VIEWPOINT

This Fix Fails to Solve the Problem

Well-intentioned state laws may actually discourage lending to underserved borrowers

By Scott Olson

New York and Illinois recently joined Massachusetts in adopting state-level versions of the Community Reinvestment Act (CRA), the 1977 federal statute designed to encourage banks to serve low- and moderate-income households in the same communities where they take deposits and have branches. These state-level statutes go further than the federal law by extending the same requirements to nonbank mortgage lenders.

People can debate the impact of the federal law for banks — whether it has any teeth or whether it makes any difference with respect to mortgages. What seems clear, however, is that it makes no sense to try to adapt the same law — which was specifically designed for banks with branches and deposits — for independent mortgage banks (IMBs). This is the epitome of trying to fit a square peg in a round hole.

The Community Reinvestment Act was designed to prevent banks from taking federally insured deposits from underserved communities and diverting them to provide credit in wealthier communities. But independent mortgage banks don't have access to insured deposits, to Federal Home Loan Bank advances or to the Federal Reserve's discount window.

Independent mortgage banks don't take money out of underserved communities. They bring mortgage credit into underserved communities by accessing Ginnie Mae mortgage-backed securities, cash windows from Fannie Mae and Freddie Mac, or by selling loans to aggregators. Unlike banks, only a small fraction of the mortgage business for these institutions is generated through physical offices.

Most importantly, there is no evidence that IMBs fail to work with underserved and minority borrowers. Year after year, these financial companies decisively outperform banks in originating mortgages to minorities (e.g., see the annual reports from The Greenlining Institute) and to underserved borrowers (e.g., see the monthly reports from the Urban Institute).

Unlike banks, independent mortgage banks generally do not impose credit overlays, or additional guidelines to prevent default, which in effect limit loans to wealthier borrowers. And unlike correspondent lenders such as Wells Fargo, independent mortgage banks don't exit the mortgage market when times get tough.

Simply put, CRA statutes for independent mortgage banks are solutions in search of problems. Still, with states like New York and Illinois joining Massachusetts in adopting legislation, this seems to be a trend. So, let's take a look at what these states have done and what the likely impact will be.

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Massachusetts experiment

Advocates of CRA for independent mortgage banks point to Massachusetts, which adopted its law in 2007. Let's take a look at how this turned out. Home Mortgage Disclosure Act data for Massachusetts since it adopted CRA for nonbanks (2020 versus 2008) showed that growth in nonbank lending within the state significantly trailed the national average.

When Massachusetts adopted its CRA, the 26% independent mortgage bank share of mortgages in the Bay State in 2008 was above the national average of 24%. Twelve years later, however, the IMB share of mortgages in Massachusetts (55%) had fallen significantly below the national average of 63%.

In these 12 years, the IMB share of mortgages to low- and moderate-income borrowers in Massachusetts increased from 27% in 2008 to 62% in 2020, while the national average of IMB lending to such borrowers increased at a faster pace, from 29% to 67%. The IMB share of mortgages to borrowers of color in Massachusetts increased by the same percentage (from 27% in 2008 to 62% in 2020). But the national average of IMB lending to minority borrowers increased even more rapidly, from 33% to 71%.

You can't pinpoint cause and effect here. But clearly, the Massachusetts experiment has not lived up to its billing. And it is possible that the Massachusetts CRA was a factor in discouraging IMBs from coming into the state to make mortgages.

Plaguing questions

New York's CRA law was enacted in 2021 and went into effect one year later on Nov. 1, 2022. It directs the superintendent of the New York Department of Financial Services (DFS) to assess the performance of a mortgage banker in helping to meet the credit needs of their entire community, including low- and moderate-income neighborhoods.

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Specific factors to consider in this assessment include efforts taken by the mortgage banker to ascertain the needs of their community; marketing to members of their community; community outreach and educational programs; participation by management; any practices intended to discourage applications; and the geographic distribution of loan applications and denials. The New York state law also requires DFS to monitor the mortgage banker's record of opening and closing offices; its participation in government-insured, guaranteed or subsidized loan programs; and the mortgage banker's ability to meet community credit needs based on their company's financial condition, size, legal impediments and local economic conditions.

The law provides for the assessment and all communications by DFS to be available to the public upon request. Furthermore, the superintendent may conduct public hearings when an objection to an application has been submitted.

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Therefore, in addition to the normal risks associated with noncompliance, there is a substantial reputational risk for failure to meet the department's standards.

A fundamental question raised by this law is what constitutes the "community" of the mortgage banker. Under the federal Community Reinvestment Act, regulators such as the Office of the Comptroller of the Currency have defined the assessment area of a bank based in part on the location of its principal office, branch office or another deposit-taking facility.

A mortgage banker who is licensed in New York is not required to maintain an office in the state — and many do not. What is the "community" in New York for an out-of-state mortgage banker? The industry will look to DFS for clarity in areas such as this, as this is the sort of question that plagues any state-based effort to apply CRA to independent mortgage banks.

Recipe for retreat

The Illinois CRA was signed into law in March 2021. In December of last year, the state released draft regulations on how to implement the law. This draft exemplifies the problems of applying CRA to independent mortgage banks. The proposed regulations show a fundamental lack of understanding of these financial companies' business models.

For example, one assessment criteria is "innovative or flexible lending." So, will an independent mortgage bank that overwhelmingly originates Federal Housing Administration (FHA) or U.S. Department of Veterans Affairs (VA) loans — which include low- or zero-downpayment terms designed for underserved and first-time homebuyers — be penalized because they are not "innovative" or "flexible"?

The same goes with requirements for loss mitigation. Independent mortgage banks predominately originate FHA, VA and conventional loans that have the strongest loss-mitigation requirements — much stronger than banks typically have. As long as an IMB follows these requirements, it makes no sense to have an additional test.

The regulations show a bias toward banks and against IMBs. They disallow credit for loans that independent mortgage banks originate and sell to banks, if a bank claims federal CRA credit for the same loan. This is backward. The loan would not have been made if the IMB didn't originate it. And if a specific bank didn't buy an FHA, VA or conventional loan, another bank would have done so.

Finally, like in New York, the Illinois regulations are unclear as to whether they impose a requirement that if a lender enters a state, it has to serve all geographic parts of the state. Combined with low loan threshold for CRA applicability, and new CRA exam costs and burdens, this is a recipe for discouraging lenders in adjoining states from expanding into Illinois.

Sensible alternatives

There are more effective ways for states to encourage mortgage lending to minority and underserved borrowers. For example, one way to generate more mortgages to minority borrowers is simply to have more minority loan originators.

The Secure and Fair Enforcement for Mortgage Licensing (SAFE) Act creates high qualifications standards for independent mortgage bank originators. This is fine, even though for some reason the standards are much lower for bank-based originators.

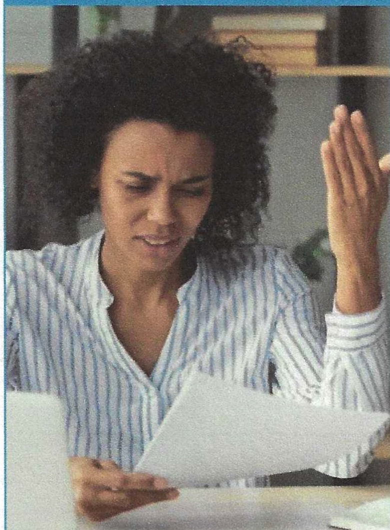
But states should also look at ways to lower the hurdles for a nonbank originator to become licensed. States should waive SAFE Act exam fees and subsidize these courses for minority and low-income originator candidates. Additionally, states should not deny licenses to loan originators who have blemishes on their credit reports, which have nothing to do with their qualifications to be an originator.

For states determined to adopt CRA, it matters how they do it. There should be appropriate volume-exemption levels to avoid deterring nonbanks in nearby states from deciding to lend in that state.

The CRA process should be streamlined with appropriate safe harbors. If an IMB has loan statistics showing they are adequately serving low- and moderate-income borrowers, they should not have to undergo extensive and costly exams. And these institutions should not be forced to contribute to community development funds of nonprofits, because that is not their mission.

Finally, to other states considering the adoption of CRA for independent mortgage banks, consider one thing: Look before you leap. This all sounds like a good idea. But you will discourage the very thing you want to encourage. ●

KEY POINTS



The problem with a state-level Community Reinvestment Act

- The Community Reinvestment Act of 1977 encourages lending in local communities.
- The federal law aims to aid underserved and minority borrowers.
- More recently, three states have passed their own versions of the law.
- Unlike the federal law, these laws extend to independent mortgage banks.
- This may discourage independent mortgage banks from lending in these states.
- This could end up hurting underserved borrowers in the long run.
- There are better ways to encourage this type of lending activity.