May 2, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. R-1406, RIN No. 7100-AD 65 (76 Fed. Reg. 11598 (March 2, 2011))

Dear Ms. Johnson,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Board of Governors of the Federal Reserve System's proposed rule amending Regulation Z, 12 C.F.R. Part 226, regarding escrow accounts for higher-priced mortgage loans secured by first lien dwellings, Docket No. R-1406, RIN No. 7100-AD 65. As noted in comment letters in April 2008 and October 2010, CSBS supports the Federal Reserve Board's proposal and the Dodd-Frank Act's mandate to require escrow for higher-priced loans; however, CSBS continues to support an exemption for insured depository institutions that portfolio mortgage loans. Further, CSBS believes the proposed rule's exemption for banks operating in rural or underserved areas falls short of the spirit of the statutory exemption and applies too narrowly and inconsistently across locations.

PORTFOLIO LENDING

As a matter of policy, CSBS believes regulations should not hinder an insured depository institution's willingness to engage in portfolio lending. Banks that portfolio loans retain the risk associated with borrowers failing to pay taxes, insurance, and other periodic payments; accordingly, it is not logical to require them to provide escrow accounts where the underwriting takes such factors into consideration. The margins on mortgages at portfolio lending depository institutions in many small communities are thin enough that escrow requirements could push local institutions to exit the market for higher-price jumbo mortgages, despite statutory language aimed at exempting institutions with smaller customer bases. Many banks today are not making residential real estate loans due to increased compliance burden. We cannot accept this as collateral damage in the interest of consistency and national policy.

EXEMPTION PURPOSE

As the Board notes in its discussion of the exemption, maintaining escrow accounts is not cost-effective for institutions with smaller portfolios. The exemption prescribed by §129D(c) is designed to relieve small portfolio lenders in less populated areas from the costs of escrow programs because these lenders operate in markets that prevent them from achieving the economies of scale necessary to absorb the marginal costs of escrow accounts. Where there is lower demand for mortgages simply due to the fact there are not high numbers of people in a geographic area, it is difficult for community banks to acquire the scale necessary for escrowing

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to be cost effective. The importance of understanding customers and local markets is crucial in these areas, and the payment of taxes and insurance becomes a part of the lending decision. Based on this market reality, the exemption should target institutions based on their size and customer base, which is not necessarily reflected under the proposed rule.

EXEMPTION CRITERIA

CSBS appreciates that determining whether an "area" is "rural" is not an easy task to implement on a nationwide basis. However, as currently written, the proposed rule does not sufficiently exempt all institutions that operate in rural areas and creates inconsistencies across geographic locations and across time.

Narrow Locations: As of December 31, 2010, 754 banks were located across 40 states in counties designated 7, 10, 11, or 12 on the Urban Influence Code. 600 of these banks are state chartered. Though the Urban Influence Code (UIC) is a good place to look for general area characteristics, there are areas that should be considered "rural" outside of counties coded 7, 10, 11, or 12. For example, Lincoln County, Nevada, has an Urban Influence Code of 4. Accordingly, banks predominantly engaged in business in this county will have to provide escrow accounts despite the fact that the county only had 4,165 people in 2000, or .39 persons per square mile. Similarly, banks in Roberts County, Texas, an 8 on the Urban Influence Code scale, would also be required to offer escrow accounts despite a county population of 887 persons, or 0.96 persons per square mile in 2000. Using only UICs to determine whether a bank is operating in a rural area chooses winners and losers outside of the intended statutory language. A community bank should not be required to abide by an escrow requirement simply because it is "adjacent" to a large metropolitan area 150 miles away.

Inconsistencies Over Time: The proposed rule's basis for determining rural areas creates a scenario where banks may be qualified or disqualified depending on the year. For example, while Dukes County, Massachusetts, the home of Martha's Vineyard, qualifies as "rural" under the proposed rule as a 12 under the Urban Influence Code, it contains almost 100 more people per square mile than Grafton County, New Hampshire, an 8. Under the 1993 Urban Influence Codes, Grafton County would have been rural as a 7, whereas Dukes County would not be rural as a 9. A change in "urban influence" will force exempt banks to provide escrow accounts regardless of whether the underlying customer base changes. The cost of this inconsistency is not one that should be borne by portfolio lenders.

RECOMMENDATION

As illustrated above, mandating that each regulatory standard be met for an institution to be exempt stymies the purpose of the statute because many institutions that cannot achieve the economies of scale for escrowing will nonetheless be forced to escrow. The proposed rule veers from the statutory intent by compounding each of the exemption criteria without taking asset thresholds into account. Accordingly, CSBS recommends multiple exemption thresholds to implement the tiered approach to banking that is necessary for meaningful statutory exemptions. Each exemption criteria in the proposed rule is a strong standalone threshold for escrow exemption and is an appropriate measure if the rule was written with "or" language.

Since the statutory language uses “and” language, CSBS recommends creating flexible exemption standards by using different sets of criteria, including asset thresholds, which would alternatively qualify institutions that the statute aims to exempt. For example, in addition to the current rule’s standards, an alternative could be added for banks predominantly lending in counties with less than a certain number of people and assets below a certain level. Another standard could be based on the number of originations (e.g. 100) under which institutions of all sizes would not have to escrow. This alternative would exempt the mid-size banks that do mortgage lending only as an accommodation to existing customers and may not have the scale to efficiently escrow. The proper lines to be drawn for such alternatives should be based on an understanding of markets, not broad statistical categories.

To better understand how to shape alternative exemption standards, CSBS recommends discussing the escrow exemption with community banks in rural and underserved areas. A firsthand account will be invaluable to determine a scale for “rural area” that transcends the geographic inconsistencies associated with county locations. Field hearings provide a good forum to hear from community banks and local officials to more fully understand the impact the dramatic changes in mortgage finance are having on a traditional bank’s ability to originate mortgage loans. The dialogue from such meetings can be a useful way to better understand an institution’s access to customers and the costs associated with limited access thereto. While most counties with an Urban Influence Code of 4 or 8 are unlikely to be rural, exceptions exist, and the institutions in these exception counties should not be prevented from utilizing an exemption designed to fit their economic needs. Discussing the costs of doing business with these institutions will be useful for shaping escrow exemptions for the institutions that cannot achieve the economies of scale necessary to cover escrow costs and shed light on other cost issues that may force community banks out of the housing finance market.

CONCLUSION

The issues raised by this exemption are illustrative of a difference in business models in today’s bifurcated banking industry. Regulatory requirements affect smaller institutions disproportionately because of a wide range of factors, including size, complexity, geographic location, management structure, and lines of business. Statutory exemptions aimed at minimizing regulatory consequences that disproportionately affect smaller institutions must be meaningful and should be construed broadly. By discussing this issue with community banks and local officials, all parties could start to better understand regulatory consequences inherent in the bifurcated banking arena.

Sincerely,

Neil Milner

Neil Milner
President & CEO