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FinPro's Don Musso talks QM, community bank challenges

By Robb Soukup

After covering FinPro Inc.'s annual Directors and Presidents conference, SNL caught up with FinPro President, CEO and Founder Don Musso. The longtime industry veteran discussed his concerns about the fallout of qualified-mortgage lending, the potential for more consolidation and how community banks need to adapt to survive in a rapidly changing industry. The following is an edited transcript of the conversation.

SNL Financial: I was in attendance earlier this month when FinPro held your President and Directors conference. What did you take away from the event or think were some important highlights?

Don Musso: The thing that surprised me the most was from our regulatory panel and the discussion on qualified mortgages. I think the regulators are living in a complete state of denial if they really believe that they're going to magically treat non-QM loans the same as QM loans — that is just not going to happen. So we're going to wake up and all non-QM loans are going to have a difficult time getting written and that's going to create all sorts of issues related to CRA and disparate impact. I think you heard Scott Polakoff and I stand up to them at the conference and say do you really know what the unintended consequences of this are? I am still in a little bit of a state of shock that the regulators have gotten this far and really don't have a clue about what will come down the pike.

In addition to those regulatory concerns, how is this going to change the way that community banks do mortgage lending, and business overall? Seems like it's a new process in a lot of ways for everybody?

I think community banks are in the business of relationships — we're relationship bankers. We're not commodity bankers. That's left to the big guys, so they can have a program that says your debt coverage ratio has to be X and the loan to value has to be Y. That's all well and good but in the real world there are all sorts of situations that create minor exceptions to those rules. And historically community banks have given those loans because we've known these borrowers. We're relationship oriented. Now, if it doesn't meet criteria it opens banks up for a huge amount of risk and I don't think banks are going to write those loans, certainly not until some case law gets established. Anybody with any wart whatsoever won't be able to get the loan, which won't be good for the economy, or banks or the local community. It's a disaster across the board. It seems like there are solutions being in place to problems that don't exist.

Is there going to be an unspoken expectation from regulators that banks write these non-QM loans?

There are a number of conflicting regulations out there, and no one has thought through how to unwind the conflict and get it so there's one coherent process. So on the one hand, community banks are not going to want to write non-QM loans because it means taking on liability, and if there are problems with the loans community banks are going to be the ones at risk.

So what would you want to see from regulators?

I'd like to see very clear guidance given on how non-QM loans are going to be treated by examiners. So, policy assurances that they are not going to be substandard the day that we write them. Policy assurances that they are not going to come back and criticize boards of directors for making policy exceptions and writing non-QM loans. A number of things.

What are some other strategic issues that you're really advising clients to keep a close eye on?

The whole issue of the way we go about planning has to change in our industry. We no longer can operate in a silo environment — we can't have one group that does asset liability, another doing budgeting and planning, another that does risk management. It's all one process and it's all integrated; it should be one mathematical and financial engine. What we're trying to impress upon our clients is that we are making decisions on an integrated basis, and proactively.

Obviously a lot of directors come from backgrounds other than banking, but we're in an increasingly complex banking world. How is that going to change the job of the director?

It's going to be a second job, which means that compensation is going to go up, even though a lot of activist investors don't like that. In the real world right now if you're a director you're spending a considerable amount of time and energy not just at meetings but at board training and understanding your bank, so I think it's going to be hard to attract talent into the ranks of community bank directors, and I think we're going to have to start compensating them adequately.

Switching gears, a lot of the industry is really focusing in on interest rate risk right now. How are you viewing that issue?

We are very concerned about two scenarios. One is that the economy just continues to sputter along, if you will, and it's not a super robust recovery. That's where we've been. When the Fed tapers it's very clear interest rates are going up. So we just don't know when they'll fully taper, in 2014 or 2015, but as soon as they do rates are going up. We clearly have interest rate risk in this business that has to be managed. So we are pushing people to do deposit disintermediation studies now so we understand which of our deposits are likely to stick with us and which are likely to run. It's clear to us based on the work we've done that money markets ebb and flow based on rates, so it's clear that all of the money markets parked in the banking space are likely to run. So we've recommended people move back into certificates of deposits, where we have a better propensity to renew.

One thing history has shown is that rates don't move up in a nice steady path. They jump and they jump quickly, so we're preparing clients for that now.

What do you see happening in the M&A market this year and going forward?

I think 2014 will see a lot of small bankers continuing to give up the reins. I just think it's becoming too burdensome for the small guy. I think many of them were waiting to get the right kind of metric, the right pricing so they could get out whole or with a modest gain. I think we're there now, but the problem is that there is a dearth of really good buyers. I think buyers are wondering: what I am acquiring and am I going to be able to keep what I bought? I do think there will be an uptick, but at the small end. I don't see a lot of big blockbuster deals happening, and I think it's mostly going to be the $500 million and under shop that is going to consolidate.