle-income tract in a distressed county could have a reasonably high absolute income level in a state in which the median income level of rural counties is also relatively high. Or the middle-income tract itself could simply have a high median income level, regardless of the rural statewide median income level. In these instances, community development financing in the middle-income tract in a distressed county would still count on CRA exams. However, CRA examiners should also ensure that a bank is financing community development activities in low- and moderate-income census tracts as well. The recently revised Interagency Question and Answer document on CRA indicates that addressing credit needs in distressed rural counties includes financing projects in low- and moderate-income areas. This Question and Answer was added to prevent the possibilities of a disproportionate amount of community development financing flowing to middle-income census tracts, particularly those that have relatively high absolute income levels.

Finally, the sample revealed that the largest share of community development lending and investments went towards meeting affordable housing goals. Affordable housing community development investments are often in the form of mortgage-backed securities (MBS), which while a qualified investment, are neither innovative nor complex. In addition, examiners should ensure that banks are not churning MBS investments. In other words, one bank will buy a MBS right before their CRA exam, and then sell the securities to another bank that is preparing for its CRA exam. Investing in MBS serves a community development need only if churning is prohibited. Also, the new community test should reward mid-size banks for pursuing a diversified portfolio of community development

investments and loans, including affordable housing, small business and economic development, and other initiatives to support low- and moderate-income areas.

Conclusion

This chapter reviewed CRA exams of banks headquartered in Appalachia in order to quantify banks' level of community development lending, investing, and branching. The chapter focused on community development lending and investing that supports small business development.

The chapter detailed bank headquarter location and asset distribution in Appalachia. Almost 30 percent of the Appalachian banks were located in Pennsylvania with the next highest portion (14 percent in Alabama). While the numbers of banks located in MSAs and NonMSAs were similar, banks located in MSAs had combined assets of \$420.6 billion versus \$73.3 billion for banks in NonMSA counties (see Appendix Table 36c). Of the more than \$5 billion in community development lending and investing that occurs during the CRA exam cycle, the great majority of it was financed by banks located in MSAs. This does not mean that NonMSA counties are starved of community development financing since banks located in MSA counties likely have CRA assessment areas extending into NonMSA counties. However, the disparities in community development lending and investment by metropolitan status of county are possibly significant. Further study should investigate if banks headquartered in MSAs have assessment areas extending into NonMSA counties and if the banks located in MSAs offer significant amounts of community development financing in NonMSAs.

The chapter found an imbalance in the amount of community development lending and investments devoted to affordable housing and small business development. For example, the chapter documented about \$807 million in affordable housing investments as opposed to \$174 million in small business investments (see Appendix Table 37c). Banks located in Appalachia should be encouraged to increase their overall level of community development financing and devote a significant portion of that increase to small business development.

Lastly, the chapter revealed that banks with different CRA exam ratings actually did have substantial differences in their levels of community development investments, loans and branches. This has important policy implications in the context of the new CRA exam for mid-size banks, which constituted a majority of the banks located in Appalachia. The chapter concluded with observations of how to ensure that the new CRA exams for mid-size banks were as rigorous as the old exams.