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Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



A Proposal: Using the CRA to Fight Vacancy and Abandonment

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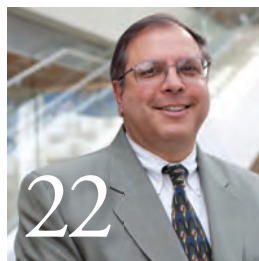
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A Proposal: Using the CRA to Fight Vacancy and Abandonment

In 2009, banks became the reluctant holders of more than 1,500 foreclosed properties in Cuyahoga County, Ohio. Most of these houses are in Cleveland, worth little to nothing, and in danger of remaining vacant for the foreseeable future—destined to define neighborhood decay.

Cuyahoga County is not alone. In the wake of the housing market crisis, urban communities across the nation are suffering under the crush of vacant homes. At first glance, one solution seems simple enough: Banks should donate these homes—known as real estate owned, or REO—to community groups or land banks that would rehabilitate, demolish, or repurpose them to help stabilize neighborhoods.

But it doesn't often happen that way. Many times, banks would like to hand over foreclosed houses, but community groups don't want them unless they come with clean titles; that is, free from liens. Community groups also want banks

to provide resources needed for restoration, such as loans or charitable donations. Other times, private investors snatch up vacant houses before community groups can acquire them, then make cosmetic changes and put them on the market for resale. Either way, the houses tend to stay empty and neglected for long stretches.

A recent proposal from researchers at the Federal Reserve Bank of Cleveland puts a new spin on decades-old policy: modifying the Community Reinvestment Act (CRA) rules so they increase banks' incentives to provide community groups with loans, services, and investments that support neighborhood recovery efforts.

The Nuts and Bolts of CRA Rules

Under CRA rules, banks are obligated to meet the credit needs of people who live in the areas they serve. Banks can already get some points toward higher CRA ratings by donating properties to community groups and providing loans for rehabbing or demolishing them. But CRA exams put heavy emphasis on lending activities, particularly within banks' so-called assessment areas, the geographic regions where they maintain branch offices.

The proposal would leverage the appeal of high CRA ratings by awarding *outstanding* ratings to banks that focus on rehabilitating and disposing of foreclosed properties in any lower-income census tract nationwide. What's more, banks could earn a rating of *outstanding* based exclusively on their efforts related to foreclosed properties, as long as their other CRA activities remain satisfactory. Banks would still need to fulfill certain lending requirements, but they could amass extra points for lessening the vacancy and abandonment problem.

Emre Ergungor, senior research economist with the Federal Reserve Bank of Cleveland, advocates giving banks new incentives to relieve this problem. For example, banks could do a little less lending in lower-income neighborhoods so they could give community groups more help in dealing with the problem of vacant homes. At the same time, they would improve their chances of earning a CRA designation of *outstanding*.

Banks would still need to fulfill a certain number of lending requirements, but they could amass extra points for lessening the vacancy and abandonment problem.

"You could just change the test so that banks increase their REO activities along with everything else they were doing before," Ergungor says. "But I think we can achieve a path of least resistance if we do not increase the burden on banks."

The Proposal in Detail

The proposal recommends that regulators adopt the following changes until the stock of foreclosed properties in the nation no longer exceeds a predetermined threshold:



- Provide CRA consideration under the **investment** test for REO dispositions (REO donations or sales to qualified community development organizations) *outside* a bank's assessment area as long as the investment needs of the assessment area are satisfactorily met.
- Provide CRA consideration under the **service** test for the provision of technical assistance to qualified community development organizations in developing guidelines and standards for REO acquisition and rehabilitation programs *outside* the assessment area as long as the service needs of the assessment area are satisfactorily met.
- Provide CRA consideration under the **lending** test for community development loans to qualified community development organizations engaged in REO rehabilitation programs *outside* the assessment area as long as the credit needs of the assessment area are satisfactorily met.
- Allow banks to attain an overall rating of *outstanding* based on REO-related activities within or outside their assessment areas as long as their rating for the assessment area is *satisfactory*.
- Put these changes back into effect if the foreclosure threshold is exceeded in the future.
- Redistribute the weight of the lending, investment, and service tests to emphasize investment and service activities. Lending should still be an important component, but an intensified focus on investment and service activities will address the immediate needs for community stabilization and longer-term reinvestment.

(Note: These changes are intended to give banks more flexibility with REO dispositions and would not prevent institutions from obtaining an *outstanding* rating under the existing rules.)

The CRA Test

Depending on their size, banks in good standing undergo CRA compliance exams every two to four years. Regulators evaluate large and medium-sized banks (those with more than \$258 million in assets) on the basis of their lending, investment, and service. Small banks undergo a streamlined test that focuses on lending and receive ratings of *outstanding*, *satisfactory*, *needs to improve*, or *substantial noncompliance*. These ratings are especially important to a bank that wants to expand or merge with another bank, because regulatory approval of these activities may be challenged by community groups if the bank receives a less-than-stellar rating.

As Ergungor puts it, the proposal would allow banks to shift some of the resources they usually devote to local CRA activities to REO dispositions in the weakest housing markets across the nation.

In 2009, 98 percent of America's insured depository institutions were rated *satisfactory* or better on their CRA exams, but only 7 percent were certified *outstanding*. The distinction is important to some banks from a marketing perspective; for others, it demonstrates a community-minded approach to business.

Although there are no exact formulas, lending activities tend to be given the most weight in the rating process. The lending assessment shows whether an institution is making loans to small businesses and, most importantly, to low- and moderate-income borrowers in lower-income census tracts. Loans to community development groups can also be factored in.

As it stands, banks earn a certain number of CRA points for activities related to the disposition of REO properties, which tend to be included in the investment and service tests. Donations of properties count, as do loans to

community development organizations serving lower-income areas (the latter fall under the lending test). Technical assistance, which might include serving on nonprofit boards, writing grants, and advising on financial transactions, also qualifies.

To banks, CRA compliance can seem like trying to solve a puzzle: to obtain a high rating, they must place many different pieces in just the right spots. On top of its complexity, compliance is seen as a burden: Some banks complain that CRA activities are unprofitable, or less profitable than other activities they could be pursuing. Banks are understandably disinclined to pay for liens or property demolition when they have already written off the loans. For that reason, they may see CRA compliance mostly as a regulatory tax.

The Proposal

The Federal Reserve Bank of Cleveland's proposal aims to modernize CRA compliance to recognize the growth of interstate banking since the law was enacted three decades ago.

Under the proposal, banks would be able to earn an overall rating of *outstanding* based on their activities with vacant properties, as long as everything else remains at least satisfactory inside their assessment areas. For example, as long as levels of mortgage and small-business lending were satisfactory inside a bank's assessment area, activities involving REO/vacant properties anywhere in the country would be sufficient to be considered for an *outstanding* rating. Examples might include credit lines to community groups that are engaged in rehabilitating and disposing of vacant properties or donating them to land banks.

The opportunity for banks to get CRA credit outside their assessment areas may be particularly important for community groups that are working with the largest banks.

These banks may not have any local branches, but they nonetheless were very active in underwriting mortgages during the housing boom. These institutions may have to work with national community groups to identify local players who have the experience and credibility to deal with these properties once they are off the bank's balance sheet.

Another virtue of the Cleveland Fed's proposal is that it works around the profitability issue by modifying the cost structure of CRA compliance to place increased attention on foreclosed properties. Under the proposal, banks can make a positive dent in the vacancy and abandonment problem but are no worse off in CRA compliance.

In this way, banks can take a straight route to an *outstanding* rating by focusing squarely on activities that reduce the number of vacant houses. At the same time, communities can win big. The hardest-hit housing markets can get the extra help they need, regardless of whether they happen to be in a given bank's main region of service.

The proposal doesn't prevent institutions from obtaining the highest rating under the existing rules—it just adds flexibility to help banks put their swollen portfolios of vacant houses to positive community use. What's unique in the proposal is that it identifies a single factor as the determinant for an *outstanding* CRA rating. As Ergungor puts it, the proposal would allow banks to shift some of the resources they usually devote to local CRA activities to REO dispositions in the weakest housing markets across the nation.

Granted, this means fewer resources for other CRA activities, but the tradeoff may be worthwhile, given the magnitude of the foreclosure crisis. As long as the housing decay persists, other loans and investments will struggle to make a positive difference. Either the area lacks the population density that a small business needs in order to succeed, or it is deemed too risky to insure, an outcome that hurts homeowners and businesses alike.

It is important to recognize that a significant percentage of the nation's vacant properties are held by securitization trusts, which are not subject to CRA rules and thus unaffected by the proposal. But there are still plenty of foreclosed homes on bank balance sheets—more than enough for community groups to acquire on the road to neighborhood stabilization.

The hope for the future is that the need to focus on vacant and abandoned properties will wane along with the housing crisis. For that reason, the proposal would apply only until the nation's stock of foreclosed properties no longer exceeds a predetermined level.

Next Steps

The Cleveland Fed has been talking with bankers and community groups to get their preliminary reaction. Researchers are using the feedback to refine the proposal and then seek more views.

“While we don't expect our proposal to singlehandedly solve the vacancy and abandonment problem, we do think it could have a material impact,” Ergungor says. “We look forward to comments and suggestions.” ■

What do you think?



Tell us what you think about the proposal. Will it work? Under what conditions? Send comments to forefront@clev.frb.org and put “CRA Proposal” in the subject line. We will publish a selection of comments in the next issue of *Forefront*.



Podcast with Emre Ergungor and Ruth Clevenger

Cleveland Fed researchers discuss the Bank's proposal for recasting the CRA to address the vacancy and abandonment problem. www.clevelandfed.org/forefront
