



Testimony of

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On behalf of the
Independent Community Bankers of America

Before the

United States Senate
Committee on Banking, Housing and Urban Affairs

Hearing on

**“Housing Finance Reform: Access to the Secondary Market
for Small Financial Institutions”**

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Washington, D.C.

Opening

Chairman Johnson, Ranking Member Shelby, members of the Committee, I am Jack Hartings, President and CEO of The Peoples Bank Company and a member of the Executive Committee of the Independent Community Bankers of America. The Peoples Bank Company is a \$350 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 "Housing Finance Reform: Access to the Secondary Market for Small Financial Institutions." Community bank mortgage lenders have a great deal at stake in the future of housing finance in this country. Any proposal for reform must support fair and robust access to the secondary market for community banks.

Community Banks Strengthen the Mortgage Market

Any broad based recovery of the housing market must involve community bank mortgage lending. 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. We all witnessed the danger and devastating fallout that resulted when mortgage lending became concentrated in a few major market players. We must promote beneficial competition and avoid further consolidation and concentration of the mortgage lending industry.

Quality Community Bank Mortgage Lending

The Peoples Bank Company has been in business for 105 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 personal knowledge of the borrower and their circumstances – not based on statistical modeling done in another part of the country. Community banks generally did not make subprime loans with the characteristics that have led to recent problems, such as "teaser" rates and lack of appropriate documentation. As responsible community-based lenders, community banks require appropriate documentation of borrower income and do not make loans that compel borrowers to refinance or sell in order to remain solvent. As a result, our borrowers are less likely to default.

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 portfolio. We often go beyond the ratios and statistics used by the GSE automated programs and underwrite based on direct and personal knowledge of the community and the lifestyle of the borrower him or herself. This 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. Community bank loans perform better in all market conditions and contribute to the safety and soundness of the secondary markets. Our role must be preserved in any reform.

Better underwriting is complemented by better servicing – the two sides of the lending equation. Community bank servicing, which is also based on our close ties to customers and communities, is more effective at keeping mortgages out of default. We know, for example, when an employer closes in our community and how that closure impacts the income of our borrowers. A servicer based 1,000 miles away won’t have such knowledge. Smaller servicing portfolios and better control of mortgage documents also provide an advantage over the large servicers. For these reasons, community banks have generally been able to identify repayment problems at the first signs of distress and work out mutually agreeable solutions with struggling borrowers.

As Congress and the agencies consider how to address the abusive servicing standards of some large lenders, they must recognize community banks have fundamentally different standards, practices, and risks. Overly prescriptive servicing requirements should not be applied across the board. For example, if the state attorneys general foreclosure settlement term sheet were applied to all banks, regardless of size, it would cause many community banks to exit the mortgage servicing business and accelerate consolidation of the servicing industry, leaving it to the largest too-big-to-fail lenders.

Fair Access to the Secondary Market

While community banks choose to hold many of their loans in portfolio, it is critical for community banks to have robust secondary market access in order to support lending demand with their balance sheets. My bank’s access to Freddie Mac, for example – I have a \$75 million servicing portfolio of loans we originated and sold to Freddie Mac -- allows me to support the broad lending needs in my community, fixed-rate lending in particular. 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. In addition, I have the assurance that Freddie Mac won't appropriate data from loans sold to solicit my customers with other banking products.

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 my mortgage loans into the secondary market frees up capital for other types of lending, such as commercial and small business, which is critical to our communities.

In addition to selling mortgage loans to Freddie Mac, for the past two years my bank has participated in the Mortgage Purchase Program (MPP) through the Federal Home Loan Bank of Cincinnati. While our sales to the MPP 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 an important 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. Given the fragile state of the housing market across America, there is no room for policy missteps and no luxury for experimentation. Housing and household operations make up 20 percent of our economy and thousands of jobs are at stake. Proven, practical solutions must take precedence over the theoretical.

With regard to the secondary market, the critical questions of corporate structure, governance, and mission will determine whether, and to what extent, community banks are able to participate. 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 seek 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 is operating 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 seek to deepen and extend 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 our customer relationships and our franchises after transferring loans.

Originators must have 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 – in fact I would make more by releasing servicing rights – it is a crucial aspect of my relationship-lending business model, giving me the opportunity to meet the additional banking needs of my customers.

Because the income provided by servicing is only enough to cover costs, ICBA is very concerned about a recent Federal Housing Finance Agency (FHFA) proposal to significantly reduce servicing fees and, by rewarding servicers of non-performing loans, remove the incentive for diligent servicing that keeps loans current. This would be unfair to community banks that predominantly service performing loans. Additionally, some of the proposed fees do not reflect the cost of loan servicing at a community bank.

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 the 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 not only provide credit assurances to investors, sustaining robust liquidity even during periods of market stress.

The Future of the Secondary Markets

For decades the housing GSEs worked well and supported high-quality mortgage lending by banks of all sizes. However, conflicting demands of investor expectations and arbitrary affordable housing goals, combined with weak oversight and inadequate risk management, sent the GSEs off track, ending a long and successful run. The steep and sudden drop in the value of GSE preferred shares had staggering consequences for many community banks that purchased these shares with the support of their regulators. My bank held Freddie Mac preferred shares, so I speak from first-hand experience. This injustice must be corrected by restoring the dividend payments on the preferred shares and paying injured holders the amount of suspended dividends.

There is widespread agreement that this troubled model must be reformed. Any reform cannot simply reestablish the GSEs or recreate them under a different name with the same scale and risks. An aggressive role for 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 however different are the successors to Fannie Mae and Freddie Mac are from the legacy of those institutions, we believe they must retain the key features and principles that allowed community banks to thrive 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. This would create a new moral hazard, just as pernicious as the one it replaced. The concentration of assets would make them too-big-to-fail. The market would know full well that the government would bail them out (as it did in 2008) rather than let the housing market and the economy collapse. These lenders would in effect become privatized “Fannies” and “Freddies,” with all the benefits and the risks that come with TBTF status. 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 fuels this 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 Wall Street 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 have exploited the trust of investors and brought the economy to the brink of collapse. Lack of trust in these firms has hindered private investment in the mortgage market and prolonged government dominance of it. They must not be allowed to reclaim a central role in our financial system.

A Note on Covered Bonds

While covered bonds have been advanced as an alternative to the secondary markets in providing liquidity to loan originators, they have, to date, enjoyed little investor interest. Also, these bonds are capital intensive which makes them infeasible for all but the largest banks. Banks like mine would have to sell their loans to larger banks thus fueling further concentration and consolidation.

With the conservatorship of Fannie Mae and Freddie Mac, there is some legislative interest in making covered bonds more attractive to investors by enhancing investor claims over the pool of assets that secures (or “covers”) a covered bond. ICBA continues to analyze the legislative proposals that have been put forward. We are concerned the covered bond system may provide covered bond investors superior rights in receivership that aren’t provided to other secured creditors. We have expressed our concerns with how this “super priority” status for the covered bond investor could affect the Deposit Insurance Fund (DIF) in the event an FDIC institution that held these covered bonds failed. Therefore, like all secondary market proposals, more analysis and rigorous debate is warranted to avoid unintended consequences.

ICBA Concept for Secondary Mortgage Market Reform¹

One option for reform, which would address the criteria outlined above, would replace Fannie Mae and Freddie Mac with lender-owned cooperatives.

We believe this proposal would protect taxpayers from another bailout, ensure equal access and pricing for lenders of all sizes, deter further consolidation, ensure liquidity during periods of market stress, preserve the significant benefits of the “to-be-announced” (TBA) market, and minimize disruption in the market by providing for the direct transfer of Fannie Mae’s and Freddie Mac’s infrastructure to the new co-ops. While ICBA is prepared to advance the co-op option, other options that address our principles may be equally appealing to community banks.

Cooperative governance would ensure broad access and deter excessive risk taking

The key securitization role of Fannie and Freddie could be done by cooperative entities owned by mortgage originators who purchase stock commensurate with their loan sales to the co-ops. This is similar to the capitalization of the Federal Home Loan Banks (FHLBs) and provides a capitalization source that can be adjusted based on market conditions and risk profile and performance of the co-ops’ book of business. Members

¹ ICBA’s cooperative model is similar to a proposal favorably analyzed by the New York Federal Reserve and the Government Accountability Office.

would have an incentive to transfer only soundly underwritten loans to the co-ops because any losses would adversely affect their own capital investment.

The co-ops would be governed on a one-company-one-vote basis. Big banks would not be allowed to dominate the new co-ops. Further, directors would be appointed to represent various sizes and classes of members, while a minority number of seats would be reserved for outside independent directors with financial expertise.

The advantage of this form of governance is that all co-op members would enjoy open and equal access and benefits in terms and pricing, regardless of their origination volume. This would prevent industry consolidation and preserve access to credit for the millions of small town and rural borrowers served by community banks. The co-ops would be required to provide liquidity to all home mortgage markets on a continuing and equitable basis. Guarantee fees and reinsurance fees would be set by the co-op boards and would be the same for all members. However, any mortgage originators with substandard loan performance would be subject to additional surcharges and restricted access until their loan performance improved.

The co-ops would guarantee a limited range of conservatively underwritten products: 15- and 30-year fully amortizing mortgage loans.

The co-ops would only be engaged in the secondary market and would be barred from operating in the primary market. They would not unfairly compete with mortgage originators.

A privately-capitalized guarantee fund would insulate taxpayers

Mortgage-backed securities issued by the co-ops would be guaranteed by a fund capitalized by co-op members as well as 3rd party guarantors. Resources would be mandatorily set aside in good times to prepare for challenging times. Any government catastrophic loss protection would be paid for by an appropriately-priced co-op premium. Any guarantee, must be fully and explicitly priced into the guarantee fee and loan level price, and would not only provide credit assurances to investors, sustaining robust liquidity even during periods of market stress, but – a point less often noted – it would enable the co-op securities to be exempt from SEC registration and trade in the “to-be-announced” (TBA) forward market.² Without the TBA market, which allows lenders to sell loans forward before they are even originated and to hedge their interest rate risk during the rate “lock” period, the typical 30-year fixed rate loan as we know it and on 8 8

² In a TBA trade, participants agree to exchange a given volume of mortgage backed securities at a specified date and at an agreed-upon price. This allows lenders to sell mortgages forward before they are even originated. Because it facilitates hedging of interest rate risk, the TBA market also allows lenders to offer borrowers an interest rate “lock” for as long as 90 days. TBA trades are based on an assumption of homogeneity among the securities that will actually be included in the MBS. This assumption is facilitated by standardization in the underwriting of mortgages and by a government guarantee, implied or explicit.

which our housing market is based will become a rarity. Again, private capital from members, mortgage insurers, and private reinsurers would absorb all but catastrophic losses to ensure taxpayer would be well insulated.

The infrastructure of Fannie and Freddie – including their personnel, patents, systems, automated underwriting engines – could be transfer to the new co-ops. This is an important and essential feature of the proposal as it would minimize disruption in the market and reduce the cost of the transition to the new system.

The outstanding debt and securitizations of Fannie and Freddie would maintain the current guarantee.

Strong Supervision

The Federal Housing Finance Agency (FHFA) would regulate and supervise the co-ops. FHFA would be responsible for setting and monitoring capital levels based on market conditions, portfolio performance and overall safety and soundness. FHFA would approve all new mortgage products purchased by the co-ops.

Closing

Private entities must play a more robust role in the mortgage securitization market. That much is all but settled. Still to be determined is what form those entities will take – instruments of Wall Street or those in which community banks and lenders of all sizes are equally represented and communities and customers of all varieties are served.

The co-op proposal is one option that encompasses our principles for a successful secondary market. ICBA looks forward to working with this committee, the Administration, and our industry partners to examine proposals that can support quality, competitive mortgage lending and are in the best interest of the communities we serve.

Thank you for holding this hearing and for the opportunity to testify.