



Residential mortgages *and community banks*

Smaller insured financial institutions see less decline

Although the U.S. residential real estate market has deteriorated at an unprecedented level, with dramatic declines in both the number of homes sold and home prices, mortgage lending at First Westroads Bank in Omaha hasn't been affected quite like you'd guess.

Many financial institutions are experiencing steep reductions in lending, but Steve Robinson, the community bank's president and chief lending officer, says, "We have certainly seen an increase in the demand for permanent residential mortgage loans."

While the housing industry's descent has affected the banking industry as a whole, it seems that certain areas are faring better than others, says Jim Harvey, a policy economist at the Federal Reserve Bank of Kansas City. Harvey recently researched residential mortgages and their impact on community banks (small institutions, generally with assets less than \$1 billion). His analysis includes real

estate trends since 2005 and the likelihood they will continue.

The decline in the residential real estate industry has reduced demand for home mortgages. All lending, regardless of the type and size of lender, has dropped.

However, insured financial institutions—particularly smaller ones—have seen smaller declines in loan origination than other lenders, especially private mortgage banks. Loans purchased by nongovernment agencies have dropped dramatically, which has disproportionately affected private mortgage banks because they typically sell their loans in the secondary market. In contrast, insured financial institutions are more likely to hold loans rather than sell them in the private secondary market, although First Westroads Bank, for example, rarely holds loans on its books and has still fared better than larger institutions.

With the decline in the overall residential mortgage market during the last several years,

small banks' share of loan originations has doubled. This has occurred even as their overall volume of lending has declined slightly.

"There are reasons to believe this advantage may continue as the mortgage market begins to rebound during the next several years," Harvey says. "However, if this share is to be maintained, or grow, community banks likely will need to address challenges in their business practices."

Trends: mortgage lending, housing market

The U.S. residential real estate market has dramatically deteriorated during the last few years—declines in both the number of homes sold and home prices are unprecedented.

From 2005 through 2008:

- Sales: The total number of homes sold dropped by more than 35 percent. The market for new homes took a particularly hard hit—sales fell from 1.3 million to less than half a million.

- Prices: The median value of existing home prices declined 24 percent.

- Purchases: The number of home purchase loan originations fell 58 percent.

- Total loans: The number of total mortgage loan originations (including refinancing and home improvement) dropped 55 percent.

The decline in loan originations varied by the type and size of lending institution. From '05 to '08, insured depository institutions, including commercial banks, thrifts and credit unions, experienced a reduction of 45 percent, whereas private mortgage banks saw a drop of 72 percent.

"A major cause for the greater decline in loan activity at mortgage companies appears to have been their reliance on the private secondary market to fund the loans they originated," Harvey says.

Because mortgage companies don't have access to insured deposits to fund the loans they make, they typically sell the loans they originate in the secondary market. Their profits come from loan origination and other fees,

not from the interest earned on the loans. This means they're reliant on high volume and high fees.

By the second half of 2006, many secondary sources of funding, especially for higher risk loans, were nearly nonexistent. Mortgage banks didn't have sources of funding or capital to hold loans on their balance sheets, resulting in the dramatic drop in lending in '07 and '08.

"Reliance on private funding affected various types of lenders," Harvey says.

In '05, mortgage companies sold 72 percent of their loans in the private market, whereas depository institutions sold 24 percent of their loans in the private market. Both types of lenders saw similar declines in the private market, but because mortgage companies relied so heavily on the private market, they were hit harder than depository institutions, he says.

But perhaps most surprising is how well loan originations that were sold to government agencies fared, Harvey says. These loans fell just 13 percent from '05 to '08 and actually increased in '07 and '08. Mortgage companies had just a small share of this market and did not benefit from government agencies' continued growth during the recent turmoil.

While depository institutions fared better than mortgage companies, there are differences among banks depending on their size.

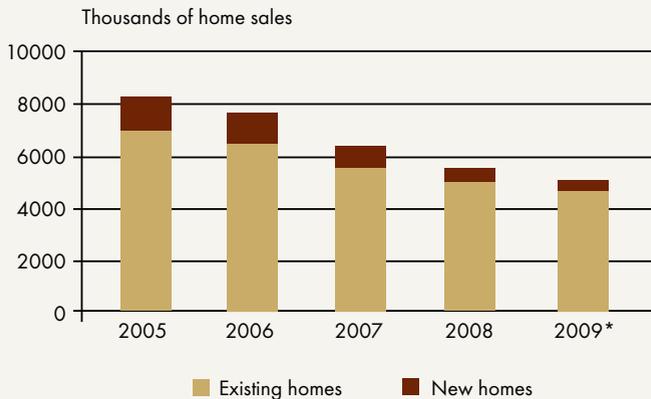


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Decline of home sales and home financing in recent years

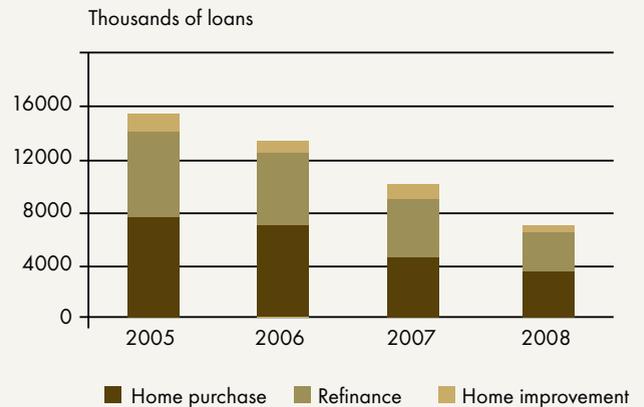
The U.S. housing market's dramatic decline in homes sold and home prices has affected the banking industry, greatly reducing the demand for home mortgages. Though all lending has dropped, smaller insured financial institutions have fared better than other lenders.

Number of new and existing homes sold



Source: National Association of Home Builders
* as of May 2009

Number of loans originated by loan purpose



Source: Home Mortgage Disclosure Reports, Federal Reserve System

- The largest banks (more than \$10 billion in assets) saw loan originations drop 51 percent;
- Medium-sized banks (\$1 billion-10 billion in assets) saw a drop of 31 percent; and
- Community banks (less than \$1 billion in assets) saw a drop of just 10 percent.

The difference, Harvey says, is that smaller banks generally are much less reliant on selling loans in the secondary market than other lenders, including larger banks. The share of loans originated at the smallest banks increased substantially, though this wasn't absolute growth but rather less of a reduction compared to the overall market. Community banks did increase their lending from 2006 onward—particularly noteworthy during what is likely the worst residential real estate market on record, Harvey says.

In addition to business practices, Robinson, of First Westroads Bank, says there

may be a couple of reasons why smaller banks have seen smaller declines in mortgage lending the past couple of years.

"I would attribute that to the availability of attractive loan rates and terms, as well as the \$8,000 first-time homebuyer tax credit (offered by the government) this past 12 months," he says. "Also, with the fallout from the subprime mortgage loan debacle, there has been a decrease in the number of residential mortgage loan originators resulting in more loan requests to those lenders still standing—including our community bank."

Relationship banking may be a factor as well.

"Another reason is the safety and soundness of the community bank and the trusting relationship the bank has established with its customers and the community," Robinson says. "Borrowers like the familiarity of their

community bank when it comes to handling the most important financial transaction of their lives.”

What does this mean for community banks?

After community banks doubled their share of loan originations since 2005, they still have just 7 percent of the residential real estate market. Maintaining or increasing this share seems feasible, Harvey says.

Residential real estate loans make up about 14 percent of community banks’ assets, or about \$178 billion total for all community banks. Assuming better than normal growth, this could reach \$400 billion during the next five to seven years, he says.

This magnitude of growth, Harvey adds, has implications for various areas of community banks’ financial performance, including:

Capital: A large increase in one type of asset such as residential real estate would mean each dollar of capital would be supporting a larger amount of assets. Some community banks may have the capacity to grow without needing additional capital, but they could also substitute residential real estate loans for other assets or raise capital, if necessary.

Asset quality: Community banks have experienced significant declines in their asset quality during the last two years. Residential real estate has been low-risk lending historically, but future expansion will require proper underwriting and pricing.

Earnings: Residential real estate loans don’t usually generate high interest rates compared to other types of lending. Therefore, increased residential real estate lending may not improve banks’ interest margins. However, it’s possible that rising residential real estate loans may improve earnings in other ways. Banks could see an increase in noninterest income if they maintain servicing rights on loans they originate and subsequently sell.

Liquidity / interest rate risk: The most difficult challenge community banks may face

in expanding residential real estate lending is managing liquidity and interest rate risk. They will need additional funding unless lending is reduced in other areas, and they already face long-term challenges to find stable funding sources. They could also face maturity mismatches if they use short-term funding sources, such as deposits, to fund longer-term mortgages. This would leave them vulnerable to rising interest rates.

For banks primarily originating and selling residential mortgage loans, Robinson says that qualified lenders, convenient locations, competitive loan products, technologically advanced tools, strong marketing and more are necessary.

“All of these elements require a capital commitment on the part of the bank,” Robinson says, “and the more the community bank wishes to grow this lending area, the more capital it will need.”

Harvey says recognizing how an increase in a specific asset, such as residential mortgages, would affect their financial performance is key.

“There are reasons to believe that this share of increases may stick as the residential real estate market begins to recover,” Harvey says. “That said, community banks will need to devise strategies to increase funding and manage interest rate risk to successfully grow their residential mortgage loan portfolios.”



BY BRYE STEEVES, SENIOR WRITER

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“TRENDS IN RESIDENTIAL MORTGAGE LOAN ORIGINATIONS AND THEIR IMPACT ON COMMUNITY BANKS”

By Jim Harvey
KansasCityFed.org/TEN

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