ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

Testimony of

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On behalf of the

Independent Community Bankers of America

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Hearing on

"Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market"

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Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is William A. Loving, Jr., and I am President and CEO of Pendleton Community Bank, a $260 million asset bank in Franklin, West Virginia that serves four rural markets in West Virginia and one Virginia community. I am also Chairman of the Independent Community Bankers of America and I testify today on behalf of the nearly 7,000 community banks we represent. Thank you for convening this hearing on "Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market."

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. ICBA sincerely appreciates the opportunity to work with the 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 Secondary Mortgage Market

Community banks represent approximately 20 percent of the mortgage market, and 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] While many community banks choose to hold most of their mortgage loans in portfolio, robust secondary market access remains critical for them to support mortgage lending demand. This is particularly true for fixed-rate lending. For a community bank, it is prohibitively expensive to hedge the interest rate risk that comes with fixed-rate lending. Secondary market sales eliminate this risk.

Secondary market sales also play a critical role in helping community banks maintain their capital levels. While many community banks remain well-capitalized following the financial crisis, others are being forced by their regulators to raise new capital above minimum levels. The new Basel III rule will increase capital requirements. With the private capital markets still largely frozen for small and mid-sized banks, some are being forced to reduce their lending in order to raise their capital ratios. In this environment, the capital relief provided by selling mortgage loans in the secondary markets is especially important. Selling mortgage loans into the secondary market frees up capital for additional residential lending as well as other types of lending, such as commercial and small business, critical to supporting credit flow in small towns and communities.

Pendleton Community Bank holds most of its mortgage loans in portfolio. Our current portfolio includes nearly 1,500 loans valued at $76.6 million. However, in recent years we've sold an increasing volume of loans into the secondary market. In 2013, to date, we've sold 35 loans with a value of $4.5 million, which is already more in number and value than we sold all of last year,

[1] ICBA Mortgage Lending Survey. September 2012.

or in any prior year. We would sell more loans but are challenged, like many community bankers in small towns or rural areas, in identifying “comparable” sales in our rural markets where properties have unique characteristics which frequently disqualify them from secondary market sales.

Pendleton’s secondary market sales are driven by customer demand for 30-year fixed rate loans. As a community banker, meeting this customer demand is critical to our broader customer relationships and to our business model. As the housing market recovers, I expect we will continue to sell an increasing number of loans into the secondary market. Secondary market access is critical even for a primarily portfolio lender such as Pendleton.

Preserve What Works for Community Banks

The current GSE secondary mortgage market structure has worked well for community banks by providing equitable access, not competing at the retail level, and permitting community banks to retain mortgage servicing rights on the loans they sell.

Community banks selling 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 access this market on a single loan basis, enjoy a virtually paperless loan delivery process, and generally receive funding from the GSEs in cash within 24 to 48 hours. Any new system of housing finance must be able to match the clear advantages of direct GSE sales enjoyed by community banks today.

Under the current GSE model, selling loans is relatively simple. Banks 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.

Potential Reforms

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 bipartisan 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 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.

In creating a new housing finance system to address the problems of the old system and restore balance among portfolio lenders, small financial institutions, and large lenders, policymakers must be careful not to create a new system that eradicates 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.

Mutual

ICBA supports the creation of a Mutual Securitization Corporation (Mutual), as described in the Housing Finance Reform and Taxpayer Protection Act (S.1217), which would secure access to the secondary market for community banks and other small originators and would allow them to sell loans on a single loan basis, be paid in cash, and to retain the servicing rights. However, the success of the Mutual depends on the details and the implementation. The key considerations are: capitalization, technology, permitted activities, eligible sellers, and governance.

Capitalization

In order to provide equitable access, including the competitive pricing of the required third party credit enhancements and guarantees, the Mutual must be well-capitalized. While the exact level of capitalization will need to be determined by policymakers and the housing finance regulator, it is clear multiple sources of capital will be needed. If community banks and other small originators are required to provide the majority of the initial capitalization, the cost to the member institutions would be prohibitive. ICBA recommends using the profits of the current GSEs – or at least a portion of them – to capitalize the Mutual. The Mutual would be required to repay the government over time through its operational earnings. An annual maintenance fee charged to all sellers to the Mutual, not to exceed $1,000, would also help to offset some of the operational costs of the Mutual.

Technology

In order to facilitate the transition to a new system, all loan aggregation infrastructure, including any automated underwriting, uniform appraisal delivery data portal, loan delivery systems, pooling and pricing, committing systems, cash transfer systems, loan activity reporting and remittance systems should be transferred to the Mutual from the GSEs. Additionally, it will be necessary to transfer key GSE staff responsible for these functions along with the technology.

Eligible Sellers to the Mutual

The question of eligible sellers is critical to the viability and competitiveness of the Mutual and its ability to provide liquidity for all market participants. ICBA recommends all current approved GSE sellers and servicers in good standing with assets up to $500 billion be eligible to sell and service mortgages through the Mutual. In addition, the Federal Home Loan Banks and currently approved mortgage banking companies with an annual mortgage production of less than $100 billion should be eligible to sell to the Mutual. While the Mutual is targeted towards small to mid-sized lenders, larger institutions may prefer to sell loans for cash rather than securitize them. Allowing these larger lenders to access the Mutual will help build the scale needed to secure competitive terms for third party credit enhancements, improving liquidity for all sellers to the Mutual.

ICBA also believes the Mutual should be permitted to manage a limited retained portfolio comprised solely of eligible mortgage loans acquired from eligible sellers to the Mutual, to facilitate optimal pooling, credit enhancement, and securitization activities.

Governance and Regulation of the Mutual

To ensure proper representation of all the lenders who would use the Mutual to access the national secondary market, ICBA recommends a Board structure and the one member one vote voting structure similar to the FHLBs.

The Mutual, and the entire secondary market that uses any type of government guaranty (apart from the FHLBanks, which would be regulated separately), should be regulated by an entity with powers and oversight duties similar to the FDIC. In addition to oversight of the Mortgage Insurance Fund, this regulator should set standards and review and approve all entities seeking to be issuers, guarantors, servicers, document custodians, credit enhancement providers, entities that intend to structure or restructure MBS or mortgage debt issued with a government guarantee.

The housing finance regulator should have a governance structure similar to the FDIC. The CEO of the Mutual, at least one Mutual board member, and one FHLB member should have seats on the housing finance regulator board.

The Mutual should have a specific duty to serve all markets at all times, including small town and rural markets. This would include developing programs, underwriting guidelines, and appraisal rules to encourage the sale/securitization of loans on manufactured housing and housing in rural areas and small towns. ICBA would strongly support appraisal guidelines that would permit rural banks to sell more loans into the secondary market. The Mutual should be charged with developing both underwriting and appraisal guidelines that acknowledge the distinctive features of small town and rural markets, such as unique or large acreage collateral properties or borrowers who may have seasonal or farming income, and bar discrimination based on these features. Today it is difficult, if not impossible, to sell loans with such characteristics to the GSEs.

Role of the Federal Home Loan Banks

The Federal Home Loan Banks (FHLBanks) have several mortgage programs currently popular with community banks. Community bankers find the FHLBank mortgage programs recognize and compensate them for the high-credit-quality loans they originate. 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. Nearly 90 percent of ICBA members are FHLBank members.

The FHLBanks should be preserved as an access point to the national secondary market for community banks and should be eligible to sell loans to the Mutual. The additional option of selling to the FHLBanks, an arrangement with which many community banks are comfortable, is fully consistent with the role of a Mutual, would provide two access points, and would ease the transition to a new system.

ICBA is concerned about proposals that would rely on the FHLBanks as the sole aggregators for community banks. Community banks need more secondary market options, not fewer. However, secondary market activities do pose new risks for the FHLBanks. In the past, some FHLBanks that concentrated more heavily on their mortgage programs experienced serious financial problems. Though ICBA supports the FHLBanks role in the secondary market, the regulator must be vigilant that FHLBank secondary market business not 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.

Regulatory oversight of the FHLBs should remain separate with an independent agency as currently structured.

Underwriting and Servicing

Only loans meeting the Qualified Mortgage (QM) definition, as defined by the Consumer Financial Protection Bureau (CFPB), should be eligible for securitization and/or sale through the Mutual and contain a government guaranty. ICBA does not believe additional underwriting criteria should be set in statute. Rather, underwriting standards should be set and administered by the housing finance regulator for loans and securities seeking a government guarantee.

Servicing standards should be consistent with current GSE servicing standards, and should accommodate any exemptions small servicers enjoy under the CFPB mortgage servicing rules.

Transition from GSEs to the New Guarantor Structure and Mutual

The transition from the current GSEs to the new credit enhancement/guarantor structure must be gradual and transparent to prevent the disruption of the flow of funds into the housing market. This will allow the marketplace the opportunity to properly evaluate the value of the new credit enhancement/guarantor structures along with any changes in the pass-through structures of the mortgage-backed securities issued. In particular, the plan must address the need to maintain liquidity and investor acceptance of the new mortgage-backed securities.

This could be accomplished by preserving the GSEs as a backstop during the construction and transition to the new securitization platform. Newly issued GSE securities could be conformed to credit enhancement structures similar to the proposed structures to allow the market to adapt to the change. Selected functions and technologies of the GSEs – such as the GSEs' cash window pooling, credit enhancement, securitization processes -- could be moved to the Mutual, while more market-critical functions, such as the cash window, remain at the GSEs. The new guarantor structure (the FMIC guaranty, in the case of S. 1217) could then be substituted for the GSE guaranty, followed by a period during which the regulator monitors market reaction and acceptance. Once the regulator determines the market has accepted the FMIC guaranty, it could be made available to all approved issuers, and finally, the last GSE backstop, the cash window aggregation activities, could be moved to the Mutual and the GSEs could be shut down. Other methods could be equally effective in avoiding market disruption, but it is critical that the transition be carried out with transparency and deliberation.

S. 1217

ICBA is grateful to Senators Warner, Corker, and all the Committee cosponsors for introducing S. 1217, the Housing Finance Reform and Taxpayer Protection Act. ICBA sincerely appreciates the opportunity to provide input into this bill. We are encouraged by the inclusion of certain provisions to address 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.

ICBA continues to evaluate and make recommendations for improving S. 1217, so that it better addresses the concerns identified in this testimony. As noted above, we recommend significantly broadening access to the Mutual so that lenders with up to $500 billion in assets are eligible to sell loans.

Another major concern is that the proposed system is significantly complex relative to the current system. Credit enhancements require significant scale as well as legal, compliance, and technological resources. In addition, 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. Community banks must be accommodated with a simple, direct method of selling loans.

Closing

Mortgage lending is very important to community banks as they serve their customers. They make high-quality loans in 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 all community banks have robust secondary market access. Equal and straightforward access to the secondary market is a critical component for community banks. It is very important efforts to restructure the housing finance system continue to provide this essential portal to small financial institutions.

ICBA is pleased to see a robust debate emerging on housing finance reform. We look forward to continuing to work with members of this committee to create a system in which community banks and lenders of all sizes are equally represented and communities and customers of all varieties are served.