Updated Census Bureau data may create new compliance risk for lenders in 2022

Lenders are facing a dynamic environment in 2021, with respect to compliance risk under Fair Lending laws and the Community Reinvestment Act (CRA). Regulatory scrutiny is expected to escalate under a new presidential administration, which may lead to an increase in the intensity of Fair Lending examinations and enforcement actions. CRA modernization will require many banks to adapt their CRA compliance management systems. And the ongoing pandemic will continue to influence compliance risk through its effects on the national economy, local economies, demand for lending products, and lending operations.

There is also another factor on the horizon that may be under the radar but will lead to systemic changes in exposure to Fair Lending and CRA compliance risk for many lenders: New data releases from the U.S. Census Bureau. In the remainder of this article, we will discuss:

- The implications for lending compliance from the pending data release of new data from the Census Bureau and
- What lenders can do during 2021 to minimize the effect from these data on their compliance positions in 2022.

Background: Census Bureau data and compliance

During 2021, the Census Bureau will begin releasing data based on the results of the 2020 decennial census. Beyond the Constitutional purposes of this data (e.g., defining congressional districts, the apportionment of legislative seats for local, state and federal elections, etc.), these data will lead to changes in census tract delineations, based on changes in population patterns since the 2010 census.

In many cases, current census tracts will be divided into two or more tracts while others may be consolidated. As was the case following the 2010 decennial census, the net effect of these changes will likely lead to an increase in the number of census tracts that will exist from 2022 through 2031.

The Census Bureau will also release new data related to tract concentrations of minorities and median family income. The Federal Financial Interagency Examination Council (FFIEC) will update its census reports accordingly and regulators will use these updated reports to classify census tracts as majority-minority, low-income and moderate-income, for compliance examinations. These new classifications will be the foundation for evaluating Fair Lending compliance under the redlining risk factor and CRA compliance from 2022 through 2026.

In terms of redlining and CRA, covered lenders are expected to achieve a satisfactory level of lending relative to their peers in majority-minority tracts (MMT) and low- or moderate-income tracts (LMIT). New census tract definitions and data will lead to systemic changes in MMT and LMIT classifications, and

many lenders will be exposed to new compliance risk as they transition from 2021 to 2022. We explore this possibility by looking at what happened during the transition period following the 2010 census .

Compliance risk emerged for many lenders in 2012 from new Census Bureau data

The results of the 2010 census data release led to substantial changes in census tract classifications in 2012. The number of census tracts increased by 7,698 (11 percent), and the share of tracts classified as MMTs and LMITs increased from 24 percent and 27 percent, respectively, to 29 percent for both.

Our review of data published under the Home Mortgage Disclosure Act (HMDA) for 2012 indicated that a significant portion of lenders were adversely affected by the systemic changes in MMTs and LMITs from 2011 to 2012. For these lenders, the year-over-year classification changes created new risk that would not have existed under the census tract definitions in effect before 2012.

For redlining, we found 2,783 new lender-level instances of high risk[1] based on having significant differences in MMT origination activity from their peers[2] in Metropolitan Statistical Areas (MSA)[3]. Among these instances of change, 48 percent went from having low levels of risk to high levels of risk, while the remaining 52 percent were changes from moderate to high risk.[4] In summary, the systemic changes in MMT classifications created new redlining risk in 2012 for many lenders that would not have been presented based on the census tract classifications in effect during 2011.

In terms of CRA, we identified nearly 1,600 instances where LMIT mortgage activity of banks in the MSAs materially declined to levels that increased the likelihood[5] of a ratings downgrade for this performance criterion. Lending managers and boards of directors should consider the census tract changes in relation to the reasonableness of the currently defined assessment area, ensuring that newly identified LMITs do not appear to be arbitrarily excluded. Given that many banks define portions of MSAs for their CRA assessment areas, more may be affected by population patterns inside the MSAs where they operate.

The impact of LMIT reclassifications would have also affected the ability for some banks to successfully qualify activities as community development efforts. In many cases, community development activities involve extensive planning that rely on existing LMIT classifications. For example, a commercial loan in consideration during 2011 but not closed and funded until 2012 may have been expected to qualify as a

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[1] We define high risk at the 95 percent confidence level. For redlining risk, this reflects instances where a lender has significantly fewer MMT records than selected peers at the 95 percent confidence level in an MSA based on a *z*-test of proportions.

[2] For the purposes of this article, "peers" represent lenders that reported 30 or more originations in the same MSA during 2012.

[3] For consistency throughout the article, MSAs are defined based on delineations effective as of 2019.

[4] We typically define moderate risk at or above the 85 percent confidence level and below the 95 percent confidence level. A low level of risk is indicated where the confidence level falls below 85 percent.

[5] Based on our experience from reviewing CRA performance evaluations, we identified banks with an increased likelihood of a ratings decline as instances where the percentage of total loans made in LMITs declined by at least 25 percent relative to the entire peer group. The reported number of instances assumes that the corresponding banks included the entire MSA in their assessment area delineations, providing an upper bound on the potential effects from LMIT reclassifications.

community development loan based on its 2011 LMIT status. If the status of the tract changed from LMIT when the loan was funded, then it may have become more difficult to receive CRA credit in the next examination.

Overall, the 2012 HMDA data illustrate that a substantial portion of mortgage lenders and banks faced new redlining- and CRA-related compliance risk following the updated MMT and LMIT classifications; however, our review indicated that the increase in compliance risk was more concentrated in some MSAs than in others. The map in Figure 1 shows how the prevalence of new lender-level redlining risk due to MMT reclassifications differed between MSAs. The effect of tract reclassifications tended to be more concentrated in the Southeast and the Southwest.

Figure 1
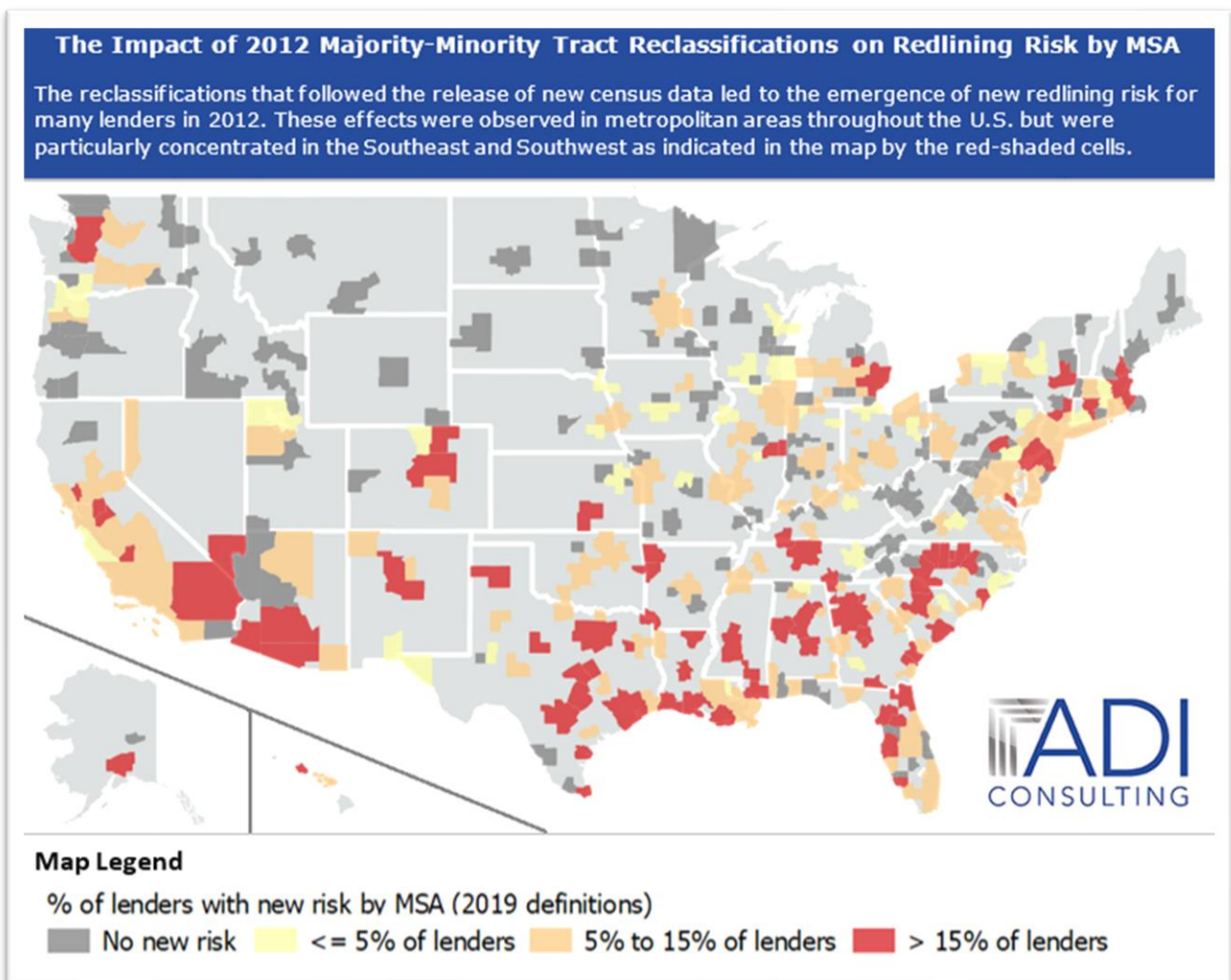
Moreover, small- and medium-sized lenders inside an MSA were particularly exposed to the effects of reclassifications: The top lenders in the 90th percentile in terms of loan volume in a market were 1.27 times and 1.40 times less likely than smaller lenders to have had an increase in risk in lending to MMTs and LMITs, respectively. This may be explained by larger lenders having greater geographic distribution

throughout a market, allowing them some cushion from the effects of reclassifications inside the MSA. Smaller lenders, on the other hand, may be more concentrated in specific regions in an MSA, which can lead to more dramatic effects from changing population patterns inside the market.

Lenders should prepare for the upcoming tract reclassifications

If 2012 is any indicator, many lenders should consider the implications of upcoming MMT and LMIT reclassifications that go into effect in 2022. As shown in Figures 2 and 3, most metropolitan areas will be affected by reclassifications based on the most recent population estimates. This will be further complicated by changes in census tract delineations from the 2020 census. These adjustments may catch many lenders off guard, especially if lending strategies rely on retail offices and marketing activities that focus on specific regions inside an MSA to maintain their compliance.
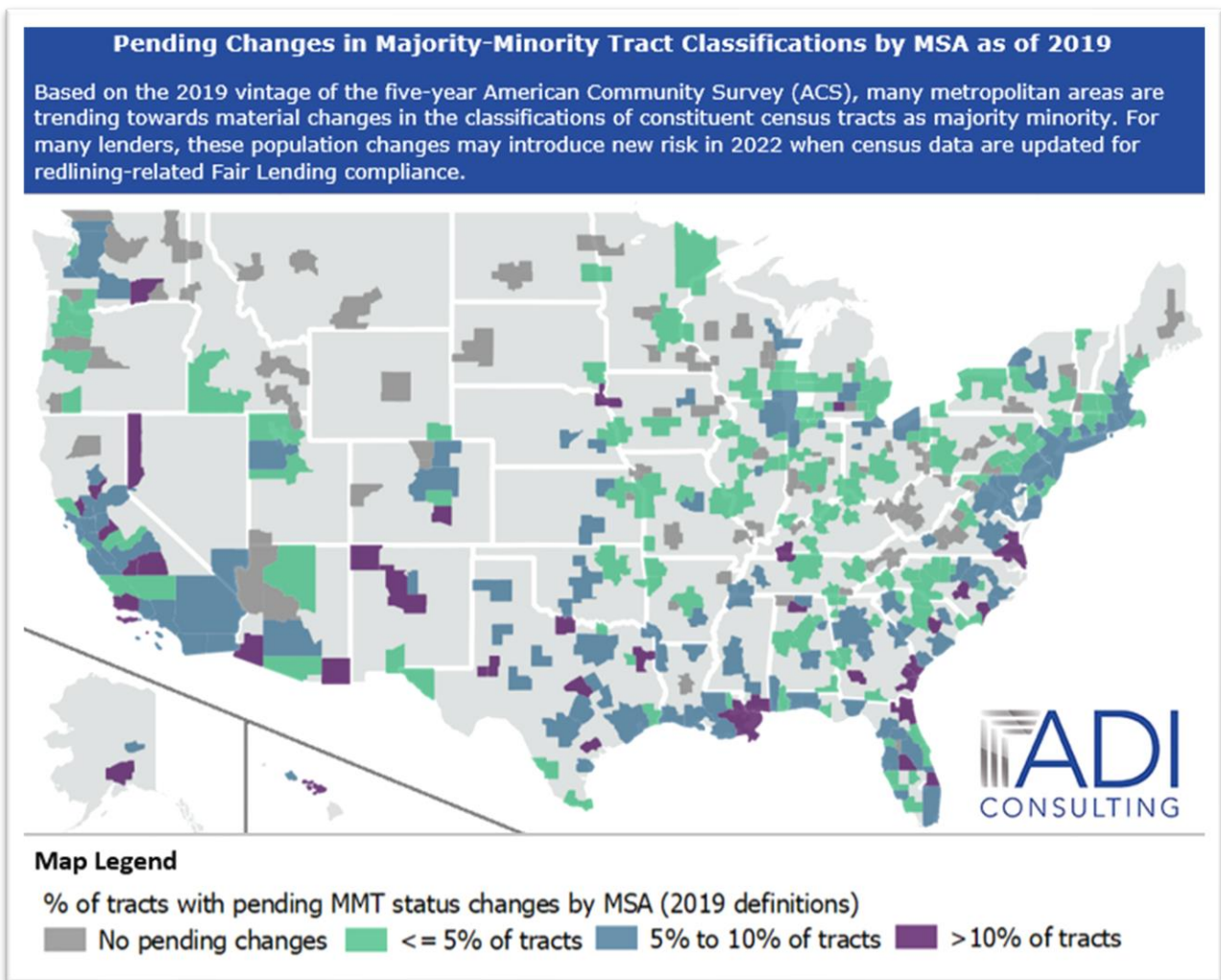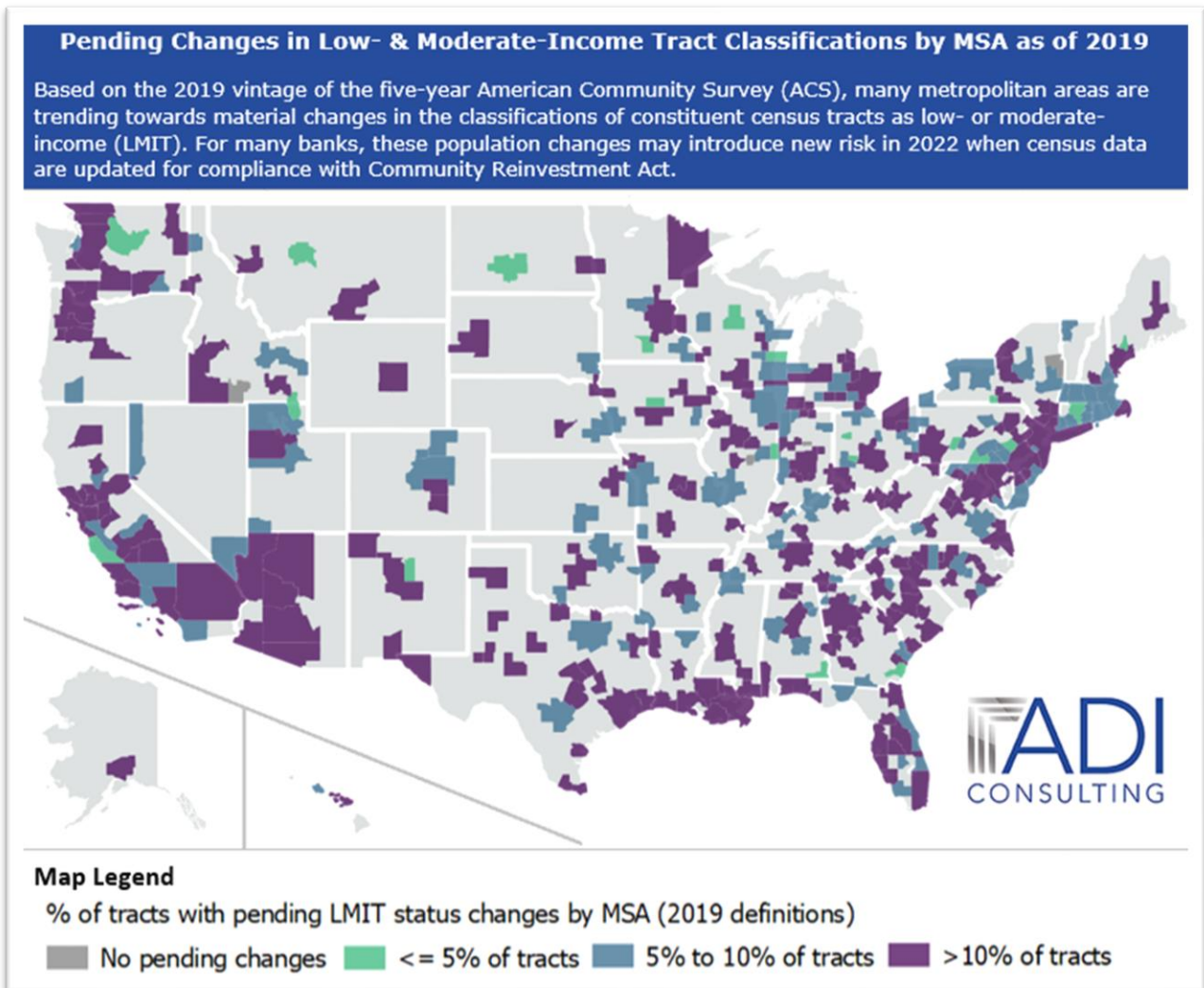
Figure 2

Figure 3

Pending Changes in Low- & Moderate-Income Tract Classifications by MSA as of 2019

Based on the 2019 vintage of the five-year American Community Survey (ACS), many metropolitan areas are trending towards material changes in the classifications of constituent census tracts as low- or moderate-income (LMIT). For many banks, these population changes may introduce new risk in 2022 when census data are updated for compliance with Community Reinvestment Act.

Map Legend

% of tracts with pending LMIT status changes by MSA (2019 definitions)

No pending changes ▮ <= 5% of tracts ▮ 5% to 10% of tracts ▮ >10% of tracts

It is prudent for lenders to explore their exposure to elevated compliance risk due to population changes in the communities they serve. We recommend that lenders analyze the tract-level population trends in their markets to anticipate where reclassifications are likely to occur. This analysis should compare current tract classifications with classifications based on the most recently released Census Bureau data.

Pro-forma estimates of compliance risk can be created by comparing lending patterns using the current and pending MMT/LMIT classifications. For instance, lenders can assess their redlining risk for the past three years using the existing MMT classifications and the pending classifications based on the most recent Census Bureau data. If the level of redlining risk is elevated under the pending MMT classifications, then exposure to new risk in 2022 is likely.

If enhanced risk from the pro-forma estimates is identified, further review is required. In this case, the lender should look for regions in which it has been under-penetrated, that are trending towards new MMT/LMIT classifications. Similarly, the lender should identify MMT/LMIT communities where it has been highly active but are trending away from those classifications. Maps can be particularly effective in

identifying these regions and finding tracts that are more likely to be split into multiple tracts or merged with adjacent tracts.

Once the regions with pending changes have been identified, the lender can develop strategies and tactics to implement in 2022, that will help it mitigate its exposure to enhanced compliance risk. Ideally, this will effectively alleviate any risk that may have emerged if no strategic shifts were implemented. However, if new risk still emerges, the lender should document measures taken to demonstrate that it made a good faith effort to anticipate and proactively address the issue.

It is better to be proactive then reactive

Being proactive about the potential issue of tract reclassifications will help your institution demonstrate its compliance management system is effective. Moreover, you may identify strategic opportunities in emerging MMTs and LMITs to enhance your compliance position, while your competitors are trying to catch up. The sooner you start exploring the effects of population changes in your lending markets - the more time you will have to develop and implement the strategies that will minimize compliance risk and identify new opportunities for sustainable growth.

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