Case Study:

Benefits of Purchasing CRA Eligible Second Mortgages

For purposes of the Community Redevelopment Act ("CRA"), examiners look at similar criteria for small and medium sized banks. These banks are eligible for scores typically ranging from "Satisfactory" to "Substantial Noncompliance". An examiner, however, may conclude that an institution's performance so exceeds the standards for a "Satisfactory" rating under the five core criteria that it merits a rating of "Outstanding". The following are the criteria examiners review for both small and medium sized banks[1]:

- **Loan-to-Deposit Ratio:** The institution's loan-to-deposit ratio adjusted for seasonal variation and, as appropriate, other lending related activities such as secondary market participation, community development loans or qualified investments;
- **Assessment Area Concentration:** The percentage of loans and other lending-related activities located in the institution's assessment area(s);
- **Geographic Dispersion:** The degree of distribution of lending among geographies of different income levels;
- **Borrower Profile Penetration:** The lending penetration among borrowers of different income levels and businesses and farms of different sizes; and
- **Responsiveness:** The institution's record of acting, if warranted, in response to written complaints about its CRA performance.

Purchasing second mortgages on the CRA Note Exchange ("CRA NE") can help a bank in all five of the above areas, but purchasing seconds mortgages can be especially helpful to banks in four of the five criteria. Since the majority of the second mortgages in the CRA NE are priced from $8,000 to $12,000, a bank needing CRA eligible assets may purchase a single $300,000 first mortgage or approximately 30 second mortgages. By assisting 30 borrowers rather than just one for the same level of investment, a bank can better demonstrate: (1) that a substantial majority of all the bank's loans are in the assessment area; (2) that the bank's geographic distribution of loans reflects a significant dispersion throughout the assessment area; (3) that the bank's lending has a broad penetration across differing income levels in the assessment area; and (4) a greater impact on, and responsiveness to, CRA needs in the community.

Table 1

Investment Amount	Loan Type	Assessment Area Concentration	Geographic Distribution	Borrower Penetration	Responsiveness
$300,000	First	Modest Impact	1 Property	1 Borrower	Modest Impact
$300,000	Second	High Impact	30 Properties	30 Borrowers	High Impact

[1] For further explanation of exam criteria, see https://www.dallasfed.org/~/media/documents/cd/pubs/quickref.pdf (last viewed on 9-28-2018)

Table 2

Purchase Price	$300,000
FHA Total 1st Loan	$294,566 5% Note Rate
DPA 2nd Loan	$10,500 8% Note Rate

1st Mortgage		**2nd Mortgage**	
Loan Purchase Price	104	Loan Purchase Price	105
Total Purchase	$306,348	Total Purchase	$11,025
YSP Paid	$11,782	YSP Paid	$525
Loan Pays off 1 year		Loan Pays off 1 year	
Servicing Value Received*	$1,296	Interest Received	$840
Net Loss:	**($10,485)**	Net Gain:	$315

*44 bps above the cost of Servicing

In Table 2, a bank seeking CRA consideration traditionally outlays $11,782 in YSP when purchasing a first mortgage loan. If that loans pays off early (due to a refinance or sale), the bank will lose a significant portion of the YSP paid. Alternatively, by purchasing a second mortgage, even if there is a YSP paid and the loan pays off early, the interest received covers the cost of the YSP.

While the examples above are only for purposes of illustration, they demonstrate how a bank might have a "Satisfactory" or lower rating in one of the five criteria mentioned above and yet raise the rating of several criteria with the purchase of second mortgages.

The CRA NE is specifically tailored to provide relevant CRA information, such as whether the loan is CRA eligible based on either a borrower's income or the census tract where the property is located. In addition, the loans on the CRA NE have never been sold before, unlike some CRA eligible loans that are sold between banks multiple times. This is important because loans are now assigned Universal Loan Identifiers that allow examiners to track how many times a loan has been purchased.