

Housing Finance Reform

A Community Banking Perspective

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Introduction

Five years after a generational financial crisis triggered in major part by poorly underwritten mortgage loans that were securitized in both private-label and mortgage securities backed by the government sponsored enterprises (GSEs), reform of the secondary market and final disposition of the housing GSEs, Fannie Mae and Freddie Mac, is the unfinished financial regulatory business of Congress. Following the resolution of many of the other recession-era emergency market support initiatives—TARP, TALF, the AIG bailout and the bailouts of GM and Chrysler, among other programs—housing finance reform will be a top agenda item for the remainder of the 113th Congress and may well extend into future Congresses. Major housing reform proposals are being advanced in the House and Senate, though many areas of disagreement remain.

Housing finance reform is supported by community banks and is clearly needed to incentivize the return of private capital and to protect taxpayers from another bailout. At the same time, housing finance reform carries a significant level of risk, and not only for the mortgage market. The dominance and threat of too-big-to-fail institutions, moral hazard and systemic risk, the economic vitality and quality of life in small communities and rural areas, and the recovery of the housing market that will drive revival of the broader economy are all at stake in housing finance reform. The purpose of this paper is to discuss these risks from the perspective of America's nearly 7,000 community banks and the implications for the customers and communities that community banks serve. This paper sets forth principles for a strong and broadly accessible housing finance system that serves the needs of all creditworthy borrowers and the broader economy.

While final legislation may not be enacted in the near term, members of Congress are already committing themselves to preferred solutions and directions. Decisions made today will greatly influence the shape of any final law and the key features of the future secondary mortgage market. A risk of particular concern to community banks and their customers is that policies that create a secondary market that is structurally more complex will effectively limit their access to that market and accelerate the trend toward industry consolidation, giving effective control of the mortgage market to the same megabanks and Wall Street firms that precipitated the last crisis. Policymakers must take care that in attempting to address the problems that led to the GSE conservatorship they do not create a market that can only be accessed by fewer and much larger lenders. Such a market would offer fewer choices, commodity-only products, a degraded consumer experience, and an absence of mortgage options for borrowers in rural markets. Consumers are better served by a diverse, competitive market with thousands of active mortgage lenders, including community banks, which specialize in personalized and customized lending that megabanks are structurally incapable of providing. If secondary market reform is not done right, if policies are implemented that are unworkable for community banks and other small lenders, these lenders would have no choice but to exit the mortgage lending business in droves, changing the market for all borrowers especially in the small communities served by community banks. Community banks and other small lenders would have no alternative but to sell their loans to the large national aggregators. This would concentrate more risk in fewer and larger too-big-to-fail institutions, increasing moral hazard and systemic risk, and setting up the financial system for a collapse even larger and more devastating to the economy and American homeowners than the one we just lived through.

The Independent Community Bankers of America® (ICBA)¹ is firmly committed to preserving and expanding the role of community banks in both the primary and secondary mortgage market. ICBA is also committed to preserving the 30-year fixed-rate mortgage for creditworthy customers in all markets. The loss or curtailment of the 30-year fixed-rate mortgage, which has been a staple of the residential market for more than 40 years, would have a sharply negative effect on home prices, personal wealth, consumer spending and the broader economy.

This white paper will fully describe how community banks use the secondary mortgage market and distinguish community banks' use of the secondary market from that of large banks and mortgage companies.

Community Banks and Mortgage Lending

Mortgage lending has always had a significant place in the community bank business model that is focused on relationship lending. Community banks are locally owned, typically closely held institutions deeply rooted in their communities and funded primarily by local deposits. They have a vital stake in the success of their local economies because the fortunes of the local bank and the local economy are inextricably linked. Community banks thrive by cultivating long-term, cross-generational relationships with local families, farmers and small business owners and by serving the full spectrum of their financial needs. To sustain this business model and retain valuable customer relationships, community bankers must be able to meet the mortgage needs of their customers. Providing residential mortgages helps community bankers cement relationships with small business clients, for example, and opens up additional lending opportunities.

It's part of community bankers' DNA to help clients purchase, build, or refinance their homes. Small town America is built on community bank credit. Most small towns would not have survived or grown if local community banks had not provided the construction loans to build new homes or helped a homeowner with a cash-out refinance to help start a new business. Community bankers lend based on direct knowledge of the borrower and local market conditions and offer customized terms. This is the source of their competitive advantage over larger banks that offer only commodity products and operate from another state or region of the country.

Mortgage lending by community banks represents 17 percent to 20 percent of the national mortgage market.² However, in small towns and rural communities the local community bank is often the main source of mortgage credit. As the recent FDIC Community Banking Study showed, in one out of every five counties in the United States, the only physical banking offices are those operated by community

¹ *The Independent Community Bankers of America®, the nation's voice for nearly 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services. For more information, visit www.icba.org.*

² The Federal Reserve's analysis of Home Mortgage Disclosure Act (HMDA) data indicates that banks with assets under \$10 billion account for 18 percent of home loan originations. See "Community Banks and Mortgage Lending," Remarks by Federal Reserve Governor Elizabeth Duke, November 9, 2012. However, HMDA data does capture institutions that operate exclusively outside of metropolitan areas. Therefore, we estimate that the community bank mortgage market share is slightly larger than 18 percent.

banks.³ These markets are often neglected by larger national mortgage lenders that are driven by volume and margins, because the markets may not generate enough real estate lending activity. These communities will be hit the hardest by any policy changes that drive community banks out of the mortgage lending business.

What's more, the 18 percent to 20 percent market share of community banks understates the significance of their mortgage lending. For example, community banks make a larger share of their home purchase loans to low- or moderate-income borrowers or borrowers in low- or moderate-income neighborhoods. Further, compared to larger banks, community banks make a larger share of home purchase loans than loans for other purposes such as refinancing or home improvement. For this reason, community bank mortgage lending plays a more significant role in the housing market than their percentage of market share would suggest. Finally, community banks make mostly conventional, non-government-backed loans, which most policy makers want to encourage.⁴

Community banks strengthen the mortgage and housing markets with their conservative underwriting practices, as confirmed by Federal Reserve data. In recent years, the delinquency rate of mortgages held by community banks never exceeded 4 percent, compared to 8 percent to 12 percent for GSE mortgages, 22 percent for fixed rate subprime mortgages and 46 percent for subprime variable rate mortgages. In fact, community bank mortgages have outperformed fixed-rate, prime loans, thought to be the best-performing category of all loans.⁵

Community banks originate mortgage loans to be held in portfolio as well as to be sold into the secondary market. Properties in small and rural communities served by community banks are often unique with large and irregular plots of land. Because these properties lack adequate appraisal comparable sales, mortgages collateralized by these properties do not fit the standardized "cookie-cutter" requirements of the secondary market. In addition, the borrowers may be farmers, small business owners or first-time homebuyers whose debt-to-income ratios fall outside of secondary market parameters, despite their personal net worth and other means to repay the loan. For this reason, community banks that serve rural markets are often predominantly portfolio lenders. Large lenders shun such loans because they do not fit their underwriting models and require first-hand assessment of the property and the borrower. Only community banks are willing to extend credit to such borrowers, often through the use of balloon payment or adjustable-rate mortgage loans held in portfolio, because holding a fixed-rate 15-year or 30-year fixed-rate mortgage would expose a community bank to unmanageable interest rate risk. Still, even for community banks that are predominantly portfolio lenders, it is critical they have robust secondary market access in order to meet customer demand for 30-year fixed-rate loans.

Community Banks and the Secondary Market

Community banks have been active users of the secondary market and sellers to the GSEs for many years. Depending on the bank's business strategy and loan demand, some community banks may sell all

³ FDIC Community Banking Study, December 2012. Page 3-5.
(<http://www.fdic.gov/regulations/resources/cbi/study.html>)

⁴ The data in this paragraph derive from "Community Banks and Mortgage Lending," Remarks by Federal Reserve Governor Elizabeth Duke. November 9, 2012. Page 9.

⁵ Ibid. Page 13.

or a significant portion of their loans into the secondary market, directly to the GSEs. According to a recent ICBA survey, nearly 30 percent of community bank respondents sell half or more of the mortgages they originate into the secondary market.⁶

Other community banks may sell only a portion of their mortgage loan originations to the GSEs. Some do not have the production volume to support the staff and technology resources needed to sell and service mortgage loans for the GSEs. These banks may sell up to other larger community banks on a correspondent basis, or to larger aggregators.

The Federal Home Loan Banks (FHLBanks) have several mortgage programs that are popular with community banks. These programs vary between the FHLBanks, but are another option for community banks to sell loans in the secondary market without going through GSEs or large national aggregators. In recent years, many community bankers have increased their use of the FHLBank mortgage programs as the GSEs became focused on large mortgage lenders and the large national aggregators. Community bankers found the FHLBank mortgage programs recognized and compensated them for the high-credit-quality loans they originated, whereas the GSE programs tended only to reward large production volumes with better pricing and more favorable credit terms. The FHLBank mortgage programs also permit the community bank to retain the servicing on mortgage loans sold, thereby maintaining the bank's relationships with their customers.

Community banks that sell directly to the GSEs today enjoy a very liquid market that permits them to effectively hedge interest rate risk and offer rate locks to their customers with relative ease and at a low cost. They can access this market on a single loan basis, retain servicing rights, enjoy a virtually paperless loan delivery process, and generally receive funding from the GSEs in cash within 24 to 48 hours. In contrast, a typical aggregator (i) generally requires delivery of paper loan files; (ii) delays funding to the community bank by 7 to 14 days; and (iii) requires the transfer of servicing rights. Aggregator sales are an inferior option that will only deter community bank mortgage lending. Any new system of housing finance must be able to match clear advantages of direct GSE sales enjoyed by community banks today. The advantages cut both ways. Ready secondary market access strengthens community banks, and community bank-originated mortgages strengthen the secondary markets. Community bank loans sold to Fannie Mae, Freddie Mac, and the FHLBanks are underwritten as though they were to be held in portfolio. The bank often goes beyond the ratios and statistics used by the GSE automated programs and underwrites based on direct and personal knowledge of the community and the lifestyle of the specific borrower. This high-quality relationship underwriting makes a striking impact on the performance data. In a typical year, before the GSEs accelerated their purchases of riskier loans, community bank-originated loans became "seriously delinquent" (i.e., more than three months delinquent) at about one-third the rate of all GSE loans. In the most frenzied, exuberant years of mortgage lending, 2005 through 2007, the general pool of GSE loans was seriously delinquent at a rate four or five times higher than loans originated by community banks and sold to GSEs. In the wake of the financial crisis, with the general tightening in underwriting standards, community bank loans have continued to perform better—with a delinquency rate one-third to one-half that of other loans.⁷ Community bank loans perform better in all market conditions and contribute to the safety and soundness of the secondary markets. Their role must be preserved in any reform.

⁶ ICBA Mortgage Lending Survey. September 2012.

⁷ Affinity External Report –ICBA, Fannie Mae, June 2013

Selling loans into the secondary market frees up valuable capital, which allows community banks to reinvest in mortgage loans or small business or commercial loans, helping their communities grow. What's more, according to Federal Reserve data, community banks that originate and sell mortgages into the secondary market are significantly more profitable than those that do not.⁸ In view of this data, the government should pursue policies that preserve and expand secondary market access for community banks in order to sustain a competitive banking sector by supporting community bank revenues and helping them to offset increasing regulatory costs.

Principles for Secondary Market Reform

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 and conditions 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 and direct access on a single-loan basis. To be sustainable and robust, a secondary market must be impartial and provide equitable and direct access for community banks on a single-loan basis that does not require the community bank to securitize its own loans. Pricing to all lenders should be equal regardless of 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.

Complexity should not force consolidation. Under the current GSE model, selling loans is relatively simple. Sellers take out commitments to sell loans on a single-loan basis and are not required to obtain complex credit enhancements except for private mortgage insurance for loans in excess of 80 percent loan-to-value or other guarantees. Any future secondary market structure must preserve this relatively simple process for community banks and other small lenders that individually do not have the scale or resources to obtain and manage complex credit enhancements from multiple parties.

Capital, liquidity, and reliability. Secondary market entities must be very well capitalized, liquid, and reliable enough to effectively serve the entire mortgage industry in all markets, at all times, even in challenging economic circumstances. They must be able to access the financial markets at all times to provide the required credit enhancements and to securitize and distribute the mortgage loans they acquire through their aggregation efforts. The current market in GSE mortgage-backed securities (MBS), with over \$10 trillion in securities issued, is well known and understood by institutional investors and highly liquid. The GSEs' MBS trade with the same speed and ease as U.S. Treasury securities. They are held by investors worldwide, including many community banks. Any new MBS will not have this liquidity initially, which will likely increase mortgage rates for some time until investors become comfortable with any new pass-through and guaranty structure. Care must be taken in the transition to any new MBS structure not to disrupt this critical liquidity.

⁸ Governor Duke Remarks, page 12.

Strong oversight from a single regulator. Weak and ineffective regulation of the GSEs enabled them to stray from their primary mission as aggregators, guarantors, and securitizers. Robust oversight must be provided by a strong and competent regulator. This regulator must ensure the GSEs or any future entity are adequately capitalized commensurate with their risks and compliant with their primary mission. The regulator must also ensure the secondary market operates in a safe and sound manner so taxpayers are not put at risk.

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 that lenders release servicing rights along with their loans. 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 community banks the opportunity to meet the additional banking needs of their 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 for good.

An explicit government guarantee. In order for the market to remain deep and liquid, government catastrophic loss protection must be fully and explicitly priced into the guarantee fee and the loan-level price. This guarantee is needed to provide credit assurances to investors, sustaining robust liquidity even during periods of market stress.

The Future of the Secondary Market

There is widespread agreement the secondary market must be reformed to prevent or greatly reduce the impact of devastating market failures that hobbled our economy. There is consensus that, as the market recovers, the government's dominant role in the housing market should be reduced to its more traditional role (less than 50 percent of secondary market sales). The private sector should return to its traditional role in providing the majority of the capital in mortgage finance. ICBA welcomes the return to a more balanced and less concentrated housing finance system with an appropriate role for portfolio lenders, originate-and-sell lenders, and small as well as large lenders. If implemented thoughtfully, such a system would reduce the moral hazard and taxpayer liability of the current system. Community banks are prepared to adapt and thrive in this environment.

Concepts That Would Not Meet Community Bank Principles. However, a number of proposals have been advanced that would not meet the principles described above and would effectively limit community bank participation or eliminate direct access to the market completely.

Federal Home Loan Banks. While there may be a role for the FHLBanks in a future secondary market system, they should not be the sole aggregator for community banks. Community banks need more secondary market options, not fewer. In addition, secondary market activities pose new risks for the FHLBanks. Those that concentrated more heavily on their mortgage programs experienced serious financial problems. What's more, secondary market business would be a distraction from the primary function of the FHLBanks: providing liquidity and wholesale funding through the advance business. Community banks depend on FHLBank advances, and secondary market reform should not put this important source of liquidity at risk.

Covered Bonds. Covered bonds have been advanced as an alternative to the secondary markets in providing liquidity to loan originators. However, these bonds are capital intensive, which makes them infeasible for all but the largest banks. Smaller lenders would have to sell their loans to larger banks, thus fueling further concentration and consolidation, effectively exchanging one form of government guarantee (the GSEs) for another (the implicit guarantee of too-big-to-fail institutions). Legislative proposals have been put forward to make covered bonds more attractive to investors by enhancing investor claims over the pool of assets that secures (or "covers") a covered bond. ICBA is concerned these proposals may provide covered bond investors superior rights in receivership that are not provided to other secured creditors. "Super priority" status for the covered bond investor could affect the Deposit Insurance Fund (DIF) in the event an FDIC-insured institution that issued these covered bonds fails. As stakeholders in the DIF, community banks would be forced to cover these losses, though they derive no benefit from covered bonds. Like all secondary market proposals, more analysis and rigorous debate is warranted to avoid unintended consequences.

Complex Credit Enhancements. Complex credit enhancements that require the management of multiple counterparties can create additional risks for both the marketplace and the issuers themselves. Because these risks would be too great for small lenders to bear, requirements for complex credit enhancements as part of a secondary market housing finance system would force additional market consolidation and shift yet more control to the largest lenders and Wall Street firms.

Shortcomings of Current Proposals. In creating a new housing finance system to address the problems of the old system and restore balance among portfolio lenders, small lenders, and large lenders, policymakers must be careful not to create a new system that destroys liquidity for all but the few largest players, limits access to the market or narrows options for smaller lenders, and imposes requirements that make it too costly for smaller lenders and servicers to participate. The common thread in the major proposals presented to date is they would promote consolidation at the expense of smaller lenders and consumers.

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 market functions in all economic conditions. 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 at the expense of smaller, more responsible players. 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 have just been through.

Without secondary market access, long-term fixed-rate lending would be impossible for community banks to offer their customers due to the interest rate risk. Community banks might continue to engage in portfolio lending likely through adjustable-rate mortgages, which consumers understandably avoid, or balloon-payment loans. But the market for long-term fixed-rate lending would consolidate even more than it has already. Drastically reduced competition would narrow product choice, drive up interest rates and fees, tighten credit standards, and degrade customer service at every stage of the borrowing experience from application, to closing, to servicing, to accommodating consumer difficulties with repayment. Whole swathes of the country, especially in rural areas, might be left with no access to mortgage credit at all or, at best, one take-it-or-leave-it lender. Fewer mortgage options would make it harder to sell a home, depress pricing, and hinder the recovery of the housing market, which in turn is linked to construction employment, consumer wealth and spending, and the broader economy.

Closing

Reform of our nation's housing finance system, which includes the reform of the GSEs and secondary market, must be done carefully, thoughtfully, and gradually to prevent the disruption of the flow of funds into the housing market. Policymakers must consider all options, which should include restructuring the GSEs to address the issues that caused them to fail. Whatever course is chosen must have sufficient safeguards to prevent another collapse of the housing market. Steps have already been taken by Congress and the Consumer Financial Protection Bureau through new mortgage requirements and regulations. However, care must be taken to prevent further consolidation of the mortgage business both in originations and servicing. Consolidation creates outsized risk that threatens the entire financial system.

Community banks are natural mortgage lenders. They produce high-quality loans from their local communities funded by local deposits. However, they cannot, in all circumstances, hold 100 percent of the mortgages they originate in portfolio. Customer demand for long-term, fixed-rate mortgages and the imperative of reserving their balance sheets to serve the other credit needs of their communities require that all community banks have robust secondary market access. A system that requires pooling and securitization of loans with complex credit enhancements—activities that require significant scale as well as legal, compliance, and technological resources—simply does not present a viable option for community banks. They must be accommodated with a simple, direct method of selling loans. 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.