New Compliance Trends

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BY ELIZABETH KARWOWSKI

The United States has made great strides towards equality in many aspects of life since the civil rights movement of the 1960's. The housing industry, though, is one area in which we as a country have historically struggled to achieve the desired results. Congress passed two key pieces of legislation aimed at leveling the playing field in the industry. The Fair Housing Act was passed as part of the broader Civil Rights Act in 1968. This law made it illegal for banks to discriminate on the basis of race when evaluating mortgage applicants. Prior to its passage minorities were often unable to obtain loans from most banks, as systematic discrimination was commonplace.

Although the Fair Housing Act illegalized overt racial discrimination, it did little to resolve the disparate impact of some other common lending practices. Many banks began to engage in what is known as "redlining" in what they designated as high-risk lending areas. The practice of redlining is exactly what it sounds like: banks would literally draw a red line around certain areas of states or cities and refuse to lend to people in those areas. Those redlined areas tended to be home to very low to moderate income individuals and families and, more often than not, those neighborhoods were occupied predominantly by minorities.

Lending institutions abolished their explicitly discriminatory lending policies, but the racial discrimination that the Fair Housing Act was enacted to prevent was still taking place under the guise of risk-based lending. In response, Congress enacted the Community Reinvestment Act in 1977, which not only made redlining illegal, but compelled banks to lend and invest in those low to moderate income communities and neighborhoods. Although the law was enacted with the greatest of intentions, it has proven to be woefully inefficient in narrowing the housing gap for low to moderate income families, specifically minorities. Furthermore, many lending institutions struggle when trying to internally evaluate performance ahead of regulatory reviews because of the lack of definitive guidelines and frequent implementation of revisions.

Every FDIC insured bank is responsible for meeting requirements promulgated by the Community Reinvestment Act and is subject to review from regulatory agencies. As discussed above, the goal of the Act is to help low to moderate income Americans and traditionally underserved communities. The definition of "low to moderate income" varies based upon the geographic regions in which institutions operate, as they fluctuate based upon average income for those specific areas. In areas with high costs of living and higher average incomes (such as New York), the poverty line is higher than it would be in areas with lower average income and cost of living (such as Wichita, Kansas).

The region in which the lending institutions operate is not the only variable that affecs lenders' scope of responsibility under the CRA. The size of the institution also dictates the stringency of the requirements to which they are subject. The larger the institution (the greater the assets) the more resources it must devote to meeting the three compliance tests. Those tests are: 1) the Lending Test; 2) the Investment Test; and 3) the Service Test. For each test, regulators will give scores of "Outstanding", "Satisfactory", "Needs to Improve", and "Substantial Noncompliance", and then will give an overall score to denote the institution's level of general compliance. In this section we will discuss what regulators look at for each test.

The Lending Test is the most straightforward of the three. When evaluating compliance, regulatory bodies look at the dollar value of loan to deposit ratios for the institutions' low to moderate income clients. The higher the dollar value of loans to total deposits, the higher the score will be given to the institution being evaluated. One of the most common problems many lending institutions face when it comes to CRA compliance is the lack of definitive guidelines regarding grading thresholds for the three tests. Most lenders are able to develop compliance targets internally based upon past experience, but are always on edge due to the uncertainty about which rubrics regulatory agencies employ when evaluating performance. Although there is no bright-line test, Kenneth H. Thomas, president of Miami-based Community Development Fund Advisors, and former lecturer at the University of Pennsylvania's Wharton School, has formulated his own thresholds based upon his extensive experience in the industry. He surmised that in order for an entity to achieve a score of "Outstanding" on the lending test, it must have a loan to deposit ratio of at least 80%.

The second test that lending institutions must pass is the Investment Test. This test looks at the qualified investments that are made in low to moderate income service areas. This test, however, doesn't simply look at the dollar value of the investments. Although the amount of investment is important when evaluating compliance under this test, regulatory agencies look deeper in order to ensure that the investments are impacting these communities in a meaningful way. Regulators judge the innovativeness and complexity of each investment to encourage investors to thing about novel ways to remedy problems that have traditionally plagued these communities. Lenders are also required to make investments that are responsive to the development needs of these communities. Because adversity faced by beneficiaries of this law vary widely in each geographic area, there cannot be a "one size fits all" method of investing. Regulators want investors to seriously consider the needs of each community in which they invest. Again, although there are no definitive guidelines regarding how much is enough, Thomas suggests that in order to achieve an "Outstanding" rating, lenders should looks to invest 1% of review period assets.

The last test under which lenders are evaluated is the Service Test. This test looks at the type and number of retail and community development services that banks provide to each low to moderate income service area. Like the Investment Test, this test doesn't just the number of services into account. Lenders must provide services that are innovative and responsive to the needs of each community in which they are offered. From his experience, Thomas recommends that lenders who wish to attain an Outstanding score must offer 12 services per year per billion dollars in assets.

Despite numerous regulatory bodies and agencies offering overviews and some guidance regarding compliance with CRA requirements, many lenders are still in the dark about what they need to do to receive Outstanding scores because of the lack of definitive compliance standards. Approximately 90 percent of lenders were given an overall grade of satisfactory, while less than 10 percent were able to attain Outstanding marks. These statistics prove that despite devoting significant time and resources to CRA compliance, lenders still struggle with implementing programs that unequivocally meet regulatory standards.

When compiling a CRA requirement plan, lenders should seek to implement programs that will not only help the community, but will empower those who the CRA aims to help to become homeowners. For instance, many low to moderate income consumers struggle with credit. There is a demonstrable need for services that provide credit education and remediation in those communities. Many lenders have already begun to partner with non-profit entities that provide these types of services for applicants who do not have the necessary credit scores to qualify for the financial products that they seek. If those same lenders partnered with non-profits to provide those same services at no cost to low to moderate income communities that they serve, it would help them meet the requirements of not one, but two CRA tests. Funding a credit remediation program such as the one described above would obviously sere to help meet the requirements under the Service Test. However, once those low to moderate income households or individuals build their credit profile, they could qualify for mortgages or various other financial products, which would help that same lender meet Lending Test reqs also. ❖

ABOUT THE AUTHOR

Elizabeth Karwowski is the CEO of Get Credit Healthy, a technology company that has developed a proprietary process and solution, which seamlessly integrates with the lenders' loan origination software (LOS) and customer relationship management software (CRM) in order to create new loan opportunity and recapture leads.