TESTIMONY OF

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COMMISSIONER

KENTUCKY DEPARTMENT OF FINANCIAL INSTITUTIONS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

“THE ABILITY-TO-REPAY AND QUALIFIED MORTGAGE STANDARD FINAL RULE”

Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

Tuesday, June 18, 2013, 10:00 a.m.

Room 2128 Rayburn House Office Building

INTRODUCTION

Good morning Chairman Capito, Ranking Member Meeks, and esteemed members of the Subcommittee. My name is Charles Vice, and I serve as the Commissioner of the Kentucky Department of Financial Institutions. I am also the Chairman of the Conference of State Bank Supervisors (CSBS).

I appreciate the work of this Subcommittee and the full Committee to examine the impact of the Ability-to-Repay Rule and the Qualified Mortgage (QM) on the financial services industry and consumers. I also appreciate the opportunity to participate in this important discussion.

CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. State banking regulators supervise 5,271 state-chartered depository institutions, most of which are community banks. Additionally, most state banking departments regulate a variety of non-bank financial services providers, including mortgage lenders. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy.

As part of this work, state banking commissioners have devoted tremendous effort to examining the regulatory environment for community banks. Through the CSBS Community Bank Steering Group and our policy development committees, we have reviewed community bank regulation, supervision, and proposals to address the challenges facing community banks.[1] As a result of these efforts, state regulators have identified portfolio lending as a key opportunity for policymakers to ensure community banks' ability to contribute positively to the economic well-being of their local markets. While today's hearing centers around the ability-to-repay rule and issues such as rural counties and balloon loans, the broader issue is the problems posed by a one-size-fits-all approach to regulating portfolio-based lending by community banks.

THE COMMUNITY BANKING BUSINESS MODEL

In my 25 years as both a federal and state bank regulator, it has become abundantly clear community banks are vital to economic development, job creation, and financial stability. The unique characteristics of the community bank business model set these institutions apart from the largest, most complex financial institutions.

For instance, community banks make credit available to individuals in all corners of the United States, ranging from the largest city to small, rural communities. According to the Federal Deposit Insurance Corporation's (FDIC) Community Banking Study, community banks are almost three times more likely than their counterparts to operate a banking office outside a metro area.[2] In fact, community banks are the only banking presence in 629 counties in the U.S.[3]

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[1] CSBS has identified a series of specific community bank regulatory relief proposals targeted at the key regulatory challenges that we see for smaller institutions. The full list of these proposals is included as Exhibit A at the end of this testimony.

[2] FDIC Community Banking Study, 3-4 (December 2012). *Available at* http://www.fdic.gov/regulations/resources/cbi/study.html.

By ensuring access to credit throughout the United States, community banks support areas otherwise not serviced by the financial services industry and provide a stabilizing force for the broader economy through macroeconomic cycles.

Community banks also fuel America's small businesses by understanding the local markets in which their customers operate. According to the FDIC Community Banking Study, while holding only 14 percent of banking industry assets, community banks hold 46 percent of the banking industry's small loans to farms and businesses.[4] While the nation's largest banks are also engaged in small-business lending on a large scale, the types of small business loans originated by community banks vary significantly from the small business loans originated at the largest banks. By the nature of their scale, the largest banks rely heavily upon model-driven lending practices, which turn small business loans into commodities. This system allows for tremendous volumes of loan origination, but fails to allow for judgment and flexibility at the local level.

Community banks are able to offer individualized credit products because they utilize different lending techniques than the largest institutions, engaging in relationship lending that considers "soft" data that can be more qualitative than quantitative. This enables community banks to originate and hold loans customized for their customers, including mortgages that would not qualify for the secondary market. Community banks make these loans because the banks understand the property, borrower, and credit type. This approach to lending supports communities in good times and bad, as witnessed by the $36 billion increase in mortgages held in portfolio by community banks when the secondary market came to a grinding halt in 2008.[5]

PORTFOLIO LENDING

My fellow regulators, and perhaps everyone in this chamber, agree lenders should determine a borrower's ability to repay the loan before extending any form of credit. It is a simple tenet of lending that was overlooked as new securitization-based lending models developed. As such, an explicit ability-to-repay standard as a response to a structural flaw in the originate-to-distribute business model is logical, despite the fact such requirements should be an inherent part of every mortgage transaction. However, lenders that hold loans on their books are fully incentivized to ensure the borrower can meet the monthly obligations of a mortgage. As such, lenders that retain the full risk of a borrower's default should be presumed to have made a good-faith effort of determining repayment ability, and it is their regulator's responsibility to trust and verify this determination.

Loans held in portfolio should be regulated and supervised differently than those originated for sale to third parties.

State regulators have long supported a flexible approach to underwriting for institutions that retain mortgages in portfolio because interests are inherently aligned between consumers and

[3] FDIC Community Banking Study at 3-5.
[4] FDIC Community Banking Study at 5-1.
[5] The amount of 1-4 Family Loans held in portfolio by banks with less than $10 billion in assets increased over $36 billion from year end 2007 to 2008. FDIC Statistics on Depository Institutions (March 2013).

lenders that retain 100 percent of the risk of default. When the consumer defaults, portfolio lenders are incentivized to work with the borrower to fix the problem.

We were pleased to see the Small Creditor QM rule recognizes the portfolio lending business model by creating a regulatory framework that supports the retention of mortgages in portfolio by community banks. The Consumer Financial Protection Bureau (CFPB, or the Bureau) appropriately summarized the aligned interest between borrowers and lenders, stating portfolio lenders "have strong incentives to carefully consider whether a consumer will be able to repay a portfolio loan at least in part because the small creditor retains the risk of default."[6]

To memorialize the aligned interests of portfolio lending, the CFPB has conferred QM benefits on loans originated by "small creditors." Small creditors are defined as those institutions with less than $2 billion in assets and fewer than 500 mortgage originations annually who keep those mortgages in their portfolio. These small creditors will be given more flexibility in the underwriting process, will not be subject to the prescribed 43 percent debt-to-income ratio requirement in the standard QM, and will have a higher cost threshold for the levels of protection conferred by QM status. The standard QM confers safe harbor protection from liability for loans that cost less than 1.5 percent above the average prime offer rate, and a lower level of legal protection – a rebuttable presumption of compliance – for those that cost 1.5 percent or more above the average prime offer rate. Recognizing that funding for community bank portfolio lending can be more expensive than other market participants, the CFPB increased this threshold to 3.5 percent for the small creditor QM. This threshold increase appropriately accounts for differences in the community bank business model, giving portfolio lenders the flexibility they need to originate loans based on consumer needs.

The policy implications of this regulatory right-sizing are critical for local economies across the country. By instilling legal certainty, community bank portfolio lenders will be able to make individualized lending determinations based on the credit needs of their customers. This is crucial for markets and borrowers who do not fit standardized credit profiles, reassuring lenders that properly underwrite loans that they have adequate legal protections when operating outside of secondary mortgage market parameters.

By promulgating a smaller institution-focused rule that recognizes the difference between portfolio lending and the originate-to-distribute model, the CFPB has taken the first step in appropriately tailoring regulation to the community bank business models. The CFPB Small Creditor QM is a starting point for right-sizing regulations as they apply to community banks, and CSBS encourages both Congressional and regulatory policymakers to utilize the CFPB small creditor concept as a model when moving forward in the development of other laws and rules that impact the portfolio loans of small creditors, such as appraisals, escrow, and capital requirements.

[6] Ability to Repay Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6622, 6624 (January 30, 2013).

<u>Balloon loans held in portfolio should be considered QMs if the creditor has considered the borrower's ability to repay on an amortized basis over the life of the loan.</u>

The treatment of balloon loans is one example where regulation is taking a broad brush approach that disadvantages community banks. When used responsibly, balloon loans are a useful source of credit for borrowers in all areas. Properly underwritten balloon loans are tailored to the needs and circumstances of the borrower, including situations where the borrower or property is otherwise ineligible for standard mortgage products. Since the mortgage is held in portfolio, community banks must work to ensure that the product is tailored to take into consideration all risks associated with the credit in order to avoid default.

Some have suggested that adjustable rate mortgages (ARMs) provide a suitable substitute for balloon loans. While many community banks and borrowers utilize ARMs, they are not necessarily the better option for all consumers. Because banks can restructure the terms of a balloon loan more easily than an ARM, they are able to offer the consumer more options for affordable monthly payments, especially in a rising interest rate environment. As a regulator, I prefer that lenders and borrowers in my state have flexibility and options when selecting consumer products and mortgages. Consumers and borrowers should not be forced into a product because of regulations prompted by the deficiencies of another business model. The ability for institutions and consumers to make informed decisions on the best suited product for their circumstances, such as a balloon loan, is an important risk-mitigation strategy I would like to see preserved.

In the run-up to the mortgage crisis, much of the underwriting for the "exploding" 2/28 and 3/27 teaser loans did not include a consideration of the borrower's ability to repay over the life of the loan and relied on the faulty assumption that housing prices would continue to rise. This business model did not have the consumer and investor protections inherent in all loans held in portfolio. Unfortunately, in addressing the failure of these products, the Dodd-Frank Act failed to consider the ramifications for banks that make traditional balloon loans responsibly and hold them in portfolio. By limiting balloon loans to those made in rural areas, the ability-to-repay and QM standards final rule eliminates a consumer-enabling product from being originated by lenders who retain 100 percent of the risk of default by holding the loan in portfolio.

The CFPB has made an effort to limit the negative statutory effects on balloons held in portfolio by extending the time frame before the balloon loan restrictions take place, potentially offering Congress an opportunity to act on this issue. This ensures portfolio lenders have time to work through issues with existing balloons, but also allows policymakers the opportunity to ensure a useful tool is not permanently removed from a bank's toolbox. Community banks offer balloons to satisfy consumer needs and accommodate their customers on an ongoing basis, which should be recognized under law. Accordingly, CSBS supports creating a statutory Small Creditor QM and applying it to all loans held in portfolio, including balloon loans.

Absent a legislative change conferring QM status on balloon loans held in portfolio, the CFPB should establish a petition process to fix inconsistencies in the rural designation process.

Balloon loans are currently eligible for QM status if they meet the basic QM requirements and are originated in a "rural or underserved" area.[7] The CFPB has the responsibility for defining "rural" and "underserved." Originally proposed by the Federal Reserve, the CFPB adopted certain county characteristics under the USDA's Urban Influence Code to determine the definition of "rural."[8] Though the CFPB clearly put considerable thought and effort into this definition, including expanding the narrow Urban Influence Codes proposed by the Federal Reserve, it has produced some illogical results. This is hard to avoid when trying to establish one standard for categorizing every rural area in a country with 3,794,000 square miles and more than 300 million people. Indeed, there are several federal rural definitions, including those based on Census Places, Census Urban Areas, Metro Counties, Rural-Urban Commuting Areas, contiguous Urbanized Areas, and others.

No single definition gets it right because land and population characteristics are inherently local and cannot be dictated by formula. Accordingly, CSBS has proposed that the CFPB establish a process whereby an interested party can petition the Bureau to designate a certain county as "rural" for the purposes of the balloon QM requirements under current law.

State geography makes it difficult to issue a uniformly applicable definition of "rural" based on county characteristics. A comparatively small state in land area, Kentucky has the third most counties with 120, behind only Texas (254) and Georgia (159). This makes Kentucky difficult to quantify for purposes of defining "rural" via Urban Influence Codes, which essentially consider a county part of a metropolitan or micropolitan statistical area if it borders a county that has a city of 10,000 or more. Since there are comparatively more counties in Kentucky than other states, a single county can have up to seven neighboring counties, thereby increasing the likelihood the Urban Influence Code will not necessarily reflect the underlying characteristics of the county.

As currently defined by the CFPB rule, the average rural county in Kentucky contains 57 people per square mile. However, there are 12 counties considered non-rural that have 57 people per square mile or less, including Bracken, Hancock, McLean, and Trimble counties, all with fewer than 10,000 people.[9] Conversely, there are 32 rural counties with more than 57 people per square mile, including one with 215 people per square mile and a total population of 65,565. It is illogical that a "rural" county can have six times the number of people on aggregate and five times the number of people per square mile than a non-rural county with a smaller population. These are the types of results that occur when an inherently local issue like determining the characteristics of land areas is done by formula in Washington, D.C. and not by local officials.

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[7] 15 U.S.C. § 1639c(b)(2)(E)(iv)(I).

[8] The applicable Urban Influence Codes for the rural definition are all noncore counties and micropolitan counties not adjacent to a metropolitan area. 12 C.F.R. 1026.25(b)(2)(iv)(A). For more information on Urban Influence Codes, see http://www.ers.usda.gov/data-products/urban-influence-codes.aspx.

[9] All census numbers are based on the 2010 census, which is the source of the currently applicable Urban Influence Codes.

This is the case in many other states. For example, Wirt County, West Virginia is not considered rural because of its proximity to Parkersburg. Wirt County has one town, Elizabeth, 24 unincorporated communities, and only 5,717 people. In Massachusetts, the island counties of Nantucket and Dukes (home of Martha's Vineyard) are considered rural, but the considerably less commercial Franklin County is not. There are five more people per square mile in Franklin County than Nantucket, but the counties are on opposite ends of the Urban Influence Code scale.

The CFPB's approach also creates illogical results in states with fewer, larger counties. For instance, Nye County, Nevada is the third-largest county in the United States. Despite containing only 2.42 persons per square mile and being home to Yucca Mountain, once considered for a nuclear waste repository because of its remoteness, Nye is not considered rural because it neighbors Clark County, home of Las Vegas.

To remedy the inconsistencies of a blanket approach to the rural definition and in the absence of a statutory change, CSBS has suggested the CFPB adopt a petition process for interested parties to seek rural designation for counties that do not fit the Urban Influence Code definition – a step that is within the CFPB's current authorities. CSBS recommended this approach to the CFPB in a letter dated March 26, 2013.[10] We stand ready to work with the CFPB to implement a regulatory process to enhance their challenging task of characterizing over 3,000 unique counties.

MOVING FORWARD

If the regulatory framework for the ability-to-repay requirement is going to encompass all mortgage lending, it needs to have the flexibility to adapt to varying business models – from originate-to-distribute lenders, to large banks that originate mortgages in a more production-line fashion, to community banks that hold loans in their portfolios. The originate-to-distribute market and the standardized lending models of large banks provide an excellent source of mortgage credit. However, the scale of these operations requires that underwriting be standardized to support a volume-focused business. This approach precludes the individualized lending determinations performed by community banks, which make a case-by-case determination of repayment ability for loans held in portfolio.

It is our responsibility as state regulators to ensure community banks can offer flexible products to meet the needs of their local communities, and it is the responsibility of policymakers to create a legal and regulatory framework that permits flexibility where borrower and lender interests are aligned. The CFPB has created a framework to accommodate this lending model through their Small Creditor QM, and policymakers should look to this framework in any reform initiatives.

At its core, community banking is about aligning economic incentives between borrower and lender. Community bank portfolio lenders are incentivized to ensure payments can be made over the life of the loan because they retain the full risk of default. Because of this risk, I expect the institutions I supervise to determine repayment ability based on the borrower's income,

[10] The CSBS letter to the CFPB is included as Exhibit B at the end of this testimony.

assets, employment, credit history, and ability to pay other debts. These are time-tested practices that ensure banks are lending in a safe and sound manner that regulators review through the supervisory process. This process works and should be encouraged for all loans held in portfolio by community banks to ensure they can continue to meet the credit needs of their communities.

Although this testimony focuses on mortgages and the Ability-to-Repay and QM Standard, we see the potentially harmful consequences of a one-size-fits-all approach to regulation across many areas of basic community banking and rules and regulations. For instance, banks need increased levels of and enhanced quality capital, but the Basel III standards designed for globally systemic financial institutions should not also apply to a $200 million bank. By way of comparison, Citibank in New York and Deutsche Bank in Frankfurt are respectively 5,000 and 10,000 times larger than the local community bank in Flemingsburg, Kentucky, creating a drastically different scope and scale of risks. Similarly, proprietary trades should not have the benefit of the federal safety net, but small banks should not have to prove they comply with the Volcker Rule when they only engage in basic commercial bank activities. As public officials charged with ensuring these institutions are well run and serve the local communities in which they operate, it is important federal policy appropriately recognizes the community bank business model for these institutions to continue serving their markets.

Thank you for the opportunity to testify today. State regulators stand ready to work with Members of Congress and our federal counterparts to develop and implement a supervisory framework that continues to recognize the importance of our unique dual-banking system.

CONFERENCE OF STATE BANK SUPERVISORS

Proposals for Community Bank Regulatory Relief
June 2013

As locally based and locally accountable regulators, State Banking Commissioners are committed to ensuring a diverse financial services and banking industry. CSBS and its members believe that community banks are a necessary part of this diverse system and key to ensuring locally accessible credit and financial services. CSBS and its members also are concerned about the challenges facing the community bank business model, particularly those challenges arising from regulation and supervision. As a result of the work of the CSBS Community Bank Steering Group, the CSBS Board of Directors, and the entire membership CSBS has developed this list of regulatory relief proposals focused on ensuring that regulation and supervision reflect the community bank business model.

1. The Law Should Ensure Regulations are Tailored for Portfolio Lending

   Banks that originate and hold consumer loans have an aligned economic interest with the borrower. These banks provide the capital to support the credit and live with the risk of non-performance. In some cases, the credit is tailored to the needs and circumstances of the borrower which may prohibit the loan from being sold on the secondary market. This is an important source of credit for consumers and small businesses. Therefore, regulations should be tailored in such a way that they support and do not impede portfolio lending.

2. Fair Lending Examination Procedures Must be Tailored to Recognize the Relationship Lending Model of Most Community Banks

   Many times it is not the statute that creates the problem but the interpretation, guidance, and the examination techniques utilized. Despite interagency examination guidelines and assurances of continued fair lending collaboration, the states have observed a drastic difference in how the three federal banking agencies treat community banks on these issues. Our Community Bank Steering Group has listed overzealous compliance/fair lending examinations as a major issue facing community banks.

   Application of one size fits all examination techniques and tools to community banks without regard for the use of judgment based on deep knowledge of local credit markets is not appropriate. For example, loans held in portfolio often are tailored to the needs and circumstances of the borrower. A fair lending analysis of community bank loans should capture the differences and nuances of how and why certain loans were made or why there may be a difference in terms.

Despite assurances to the contrary, we are seeing an examination approach that lacks recognition of the community bank business model. Institutions are abandoning certain products due to these examination practices. The result is that the consumer and small business person are forced to leave the banking system for alternative delivery of products at a higher cost.
In addition to requiring accountability through its oversight capacity, Congress should explore ways to recalibrate fair lending requirements to recognize the community bank approach to relationship-based lending. Supervisors must utilize their flexibility to look beyond statistical models to determine fair lending violations at community banks.

3. <u>Remove the Rural or Underserved Definition for Balloon Loans</u>

   Limitation of the rural or underserved standard to balloon loan qualified mortgages should be eliminated. Balloon loans should be treated under the basic small creditor Qualified Mortgage standard proposed by the CFPB.

4. <u>Appraiser Qualifications for Certain 1-4 Family Loans</u>

   Regulations regarding appraisals can curtail credit in smaller communities where there can be a lack of qualified appraisers or a lack of comparable sales. Congress should require regulations to accommodate portfolio loans for owner-occupied 1-4 family loans, recognizing the unique challenges to securing a qualified appraisal and the lender's proximity to the market.

5. <u>Ensure State Supervisory Representation on Federal Regulatory Bodies</u>

   The current FDIC Board does not include an individual with state regulatory experience as required by law. The FDI Act and Congressional intent clearly require that the FDIC Board must include an individual who has worked as a state official responsible for bank supervision. As the chartering authority for 74% of all banks in the U.S., state regulators bring an important regulatory perspective that reflects the realities of local economies and credit markets. Congress should refine the language of the FDI Act to ensure that Congress's intent is met and that the FDIC Board includes an individual who has worked in state government as a banking regulator.

   In creating the CFPB, Congress clearly recognized that the CFPB would touch a variety of state-regulated financial services providers, and Congress directed the CFPB to collaborate closely with state regulators across both bank and non-bank supervision. Should Congress choose to establish a CFPB governing board, it must include a member with state supervisory experience.

6. Revise the Dodd-Frank Act Creditworthiness Provisions

   Certain aspects of Dodd-Frank that require the federal regulators to remove references to credit rating agencies in their regulations have negative implications for permissible investments standards. Community banks will be required to perform more in depth analysis of investment options to demonstrate their investment grade status. Many community banks do not have to capacity to perform such analysis and may be forced to turn to expensive third party analysis or abandon certain investment options altogether. Many of these investments are local bond issues that provide critical support to schools and city and county governments. Congress should revisit the Dodd-Frank creditworthiness provisions to ensure this unintended consequence for community banks is resolved.

7. Application Decisions Related to Community Banks Should Not Set Precedent for SIFIs

   Community bank applications submitted to federal banking agencies for transactions such as mergers and capital investments can take an extended time to process because the agencies have to ensure the decision will not establish a precedent that could be exploited by larger institutions. Federal law could provide the necessary protection by stating that application decisions for banks below a specified size (perhaps $2 billion) do not establish a precedent for any institution designated as a SIFI (i.e., a bank holding company over $50 billion or a designated non-bank SIFI).
   To further address the length of time the agencies are taking to review these applications, the review and approval process for applications submitted by institutions below a certain size should be de-centralized with more final decision-making authority given to FDIC Regional Offices and the regional Federal Reserve Banks.

8. Deposit Insurance for Defined Transaction Accounts

   The expiration of the Transaction Account Guarantee program eliminated an option for community banks to serve local businesses during a time of continued economic uncertainty. To encourage businesses to bank with community banks, the FDIC should treat deposits in defined transaction accounts, such as payroll, as the deposits of the designated beneficiaries of the funds. As evidenced by deposit insurance for revocable trust accounts, the FDIC has the authority to apply pass-through insurance to defined transactions where relationships are fiduciary in nature, such as when payroll funds are placed in a transaction account for the benefit of explicit employees. This would ease business concerns and protect consumers by spreading deposit insurance to each employee’s share of the sum set aside for payday.

9. Risk-Based Capital

   Congress should mandate a study (by GAO or another applicable body) that investigates the value and utility of Risk-Based Capital for smaller institutions. The study should seek to understand how risk weights drive behavior in the volume and type of credit a bank originates, as well as the burden of providing the necessary data for calculation of the ratios.

10. Concern about Delayed Recognition of Losses

    Certain proposals addressing banking relief over the last few years have included provisions, such as delayed recognition of commercial real estate losses, that manipulate accounting standards in a fashion which overstates the financial condition of banking institution. We have longstanding safety and soundness concerns about measures that delay recognition of losses and believe they should not be included regulatory relief bills in the future.

Questions? Please contact:
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CONFERENCE OF STATE BANK SUPERVISORS

March 26, 2013

The Honorable Richard Cordray
Director
Consumer Financial Protection Bureau
1700 G Street, NW
Washington, D.C. 20552

Dear Director Cordray,

As the Consumer Financial Protection Bureau ("CFPB") prepares to implement balloon qualified mortgage and escrow requirements for rural creditors, the Conference of State Bank Supervisors ("CSBS") would like to take the opportunity to suggest an additional procedural mechanism for the CFPB to utilize when determining whether an area should be defined as "rural." To mediate the inconsistencies inherent in a nationwide rural classification system, CSBS recommends adopting a petition process whereby interested parties can petition the CFPB to make a determination that a specified and bounded area be considered rural for the purposes of Truth in Lending rural requirements.

COUNTY DESIGNATIONS REQUIRE A FLEXIBLE RURAL DESIGNATION ALTERNATIVE

Practically speaking, there is no single good manner to define "rural" in a country with 3,794,000 square miles and more than 300 million people. As a result, the rural designation will not be applied to areas inherently rural because states and county sizes vary significantly. For example, the third largest county in the United States, Nye County Nevada, has only 43,946 people over 18,159 square miles, or 2.42 persons per square mile. Due to its proximity to Las Vegas, Nye County is still considered a core county under the Urban Influence Code, thereby preventing it from being defined as rural for Truth in Lending purposes. This is evidenced by the fact that Nye is the site of Yucca Mountain, the Department of Energy's original proposed site for storing spent nuclear fuel because of its remoteness among other characteristics.

The variance in rural definitions stems beyond the Urban Influence Code. The United States Department of Agriculture Economic Research Service can generate nine different definitions of "rural" depending on land boundaries and population thresholds. This creates a myriad of "rural" possibilities, from Census Places with a population less than 2,500 people, to a definition based on Rural-Urban Commuting Areas. While these options do not use counties as boundaries, it is easy to see why the CFPB would use a metric that relies on counties – the Urban Influence Code – as the applicable land boundary. Every house must be in a county, which is an easily quantifiable area. However, the population of that county may vary significantly, as might the Urban Influence Code classification because of the surrounding populations.

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To mediate these inconsistencies, a process should exist whereby an interested party could petition the CFPB for a county to be considered rural. Specified criteria could be required, such as:

- Census Places data
- Census Urban Area data
- OMB Nonmetro County designation
- Rural-Urban Commuting Area data
- USDA Business and Industry ineligible location data
- USDA Rural Housing program criteria
- Population Density
- Population per square mile

Considering the changing dynamics of population, it might be logical to have open submission periods for such a process, whereby submitted data can be compared so the results can be consistent for all lenders. This would also be logical given Urban Influence Codes are subject to change.

When definitions affect credit availability, there should be some opportunity to submit a case to the defining body arguing why an area should be considered the type of area excepted for responsible balloon loan origination. CSBS would be happy to assist in the streamlining of such a process and commits to supporting any effort by the CFPB to mitigate the rural definition issue.

BALLOON LOANS ARE A CRUCIAL CREDIT PRODUCT FOR COMMUNITY BANKS

As a policy matter, CSBS believes portfolio lending aligns the interests of consumers and lenders, warranting a regulatory framework that encourages more originate-to-hold lending. CSBS believes the rural requirement for balloon qualified mortgages and escrow will often limit this type of responsible credit origination. However, CSBS recognizes the CFPB has limited options under the statute, further supporting the petition process outlined above.

Balloon loans held in portfolio give consumers significant interest rate flexibility. Consumers will refinance balloon loans regularly when interest rates are attractive, and most community banks provide this service without fees. Banks are able to provide this service better with balloon loans than adjustable-rate mortgages because the terms are simpler. Indeed, system capabilities often prevent community banks from servicing ARMs. Further, current funding mechanisms make it easier for small creditors to match funding for balloon loans than adjustable rate mortgages, making this form of credit cheaper for the consumer.

Community banks often originate balloon products and hold the mortgage on their books, refinancing and satisfying customer needs on an ongoing basis. Community banks also originate mortgages based on cost structures that do not include escrow services, working with the borrower to make sure taxes, insurance, and other required payments are made in a timely manner. These considerations are size based, not population based, and rural requirements will have a significant effect on the responsible mortgage products offered in many states. While we appreciate the final rural definition is much broader than the definition proposed, there may be opportunity to accommodate certain areas where this credit should be available despite Urban Influence Code classifications.

THE MARKET EFFECTS OF NEW RURAL DESIGNATIONS WILL BE NEGLIGIBLE

By definition, the balloon qualified mortgage and escrow requirements are local in nature. The mortgages must be held on balance sheet by small creditors in specified areas. Accordingly, there can be no meaningful impact on the broader credit market by having a rural petition process for the balloon qualified mortgage and escrow requirements.

As the CFPB continues to implement its mortgage rules, CSBS stands ready to help in the process as it relates to state and local areas.

Thank you for your consideration,

John W. Ryan
President & CEO

cc:

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