

Elizabeth A Duke: Community banks and mortgage lending

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at the Community Bankers Symposium, Chicago, Illinois, 9 November 2012.

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It is a real pleasure for me to have the opportunity to speak to community bankers at this annual Community Bankers Symposium sponsored jointly by the Federal Reserve Bank of Chicago, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). I know that many of you are concerned about the banking agencies' recent proposals to revise the capital rules, the so-called Basel III proposals.¹ So I will start my remarks with an update on those proposals. Then I will move to a more detailed discussion of some data that I have found interesting as I have been thinking about the effect of regulations as they relate to residential mortgage lending.

Before I begin, I want to assure you that all of my colleagues on the Board of Governors, including the Chairman, are concerned about the effect of regulation on community bank lending. In fact, we have established a subcommittee of the Board, which I chair, to focus on the supervision and regulation of community and small regional banks. In addition, we have established a Community Depository Institution Advisory Council (CDIAC) made up of community banks, thrifts, and credit unions to advise the Board about issues facing smaller institutions.² But I want to also be clear that any opinions I express today are my own and may not reflect those of other members of the Board.

Regulatory capital proposals

Let me turn now to the capital proposals. As we enter the final deliberative phase of this rulemaking, I want to emphasize that the feedback we have received during the comment period has been extremely valuable and that we will work very hard to address your concerns in the final rules. Also, I would like to address the specific concern expressed by some bankers that these rules will be effective January 1, 2013, forcing them to potentially make changes with little preparation. We have received a large number of comments and want to closely consider each issue. Therefore, the agencies this morning announced that we do not expect that any of the proposed rules would become effective on January 1, 2013.³ Further, the agencies offered the assurance that institutions will have time for transition once the rules are effective.

Before the proposals were issued, our staff of economists and analysts conducted research to estimate the potential impact of the proposed rules. Their analysis indicated that the vast majority of community banks would already meet the new standards. Nevertheless, it was critically important to hear directly from community banks to better understand how individual institutions and their business plans might be affected by the proposals.

Admittedly, the capital proposals were quite lengthy and in many cases applied only to the largest banking organizations. So, for the first time in a regulatory proposal that I'm aware of, short summaries were added to the capital proposals to explain more clearly which aspects were likely to affect community banks. The objective was to spare community bankers from

¹ See 77 FR 52791, 77 FR 52888, and 77 FR 52978. See also Federal Reserve Board of Governors (2012). "Federal Reserve Board invites comment on three proposed rules intended to help ensure banks maintain strong capital positions," press release, June 7.

² For more information, see the Board's public website.

³ See Federal Reserve Board of Governors (2012). "Agencies Provide Guidance on Regulatory Capital Rukemakings," press release, November 9.

having to wade through the many elements of the proposals that would apply almost exclusively to the largest institutions, and to encourage them to comment on those elements of the proposals most likely to affect their institutions. Judging from the number of comments we received from community banks, I would conclude that the summaries were at least somewhat helpful, and I hope that this innovation will become a standard part of large regulatory proposals in the future.

We expected the summaries to make a difference in the volume and detail of the responses we received, but still we weren't content to just issue the proposals and wait for comments. So the Federal Reserve planned a systematic effort to solicit and understand the views of community banks, one that has been more comprehensive than any I have seen in my time at the Board.

We launched these efforts at the Board's public meeting on June 7 of this year, when the capital proposals were approved and we began accepting comments. At that meeting, I reiterated my support for strong levels of high-quality capital in banks of all sizes, including community banks.⁴ The large number of community banks that failed over the past several years as a result of problems in their real estate loan portfolios has highlighted the importance of having a strong cushion of loss-absorbing capital. However, I also emphasized the importance of getting the details of the proposals right. I encouraged community banks, therefore, to submit comments on the proposals to help us understand the costs that revisions to the capital framework could add for smaller banks and the changes to their businesses that might result.

This summer we held a series of "Ask the Fed" sessions aimed primarily at banking organizations supervised by the Federal Reserve to provide an overview of the proposals, answer questions, and receive feedback. More than 3,000 bankers participated in these sessions, via teleconference or in person. We later summarized some of the most common questions that our staff received in an article in the first issue of **Community Banking Connections**, a new Federal Reserve publication specifically for community bankers.⁵ Board members and staff have also been meeting directly with various industry groups, including state bankers' associations, to hear their views on the proposals.

After the proposals had been out for a couple of months, a number of parties, including many community bankers, requested more time to analyze the proposals prior to submitting comment letters. As a result, the agencies decided to extend the original 90-day comment period by an additional 45 days.⁶ Also in response to requests, in September, the agencies made available a tool to help community banking organizations and others estimate the potential impact of the capital proposals on their regulatory capital ratios.⁷

We received more than 2,000 comment letters during the consultative period, which we are in the process of posting to the Board's public website. Our staff is currently reviewing each and every one of those letters. We take these comments very seriously, and we will be working with our colleagues at the OCC and FDIC to understand and analyze the many issues that have been raised.

⁴ See "Statement by Governor Elizabeth A. Duke," attachment to Federal Reserve press release (June 7, 2012).

⁵ See The Federal Reserve System (2012), "The Regulatory Capital Proposals: Frequently Asked Questions," *Community Banking Connections* (Third Quarter).

⁶ See Federal Reserve Board of Governors (2012), "Federal Reserve Board extends comment period on three proposed capital rules rulemakings until October 22, 2012," press release, August 8.

⁷ See Federal Reserve Board of Governors (2012), "Agencies release a regulatory capital estimation tool to assist in assessing the potential effects of recently proposed regulatory capital rules," press release, September 24.

We heard many different concerns during our outreach efforts, but there were some recurring themes, including: the complexity of the proposed changes, the operational costs that would be incurred to track data that are not currently needed to calculate capital ratios, the potential impact on mortgage lending of the proposed mortgage risk weights, the accelerated phase-out of trust preferred securities from tier 1 capital, and the potential volatility in regulatory capital arising from the inclusion of unrealized gains and losses on available-for-sale securities.

It's still far too early in the process to know where we and the other agencies are going to come out on these and other issues, or when final rules may be released. But what I can promise you is that before we issue final capital rules, we will do everything possible to address the concerns that have been expressed by community banks and still achieve the goal of having strong levels of high-quality capital – built up over a reasonable and realistic transitional period – in banks of all sizes, including community banks.

As we met with bankers and listened to them describe the threat to their role in residential mortgage lending posed by the proposed mortgage risk weightings, I realized that we had very little data about mortgages on the books of community banks. Much of our research has focused on securitized loans. So I set out to learn more about residential lending in smaller institutions, and as I did, it became clear to me that there are regulatory issues that go far beyond those raised in the capital proposals. I am now concerned that, even if the specific issues in the capital proposals can be addressed, the totality of new mortgage lending regulations might still seriously impair the ability of community banks to continue to offer their traditional mortgage products. In fact, in our discussions with community bankers, more of them report that they are reducing or eliminating their mortgage lending due to regulatory burden than report that they are entering or expanding their mortgage business in response to the business potential of low mortgage rates. I think this represents a real concern, both for mortgage availability and for the viability of community banking.

Community banks and mortgage lending

When I think about community banks, I usually envision a bank, thrift, or credit union that serves customers in one or more well-defined local markets and that is engaged in a traditional community banking model – making a variety of loans and funding itself primarily with local core deposits. At the Federal Reserve, we generally define our community bank portfolio as those institutions with \$10 billion or less in total assets, which is the definition I will use in this discussion.

In evaluating the effect of regulation on community banks, I divide the potential burden into three categories: (1) additional operational costs associated with compliance; (2) restrictions on fees, interest rates, or other forms of revenue; and (3) unintentional barriers to offering a service that are a result of regulatory complexity. Each of these effects is of some concern, but to me the most disturbing is the third category. If the effect of a regulation is to make a traditional banking service so complicated or expensive that significant numbers of community banks believe they can no longer offer that service, it should raise red flags and spur policymakers to reassess whether the potential benefits of the regulation outweigh the potential loss of community banks' participation in that part of the market. Unfortunately, my discussions with community bankers lead me to believe that we might be approaching that point with residential mortgage lending regulation.

I have thought a lot about how we have come to this point. I think it is because both the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and its implementing regulations attempt to avoid a repeat of the lending abuses that were identified in the crisis by using characteristics that were common in subprime lending as proxies for identification of problematic loans. While this is an understandable approach given the abuses in subprime lending, it fails to recognize that many of these same characteristics, such as higher interest rates or balloon payments, also are key aspects of traditional

community bank portfolio lending. But, as I will discuss later, these features in community bank lending do not appear to have resulted in nearly the level of borrower stress that was prevalent in subprime loans.

Community banks have long been a source of loans that, for a variety of reasons, do not fit the parameters of conforming government-sponsored enterprise loans or eligibility for government-guaranteed programs. Community banks typically hold these loans on their own balance sheets. They use higher interest rates to compensate for the lack of liquidity in these loans or to cover higher processing costs because community banks lack economies of scale, and they use balloon payments as a simple way to limit their interest-rate risk. To the extent that regulations require additional operational procedures for such loans that are prohibitively expensive, raise the liability associated with making them, or create capital requirements that are out of proportion to the riskiness of the loans, community banks could be closed out of these products altogether.

How concerned should we be if community banks start pulling out of mortgage lending? To answer this, I think it is important to answer three more fundamental questions. First, how important is community bank lending to the overall mortgage market? Second, how important is mortgage lending to the community banking model? And third, are there any indications that community bank lending poses the same risks as the subprime lending that shared many of the same characteristics?

How important is community bank lending to the overall mortgage market?

One of the advantages of working at the Federal Reserve is having access to what I believe is one of the finest research staffs anywhere. Because of the Federal Reserve's role in the economy and financial stability, we have teams of top-notch economists and financial analysts to help policymakers reach the best possible understanding of economic and financial trends. But they are equally valuable in assessing the effects of regulatory policy. So I asked Federal Reserve staff to examine available data to try to come up with answers to my questions about mortgage lending and community banks. I would like to share with you the answers they uncovered.

Analysis of annual data on home lending reported pursuant to the Home Mortgage Disclosure Act (HMDA) provides insight into the role of community banks in the mortgage market.⁸ As you may know, HMDA requires banking institutions, credit unions, and mortgage companies with offices in metropolitan areas to report details about the applications they receive and the loans they extend each year.⁹

To investigate the role of community banks in the home lending market and to foster a more detailed understanding of mortgage lending within the broad group of community banks, our staff sorted lending institutions in HMDA into three asset size categories: smaller community banks with assets under \$500 million, larger community banks with assets between \$500 million and \$10 billion, and large banks with assets of more than \$10 billion. For the analysis, all affiliated entities were combined and treated as a single organization.

The HMDA data indicate that community banks account for a significant fraction of total home loan originations each year. Smaller community banks account for about 5 percent of

⁸ For more information refer to Robert B. Avery, Kenneth P. Brevoort, Neil Bhutta, and Glenn B. Canner (2012), "The Mortgage Market in 2011: Highlights from the Data Reported under the Home Mortgage Disclosure Act (PDF)," *Federal Reserve Bulletin*, vol. 98 (September 18).

⁹ The data include information about the types and purposes of the loans; the disposition of applications; information about the borrowers, such as their incomes; and information about the location of the properties securing loans. Although HMDA's coverage does not extend to lending institutions with offices exclusively in rural areas, its coverage of the home lending market is considerable, including more than 7,600 institutions and nearly 12 million applications in 2011.

the originations annually and larger community banks an additional 13 percent.¹⁰ Credit unions, which are nearly all small, now account for an additional 7 percent of home loan originations. Thus, taken together, community banks and credit unions accounted for one-quarter of the new origination market in 2011. This is up from a combined market share of nearly 16 percent in 2004. Over the same time period, the share of loans originated by non-banks dropped from nearly one-third of all originations in 2004 to slightly more than one-quarter in 2011. The HMDA data further indicate that large banks accounted for about one-half of all originations in 2004 and about the same share in 2011.¹¹

Therefore, as overall originations have declined, originations by small banks have not fallen as much as those of large banks or non-banks. And, as a reminder, these data do not include loan originations by institutions that operate exclusively in rural areas that, if included, would presumably increase the share originated by community institutions. Furthermore, these smaller institutions have been able to hold their own in the marketplace even as their numbers were diminished over the past few years by a number of bank closures and acquisitions by larger banking organizations.¹²

Looking more closely at the HMDA data provides considerably more information about the nature of home lending undertaken by institutions and the extent to which loans are held in portfolio or sold. Compared to larger banks, community banks

- have notably larger shares of home purchase loans than loans for other purposes, such as refinancing or home improvement
- tend to originate proportionately more conventional loans than loans backed by government guarantees
- extend larger shares of their total home-purchase loans to low- or moderate-income individuals or borrowers in low- or moderate-income neighborhoods, lending that is the focus of the Community Reinvestment Act requirements to help serve the credit needs of local communities
- hold the loans they originate in portfolio and retain the credit risk, rather than transfer the risk by selling those loans to other market participants, such as Fannie Mae, Freddie Mac, or others¹³

The HMDA data also indicate that a larger share of the conventional loans extended by smaller lenders carry higher prices.¹⁴ The data do not provide much insight into why the pricing patterns differ across lender size groups, but it may be that the types of loans

¹⁰ Estimates are based on the number of first-lien mortgage originations related to one- to four-family dwellings as reported under HMDA.

¹¹ Some industry sources suggest that the mortgage market is getting more concentrated at the top. The share of mortgage-related activity of large banks is greater if market share estimates are based on both the number of loan originations and loan purchases.

¹² From year-end 2007 to June 2012, the number of banks with assets under \$10 billion declined 15 percent from 7,188 to 6,110.

¹³ In 2011, 56 percent of the conventional home-purchase loans by small community banks and about 40 percent of those originated by larger community banks were held in portfolio as compared to 30 percent for the largest banks. For this analysis only, loans originated in the first three quarters of 2011 were considered because of the delay between origination and loan sale. The analysis assumes loans sold to affiliates are held in portfolio.

¹⁴ Under HMDA, lenders report the spread between the “average prime offer rate” (APOR) and the annual percentage rate (APR) on a loan if the difference (or “spread”) exceeds 1.5 percentage points for first-lien loans or 3.5 percentage points for junior lien loans of a similar type (for example, a 30-year fixed-rate mortgage). The APOR, which is published weekly by the Federal Financial Institutions Examination Council (FFIEC), is an estimate of the APR on loans being offered to high-quality prime borrowers based on the contract interest rates and discount points reported by Freddie Mac in its Primary Mortgage Market Survey.

originated by smaller lenders tend to be nonconforming or out of the ordinary in other ways and consequently carry higher prices to compensate for the lower liquidity or somewhat higher credit and interest-rate risk.

Although the HMDA data provide us with an opportunity to learn quite a bit about the home lending activities of community banks and other lending institutions, the data have some important limitations, particularly since they only cover urban institutions and are available only through 2011. Other sources of data we can use to monitor the home lending activities of banking institutions are the Consolidated Reports of Condition and Income, or Call Reports, filed quarterly by all banking institutions, and the FR Y-9C reports filed by bank holding companies (BHCs).¹⁵

Data from Call Reports and FR Y-9C filings show a pattern in originations for sale that is similar to the shares of overall originations revealed by the HMDA data. In the first quarter of 2007, small BHCs accounted for less than 10 percent of mortgage loan sales by bank holding companies. However, by the second quarter of 2012, these institutions had almost doubled their share, accounting for nearly 20 percent of sales.

And, indeed, the net income from selling mortgage loans is attracting some new entrants. The number of banks reporting any income from sales, securitization, or servicing of mortgage loans has shown a substantial increase since 2007, with much of the entry occurring as the recession ended in the first half of 2009. Recent quarters have seen the entry of about 30 additional banks. But since the new entrants are all small, it will take a lot of them to make up for any pullback from the larger banking organizations.

Taken together, these data demonstrate that while the community bank share of the mortgage market is not large, it is significant. Thus, I would conclude from this evidence that the additional capacity provided by smaller lenders is important, especially at the margin, and could contribute to lowering mortgage rates and loosening lending standards.

How important is mortgage lending to the community banking model?

The same data that were used to examine the role of community banks in the mortgage market can also be used to analyze the importance of mortgage products to community banks. Overall, community banks accounted for approximately one-fifth of closed-end, first-lien mortgages retained in portfolio by all banks as of June 2012. Mortgage lending appears to be just as important to community banks as it is to larger banks, as both tend to devote about one-quarter of their on-balance-sheet loan portfolios to home loans. Moreover, the share of first-lien mortgages as a percent of loans held in portfolio has increased substantially since 2008 at institutions with less than \$10 billion in assets.

Call Report data suggest that only a small fraction of community banks engage in the origination of mortgages for sale, securitization, or mortgage servicing. Since the financial crisis, however, measures of profitability at banks with such activities have significantly exceeded those at community banks not engaged in these business lines. Comparing community banks that reported any income from sales, securitization, and servicing of mortgages in the second quarter of 2012 to those without such income reveals that those with such income had a 34 basis point advantage in terms of return on assets, that is, 1.26 percent compared to 0.92 percent. The differences in return on equity were similarly significant – 11.14 percent compared to 8.61 percent.

With net interest margins compressing and regulatory costs increasing, many community banks are struggling right now to generate income. As I said earlier, the addition of mortgage origination capacity and competition would seem likely to reduce rates and ease conditions

¹⁵ For Call Report data, refer to www2.fdic.gov/Call_TFR_Rpts. For FR Y-9C data, refer to www.ffiec.gov/nicpubweb/nicweb/nichome.aspx.

for borrowers. And the recent entry of new banks into the market indicates that barriers to entry are not prohibitive. So it seems to me that appropriate policy should encourage community banks to expand their mortgage lending rather than discourage them from doing so.

Are there any indications that community bank lending poses the same risks as subprime lending that shared many of the same characteristics?

I think I have made a reasonable case that community banks are important to the mortgage market and that mortgage lending can be, in turn, an important source of profits for community banks. None of this matters, however, if this lending poses a risk to the health of the institutions or to the consumers who are their customers. Community bankers argue that they never engaged in the sort of lending practices that led to the financial crisis. And I think that in most cases, the evidence supports their claims. However, as I mentioned earlier, data from the HMDA and Call Reports indicate that community bank lending does share some characteristics with subprime lending. For example, community banks appear to charge higher rates on their mortgage loans. And the maturity data in the Call Reports are consistent with variable-rate lending or balloon maturities on community banks' mortgage loans.

But looking for signs of stress in the performance of the loans reveals a stark difference between mortgage loans held by community banks and subprime loans. Over the last several years as mortgage delinquencies reached record levels, the serious delinquency rate of mortgages held by community banks did not go much over 4 percent, far lower than the serious delinquency rates that climbed to almost 22 percent for subprime, fixed-rate loans and more than 46 percent for subprime, variable-rate loans. In fact, over the last several years, on average, mortgages held by community banks outperformed even fixed-rate, prime loans, the best performing mortgage category. I think this statistic by itself is a strong testament to the responsible lending practices of community banks.

Balancing regulatory costs and benefits

Community bankers tell us repeatedly that they didn't engage in the problem lending that led to the recent crisis and shouldn't be punished with expensive regulation. I think the data I have presented here support the first claim that their lending didn't cause the problem. But crafting regulations to address the real problems that occurred in subprime lending without creating punitive burdens on community banks may prove to be quite difficult.

In addition to the capital proposals that I discussed earlier, community banks will be affected by a number of provisions in the Dodd-Frank Act, such as those covering escrow accounts for higher-priced mortgages,¹⁶ loan officer compensation, and appraisal requirements. Within the escrow requirements, the Dodd-Frank Act did provide for an exemption for banks in rural or underserved areas, but I think broader exemptions for community banks should be considered.

The definitions of qualified mortgages (QMs) and qualified residential mortgages (QRMs) could have a profound effect on the mortgage terms offered and the underwriting conditions for all banks. To the extent that these definitions constrain community bankers from using their experience with the cash flows from a small business customer or their knowledge of local real estate markets to customize a loan for an "irregular" situation, such loans may not be made. I do not mean to suggest that community banks are the only ones making good loans or that there weren't any problems in small banks. But I do believe that the contribution of community banks to mortgage lending abuses was proportionately small and that

¹⁶ An escrow account generally is any account that a servicer establishes or controls on behalf of a borrower to collect and pay taxes, insurance premiums, or other charges with respect to a mortgage loan.

problematic practices in smaller banks can be addressed through on-site supervision. And I also believe that many community banks simply do not have the resources to appropriately comply with all of the pending regulatory changes pertaining to mortgage lending. Thus, the cost of solving the problem falls disproportionately on them.

Conclusion: A separate set of rules for mortgage loans held by community banks

In mortgage lending, crafting a regulatory approach that is effective in preventing abuse but that leaves room for traditional community bank lending is challenging. And designing appropriate exemptions is no easier. I have presented evidence today indicating that community banks are important to the mortgage market, that they are able to relieve some capacity constraints at the margin, that mortgage lending is important to their balance sheets and their profitability in the aggregate, and that they are a source of responsible lending. Their lending is likely most important in the market for non-standard properties or borrowers.

Having confirmed these conditions, I am convinced that the best course for policymakers would be to abandon efforts for a one-size-fits-all approach to mortgage lending. Balancing the cost of regulation that is prescriptive with respect to underwriting, loan structure, and operating procedures against the lack of evidence that balance sheet lending by community banks created significant problems, I think an argument can be made that it is appropriate to establish a separate, simpler regulatory structure to cover such lending. Such a regime should still establish appropriate safeguards to protect consumers, but it should do so in a way that recognizes the characteristics of community bank lending, perhaps by focusing on appropriate disclosures and relying on regular on-site supervision to test for appropriate underwriting and loan structuring.

I originally requested this information to help me understand the implications of mortgage risk weightings in the capital proposal. But as I investigated the data, I realized that the regulatory burden surrounding mortgages extends beyond the capital rules and that addressing the problem will take more than a tweak here or an exemption there. I think it will require a different approach. The regulators cannot, on their own, craft a new approach to regulating mortgage lending by community banks. However, I hope that this data will be useful to bankers and policymakers as they discuss more broadly the establishment of a regulatory regime that preserves the important role of community banks in mortgage lending.