



Testimony of

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On behalf of the
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Before the

United States Senate
Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance, and Investment

Hearing on

**“Creating a Housing Finance System Built to Last: Ensuring
Access for Community Institutions”**

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Chairman Tester, Ranking Member Johanns, members of the Subcommittee, I am Jack Hartings, President and CEO of The Peoples Bank Company and Vice Chairman of the Independent Community Bankers of America. The Peoples Bank Company is a \$400 million asset bank in Coldwater, Ohio. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on "Creating a Housing Finance System Built to Last: Ensuring Access for Community Institutions." We are grateful for your recognition of the critical importance of preserving community bank access in any reforms to the housing finance system. It is essential to borrowers and the broader economy that the details of any reform are done right. We sincerely appreciate the opportunity we've been given to work with members of this Committee to craft housing finance reform legislation. We look forward to providing ongoing input on the impact of reform on community banks and their customers.

Community Banks and the Mortgage Market

Community bank mortgage lending is vital to the strength and breadth of the housing market recovery. Community banks represent approximately 20 percent of the mortgage market, but more importantly, our mortgage lending is often concentrated in the rural areas and small towns of this country, which are not effectively served by large banks. For many rural and small town borrowers, a community bank loan is the only mortgage option.

A vibrant community banking sector makes mortgage markets everywhere more competitive, and fosters competitive interest rates and fees, better customer service, and more product choice. The housing market is best served by a large and geographically-dispersed number of lenders. Five years after the financial crisis, an already concentrated mortgage market has become yet more dangerously concentrated. We must promote beneficial competition and avoid further consolidation and concentration of the mortgage lending industry.

The Peoples Bank Company has been in business for 108 years. We survived the Great Depression and numerous recessions before and since – as have many other ICBA member banks – by practicing conservative, commonsense lending. We make sure loans are affordable for our customers and they have the ability to repay. Loans are underwritten based on sound practices using our personal knowledge of borrowers and their circumstances.

Fair Access to the Secondary Market

Secondary market sales are a significant line of business for many community banks. According to a recent survey, nearly 30 percent of community bank respondents sell half or more of the mortgages they originate into the secondary market.¹ When community banks sell their well-underwritten loans into the secondary market, they help to stabilize and support that market. Community bank loans sold to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks ("the GSEs") are underwritten as though they were to be held in the bank's portfolio.

While community banks choose to hold many of their loans in portfolio, it is critical for them to have robust secondary market access in order to support lending demand with their balance

¹ ICBA Mortgage Lending Survey. September 2012.

sheets. For example, I have a portfolio of 867 loans with a balance of \$81 million we originated and sold to Freddie Mac. Loan sales to Freddie Mac allow me to support the broad lending needs in my community, particularly with fixed-rate loans demanded by my customers. As a community bank, it is not feasible for me to use derivatives to offset the interest rate risk that comes with fixed rate lending. Secondary market sales eliminate this risk. The ability to sell single loans for cash, not securities, is critical to my bank because I don't have the lending volume to aggregate loans before transferring them to Freddie Mac. In addition, I have the assurance that Freddie Mac won't appropriate data, from the loans sold, to solicit my customers with other banking products.

Even those community banks that hold nearly all of their loans in portfolio need to have the option of selling loans in order to meet customer demand for long-term fixed rate loans. Meeting this customer demand is vital to retaining other lending opportunities and preserving the relationship banking model.

While many community banks remain well-capitalized following the financial crisis, others are being forced by their regulators to raise new capital, even above minimum levels. With the private capital markets still largely frozen for small and mid-sized banks, some are being forced to contract their lending in order to raise their capital ratios. In this environment, the capital option provided by the secondary markets is especially important. Selling mortgage loans into the secondary market frees up capital for more residential mortgages or other types of lending, such as commercial and small business, which support economic growth in our communities.

Many community banks would like to sell more loans but for the challenge of identifying "comparable" sales, as required by Fannie Mae and Freddie Mac, in rural markets where properties have unique characteristics such as large plots of land. The nearest comparable may be 60 miles away.

In addition to selling mortgage loans to Freddie Mac, my bank participates in the Mortgage Purchase Program (MPP) through the Federal Home Loan Bank of Cincinnati. While our loan sales to the MPP – 33 serviced loans with an outstanding balance of \$4.4 million – are only a fraction of our sales to Freddie Mac, we're pleased to have this alternative secondary market access. The Federal Home Loan Banks (FHLBs) are a critical source of liquidity to support community bank mortgage lending. The FHLBs were particularly important during the financial crisis when they continued to provide advances to their members without disruption while other segments of the capital markets ceased to function. The FHLBs must remain a healthy, reliable source of funding.

Key Features of a Successful Secondary Market

The stakes involved in getting housing-finance market policies right have never been higher. Housing and household operations make up 20 percent of our economy and thousands of jobs are at stake.

With regard to the secondary market, if the terms are not right, the secondary market could be an impractical or unattractive option for community banks. Below are some of the key features community banks require in a first-rate secondary market.

Equal access. To be sustainable and robust, a secondary market must be impartial and provide equitable access and pricing to all lenders regardless of their size or lending volume. Without the appropriate structure, a secondary market entity will have a strong incentive to offer favorable terms to only the largest lenders. Such an outcome would drive further industry consolidation, increase systemic risk and disadvantage the millions of customers served by small lenders.

Financial strength and reliability. A secondary market must be financially strong and reliable enough to effectively serve mortgage originators and their customers even in challenging economic circumstances. Strong regulatory oversight is needed to ensure the secondary market operates in a safe and sound manner.

No appropriation of customer data for cross-selling of financial products. When a community bank sells a mortgage to a secondary market entity, it transfers proprietary consumer data that would be highly valuable for the purposes of cross-selling financial products. Without large advertising budgets to draw in new customers, community banks grow by deepening and extending their relationships with their current customer base. Secondary market entities must not be allowed to use or sell this data. Community banks must be able to preserve customer relationships and franchises after transferring loans.

Originators must have the option to retain servicing and servicing fees must be reasonable. Originators must have the option to retain servicing after the sale of a loan. In today's market, the large aggregators insist the lender release servicing rights along with the loan. Transfer of servicing entails transfer of data for cross-selling, the concern identified above. While servicing is a low-margin business, it is a crucial aspect of the relationship-lending business model, giving a community bank the opportunity to meet the additional banking needs of its customers.

Limited purpose and activities. The resources of any secondary market entities must be focused on supporting residential and multifamily housing. They must not be allowed to compete with originators at the retail level where they would enjoy an unfair advantage. The conflicting requirements of a public mission and private ownership must be eliminated.

Private capital must protect taxpayers. Securities issued by secondary market entities must be backed by private capital and third-party guarantors. Any government catastrophic loss protection must be fully and explicitly priced into the guarantee fee and the loan level price. This guarantee would provide credit assurances to investors, sustaining robust liquidity even during periods of market stress.

The Future of the Secondary Markets

There is widespread agreement the secondary market must be reformed. An aggressive role for the government in housing is no longer a viable option. The private sector should and will take

the lead in supporting mortgage finance. ICBA welcomes this new reality as an appropriate response to the moral hazard and taxpayer liability of the old system. Community banks are prepared to adapt and thrive in this environment. But whatever replaces Fannie Mae and Freddie Mac must have features to allow community banks to continue to prosper as mortgage lenders and to serve their communities.

The worst outcome in GSE reform would be to allow a small number of mega-firms to mimic the size and scale of Fannie and Freddie under the pretense of creating a private sector solution strong enough to assure the markets in all economic conditions. Moral hazard derives from the concentration of risk, and especially risk in the housing market because it occupies a central place in our economy. Any solution that promotes consolidation is only setting up the financial system for an even bigger collapse than the one we've just been through.

The GSEs must not be turned over to the firms that fueled the financial crisis with sloppy underwriting, abusive loan terms, and an endless stream of complex securitization products that disguised the true risk to investors while generating enormous profits for the issuers. These firms must not be allowed to reclaim a central role in our financial system.

ICBA is pleased to see a robust debate emerging on housing finance reform. A number of serious proposals have been put forth to date – both from within Congress and from outside – all of which combine promising features with others that warrant additional consideration and reworking.

The Housing Finance Reform and Taxpayer Protection Act

ICBA is grateful to Senators Warner, Corker, Tester, and Johanns for introducing S. 1217, the Housing Finance Reform and Taxpayer Protection Act, as well as Senators Hagan, Moran, Heller, and Heitkamp. ICBA sincerely appreciates the opportunity to provide input into this bill. We are encouraged by the inclusion of certain provisions to accommodate ICBA's concerns. In particular:

- The Mutual Securitization company would secure access to the secondary market for community banks and other small originators and would allow them to sell loans for cash and to retain servicing rights.
- The Federal Home Loans Banks would also be allowed to issue securities, creating another access point for community banks.
- Limiting issuers to no more than 15 percent of outstanding guaranteed securities would reduce concentration in the securitization market by large banks or Wall Street firms.
- The FMIC guarantee, well insulated by private capital, would insure the securitization market continues to function in times of market stress.

These provisions would help provide access for community banks to the secondary market without requiring them to take on the additional risk and cost of securitizing loans. We look

forward to continuing to work with you and the other cosponsors and the Chairman and Ranking Member to further strengthen the bill and ensure it serves the needs of community bank customers.

Closing

Thank you again for the opportunity to testify today. Private entities must play a more robust role in the mortgage securitization market and taxpayers must be more effectively insulated from any market failures. That much is settled. But it is critically important the details of reform are done right to ensure community banks and lenders of all sizes are equally represented and communities and customers of all varieties are served.