August 1, 2011

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, DC 20219
Docket Number OCC-2011-0002

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn.: Elizabeth M. Murphy, Secretary
File Number S7-14-11

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn.: Jennifer J. Johnson, Secretary
Docket No. R-1411

Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552
Attn.: Alfred M. Pollard, General Counsel
RIN 2590-AA43

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attn.: Comments, Robert E. Feldman
Executive Secretary
RIN 3064-AD74

Department of Housing and Urban Development
Regulations Division
Office of General Counsel
451 7th Street, SW
Room 10276
Washington, DC 20410-0500
Docket Number FR-5504-P-01

Re: Credit Risk Retention Proposed Rule

Dear Madams and Sirs:

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to comment on the proposed credit risk retention regulations (Proposal)[2] issued by the Board of Governors of the Federal Reserve System (Federal Reserve), Department of Housing and Urban Development (HUD), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA) and Securities and Exchange Commission (SEC)

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] 76 Fed. Reg. 83, 24089 – 24186, (Apr. 29, 2011).

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(together, the Agencies). The Proposal implements Section 941 of the Wall Street Reform and Consumer Protection Act of 2010[3] (Dodd-Frank), which authorizes the Agencies to issue rules requiring securitizers to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells or conveys to a third party.

The views and recommendations in this letter are from the **single family residential mortgage finance perspective**. The views of MBA's members related to the commercial and multifamily mortgage finance ("commercial") perspective were previously submitted to the Agencies on July 11, 2011. Because the Proposal establishes unique risk retention frameworks for residential mortgage backed securities (MBS) and commercial MBS, MBA is submitting two comment letters.

I. Introduction

MBA supports efforts to enhance the accountability of all housing finance transaction participants including borrowers, lenders, securities issuers and investors. We believe securitization is a valuable liquidity channel, particularly because portfolio lenders lack sufficient capacity to handle demand, and the future of the government sponsored enterprises (GSEs) is uncertain. However, we are mindful that securitization has unique challenges associated with ensuring accountability given the variety of interests and participants.

During the recent housing finance crisis, securitizers, lenders, investors and regulators all failed to recognize and address flaws inherent in the securitization channel before it was too late. A new system of accountability and transparency is needed to ensure that these mistakes are not repeated. A risk retention requirement is an important step in establishing a better regulatory plan to protect borrowers and investors, and ensure a safe and reliable mortgage system.

At the same time, it is essential that any risk retention requirements be done without unnecessarily constraining liquidity. Without a viable securitization market, the nation's housing finance needs cannot be met. MBA's detailed analysis regarding market impacts associated with risk retention requirements is included in the **Appendix** accompanying this letter.

There are two alternative frameworks for conceptualizing Dodd-Frank's risk retention provisions:

1. Some believe that Congress intended for risk retention to be the norm, i.e. that the vast majority of mortgage loans would be made with some form of risk retention, allowing for a small subset of pristine loans to benefit from the Qualified Residential Mortgage (QRM) exemption from risk retention requirements. This belief envisions a mortgage market that is entirely different than the U.S. market as it operates today, and a narrowly defined QRM exemption.

[3] Pub. L. 111-203, July 21, 2010.

2. Others, including MBA, believe that Congress intended to clearly demarcate and set apart riskier loans, and require risk retention on that subset. This framework envisions capturing within the QRM definition the products and practices that lower default risk such as those that have reemerged since the collapse of the housing finance market.

MBA believes that Congress' intent in crafting Dodd-Frank's risk retention requirements was to address errant securitizer and originator behavior inherent in the originate-to-sell model by aligning the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option. Recognizing these costs, Dodd-Frank establishes an exemption from risk retention requirements for QRMs. The QRM exemption was intended to recognize that traditional mortgage loans – standard products, properly underwritten and with appropriate documentation – were not the cause of this recent crisis, and securitization of these loans should remain unimpeded in order to return the mortgage securitization market to being among the most liquid in the world. By requiring a QRM exemption, the statute would keep consumer costs lower for QRMs, with higher costs for non-QRM loans. Congress has repeatedly expressed in statements and letters to regulators its belief that the QRM should be broadly defined.[4]

MBA believes the proposed regulations and structure of the QRM deviate significantly from what Congress intended and are likely to have a dramatic impact on the housing finance system unless they are substantially revised. We are grateful for the Agencies extending the comment period to provide additional time for analyzing the Proposal. However, we believe the wholesale changes needed to rework the Proposal merit the issuance of a revised Proposal along with another round of comments prior to finalizing the rule in order to fine tune and make further adjustments as appropriate. Because modifications to the rule require the approval of six regulators, it is imperative that the final rule be complete and effective in order to minimize the need for future rulemakings or supervisory issuances.

MBA's primary concerns, and suggested revisions are condensed in the Executive Summary below. The **Appendix** accompanying this letter provides an economic analysis of risk retention requirements. Although MBA has other concerns regarding operational elements of the Proposal, we believe it is imperative for the Agencies to first address the concerns raised in this letter. MBA's recommendations reflect the understanding that the risk retention regulations operate in concert with proposed regulations implementing the "Qualified Mortgage" definition under Dodd-Frank's "Ability to Repay" requirements (hereinafter "Qualified Mortgage" or "QM")[5] implementing regulations requiring lenders to verify a consumer's ability to repay any extension of housing finance credit.

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[4] See for example Credit Risk Retention comment letter submitted by Senators Mary Landrieu, Kay Hagan, and Johnny Isakson (May 26, 2011) and comment letter submitted by Representative Tom Price (April 15, 2011).
[5] 76 Fed. Reg. 27492 (May 11, 2011).

II. Summary of MBA's Principal Concerns and Suggested Modifications

1. **Qualified Residential Mortgage (QRM):** The proposed QRM eligibility criteria should be evaluated under the dual standard of whether they encourage quality underwriting and are in the public interest. We specifically request the relevant QRM eligibility criteria mentioned below to be aligned with the QM. This approach includes:
   - **1a. Loan-to-Value (LTV):** Eliminate the QRM's mandatory LTV and down payment thresholds. While a reasonable and affordable cash investment or LTV requirement may be warranted, the rules should not hardwire a specific amount but instead permit offsetting factors in the context of prudent underwriting. Higher LTV loans may pose greater risks. However, these risks can be mitigated by compensating factors such as strong credit and appropriate documentation.
   - **1b. Debt-to-Income (DTI):** Eliminate the QRM's hardwired front-end and back-end DTI ratios. Instead, require lenders to consider and verify a borrower's income, assets and obligations. Underwriters should have the flexibility to consider compensating factors to allow for a higher DTI. For lower-income households, this flexibility is especially important.
   - **1c. Credit history:** Eliminate the mandatory thresholds for individual negative credit events. This requirement may disproportionately penalize consumers for potentially minor offenses. Instead, require lenders to consider and verify credit history using widely accepted government or non-government standards.
   - **1d. Points and Fees**: Synchronize the QRM requirements with the QM standards to include, among other things, an exception for two discount points, and relief for smaller loans.
   - **1e. Mortgage Insurance or Other Credit Enhancements:** If the Agencies determine that some restriction on LTV must be included under the QRM exemption, we suggest credit enhancements to be considered when determining such a requirement.
   - **1f. Servicing Standards**: Eliminate the QRM's servicing requirements. National servicing standards may benefit the housing industry but they have no place in this Proposal.

2. **Premium Capture Cash Reserve Account (PCCRA):** MBA requests the PCCRA provisions be eliminated. The PCCRA requirements will make the securitization execution channel uneconomical for many lenders, raise consumer borrowing costs and make it harder for borrowers to obtain rate locks and finance transaction costs as part of the loan rate.

3. **Risk Retention Duration Requirement Needed:** Provide for the sun-setting of risk retention requirements between two to three years from loan origination. Defaults due to improper underwriting or other defects typically occur during the first two years. Beyond that period, most defaults are caused by life events or other external economic circumstances.

4. **Exemption for Seasoned Loans:** Exempt seasoned loans from risk retention requirements. A loan seasoned for two to three years prior to securitization and current at all times during that period should be exempt from risk retention requirements.

5. **Permit Commingled QRM and non-QRM Pools With Risk Retention Determined at the Asset Level:** Permit blended pools of QRM and non-QRM loans that meet the QM definition. If a securitizer must wait until it has assembled a "critical mass" of QRM loans sufficient to support an MBS offering, the liquidity of these loans could be significantly impaired.

6. **Other Considerations**
   - **6a. Federal Housing Administration (FHA), Fannie Mae, and Freddie Mac:** Evaluate the Proposal's impact on and alignment with contemporaneously proposed measures to restructure the federal government's role in housing finance.
   - **6b. Use MISMO[6] Standards for Data Definitions and Any Proposed Reporting Requirements:** MBA urges the agencies to utilize existing MISMO data standards when referring to proposed data elements, and these open, non-proprietary, voluntary consensus standards should be utilized for any new reporting requirements.
   - **6c. Regulatory Coordination:** The Agencies should establish a specific framework for ensuring consistency in issuing and interpreting supervisory risk retention guidance.
   - **6d. Electronic Commerce:** The Agencies should ensure that no rules are implemented that hinder movement towards the adoption of consumer-friendly electronic commerce, including electronic signatures.

7. **Re-Issue a Modified Proposal and Include a Detailed Impact Analysis:** The fundamental restructuring the Proposal would impose on the primary and secondary markets necessitates a comprehensive review of the impact on consumers, lenders, securities issuers, investors and the overall economy, including an analysis of the interplay between the Proposal and other regulatory requirements. The scope of the unresolved issues in the Proposal also merits a second round of comments on a revised proposal prior to issuing final regulations. We believe that the current cost-benefit estimate in the Proposal woefully understates the impact of this significant regulation.

III. MBA's Detailed Response

1. Qualified Residential Mortgage

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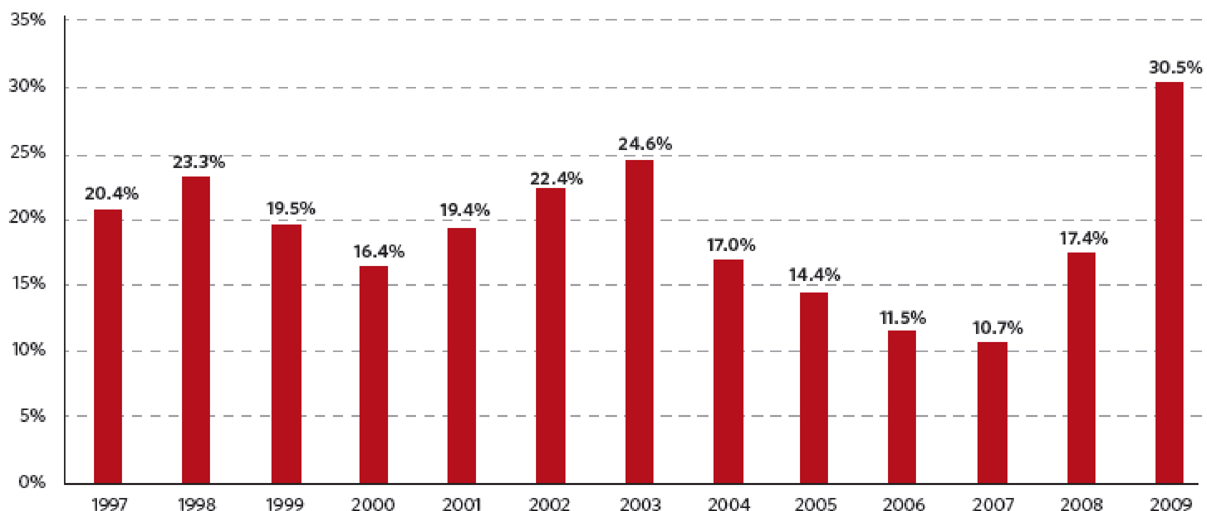
[6] See www.MISMO.org.

<u>The Proposal's Analytics Are Based on Conservative Data and Underestimate the True Impact on the Availability of Credit</u>

The Agencies expressed a desire to limit QRM loans to less than 50 percent of the market based on 2009 origination data. By most accounts, 2009 was the most cautiously underwritten, liquidity-constrained market in generations. For example, the average LTV and credit score on Fannie Mae acquisitions in 2007 was 75 and 716, respectively. By 2009 the average LTV had fallen to 66 and the average credit score had increased to 760. Similarly, the average credit score on FHA loans has risen from 650 to above 700. And the few private-label deals that have been completed have had LTVs near 60 and average credit scores near 800. Individual lender decisions and market forces have pushed underwriting standards significantly tighter. It is questionable why regulators would want to define the QRM even narrower than the underwriting practices that prevail in today's much tighter credit market, such that two out of every three borrowers either will not qualify for a loan, or will have higher payments because of the loan's non-QRM status.[7]



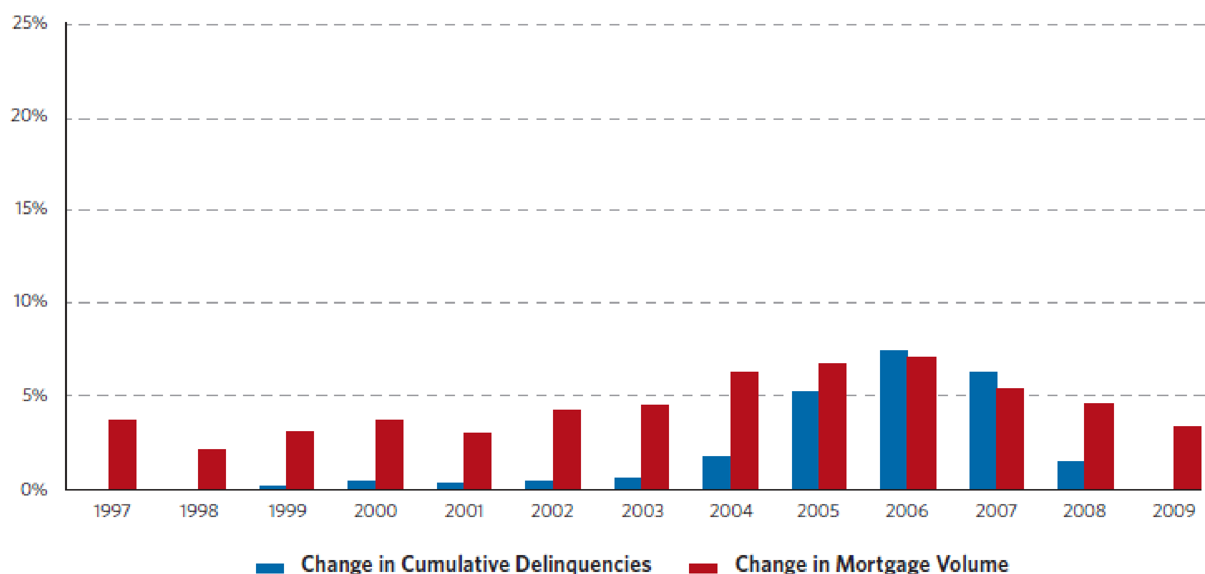
Source: FHFA. "Mortgage Market Note 11-02: Qualified Residential Mortgages." April 11, 2011.

<u>Costs of QRM Proposal Outweigh Benefits</u>

MBA believes the ratio of the socio-economic costs to the benefits of the Proposal is extremely disconcerting. The potential benefit to borrowers from improvements to lending standards undoubtedly will be offset by the impact on the cost and availability of

[7] On an historical basis, two out of the three borrowers may substantially understate the percentage of loans eligible for sale to the GSEs that would not have met the proposed QRM criteria. The FHFA data noted below does not appear to give effect to the servicing standard provisions in the proposed QRM criteria. If that provision had been analyzed, we believe that substantially all of the mortgage loans sold to the GSEs in the periods indicated would have been non-QRMs because GSE mandated loan documents do not include the servicing provisions required under the proposed QRM criteria.

credit. The Proposal will exclude more creditworthy low-to-moderate income borrowers than necessary. Minorities and first-time borrowers will fare even worse under the QRM's high loan-to-value (LTV) and low debt-to-income (DTI) requirements, as these families typically have much less savings. It is also unclear why the proposed LTV and DTI requirements are set at such conservative levels since FHFA's analysis of GSE data notes that for the 2005-2007 origination years, the requirement for product-type (no non-traditional and low documentation loans, or loans for houses not occupied by the owner) was the QRM risk factor that most reduced delinquency rates.[8]



The intent of the risk retention requirement is to make it more difficult to originate and securitize the types of loans that caused the worst problems during the downturn. The QRM definition should, and does, explicitly target these riskier attributes. However, we see no reason to further cut off credit to borrowers by layering on other more onerous restrictions that were not implicated in the downturn. Moreover, the Proposal treats each criterion of borrower creditworthiness as an independent measure with no consideration for the fact that all of the factors interact with one another. MBA believes a better approach is to allow limited variation when one or more factors exceed, in a credit-positive manner, the baseline requirement. MBA's detailed analysis regarding the regulation of underwriting quality versus credit quality through risk retention requirements is included in the **Appendix** accompanying this letter.

Eliminate the QRM's Mandatory LTV and Down Payment Thresholds

[8] 76 Fed. Reg. 83, 24141-24143, (Apr. 29, 2011).

MBA believes LTV restrictions do not belong in the QRM definition. Data show that the principal determinant in the rate of default is the quality of underwriting standards, not the down payment. While a reasonable and affordable cash investment or LTV requirement may be warranted – although they are not suggested by the statute – MBA believes the rules should permit offsetting factors in the context of prudent underwriting. Higher LTV loans may pose greater risks. However, these risks can be mitigated by compensating factors such as strong credit and appropriate documentation on purchase money mortgages.[9] Existing homeowners also are negatively impacted since for many it removes the opportunity to restructure their finances and take advantage of improvements in the interest rate environment.

MBA believes the QRM's 20 percent down payment requirement alone would provide a nearly insurmountable barrier to most first-time and low-to-moderate-income borrowers achieving homeownership, notwithstanding that they otherwise may qualify for a mortgage. Assuming a borrower devoted all of their savings towards a down payment, it can take moderate income borrowers, depending on where they live, up to 18 years to save for a 20 percent down payment for a moderately priced home. The proposed "alternative" of a 10 percent down payment is not much better.

Downpayment Calculations — Median Household

	Birmingham	Philadelphia	Chicago	Seattle	San Francisco	Los Angeles	Phoenix	Houston
Median Annual Household Income	$31,704	$36,669	$46,781	$58,990	$70,040	$54,828	$48,881	$42,797
Monthly Income	$2,642	$3,056	$3,898	$4,916	$5,837	$4,569	$4,073	$3,566
After-tax Income	$2,246	$2,597	$3,314	$4,178	$4,961	$3,884	$3,462	$3,031
Monthly Savings (After-tax income-monthly expenditures)	$202	$234	$298	$376	$447	$350	$312	$273
Median Gross Rent	$758	$912	$900	$1,015	$1,303	$1,197	$912	$848
Median Home Price	$140,450	$208,120	$166,900	$292,860	$494,730	$304,420	$130,405	$153,683
Required Downpayment (20%)	$28,090	$41,624	$33,380	$58,572	$98,946	$60,884	$26,081	$30,737
Required Downpayment (10%)	$14,045	$20,812	$16,690	$29,286	$49,473	$30,442	$13,040	$15,368
Required Downpayment (5%)	$7,023	$10,406	$8,345	$14,643	$24,737	$15,221	$6,520	$7,684
Years to save for 20% downpayment	12	15	9	13	18	15	7	9
Years to save for 10% downpayment	6	7	5	6	9	7	3	5
Years to save for 5% downpayment	3	4	2	3	5	4	2	2

Sources: MBA analysis of Census Bureau, Bureau of Labor Statistics, and National Association of Realtors data.

- This table and the following map show sample calculations regarding how long it would take a typical household in different metros to save for a 20% downpayment on a typical home.
- There are a number of assumptions necessary to complete this calculation. Values are drawn from government survey data.
- Current owners who have lost their equity would need to save for a new downpayment, thus this analysis considers all households, not just renters. The table on page 6 focuses on renters.

MBA notes that renters will take much longer to save.

[9] Streamline refinances appropriately allow for waiver of certain documentation requirement. MBA outlines our concerns and suggestions in our Qualified Mortgage comment letter dated July 22, 2011.

Downpayment Calculations — Median Renter Household

	Birmingham	Philadelphia	Chicago	Seattle	San Francisco	Los Angeles	Phoenix	Houston
Median Renter Income	$18,071	$20,901	$26,665	$33,624	$39,923	$31,252	$27,862	$24,394
Monthly Income	$1,506	$1,742	$2,222	$2,802	$3,327	$2,604	$2,322	$2,033
After-tax Income	$1,280	$1,481	$1,889	$2,382	$2,828	$2,214	$1,974	$1,728
Homeowner Costs with Mortgage (ACS)	$1,062	$1,172	$1,915	$2,200	$3,079	$2,348	$1,497	$1,453
Monthly Savings (After-tax income- monthly expenditures)	$115	$133	$170	$214	$255	$199	$178	$156
Median Gross Rent	$758	$912	$900	$1,015	$1,303	$1,197	$912	$848
Median Home Price	$140,450	$208,120	$166,900	$292,860	$494,730	$304,420	$130,405	$153,683
Required Downpayment (20%)	$28,090	$41,624	$33,380	$58,572	$98,946	$60,884	$26,081	$30,737
Required Downpayment (10%)	$14,045	$20,812	$16,690	$29,286	$49,473	$30,442	$13,040	$15,368
Required Downpayment (5%)	$7,023	$10,406	$8,345	$14,643	$24,737	$15,221	$6,520	$7,684
Years to save for 20% downpayment	20	26	16	23	32	25	12	16
Years to save for 10% downpayment	10	13	8	11	16	13	6	8
Years to save for 5% downpayment	5	7	4	6	8	6	3	4.6

Sources: MBA analysis of Census Bureau, Bureau of Labor Statistics, and National Association of Realtors data.

- Renters typically have lower incomes than owners.
- This table shows how long it would take a typical renter in different metros to save for a 20% downpayment on a typical house.

Borrowers also must pay closing costs, which typically add another $5,000 to the amount a borrower must save. Approximately 50 percent of home buyers currently put down less than 20 percent on their homes, and more than half of that population puts down 10 percent or less. Given this reality, the proposed 20 percent requirement as part of the QRM framework would increase costs or potentially cut off access to credit for hundreds of thousands of creditworthy households.

Trends in Loan-to-Value Ratio by Income and Race / Ethnicity for First-Time Homebuyers, 1989-2005

Income or Race / Ethnicity LTV Category	1989-2005 (%)	1989-1997 (%)	1997-2005 (%)	Change (%)
*Low-income buyers**				
80% or less	44.4	45.9	43.1	-2.8
80.1 to 90%	19.3	19.5	19.1	-0.4
90.1 to 95%	12.1	10.2	13.5	3.3
Above 95%	24.3	24.3	24.2	-0.1
Moderate-income buyers				
80% or less	41.9	43.4	40.4	-3.0
80.1 to 90%	22.4	24.2	20.8	-3.5
90.1 to 95%	14.4	14.1	14.7	0.6
Above 95%	21.3	18.3	24.1	5.9
High-income buyers				
80% or less	45.5	44.5	46.4	1.9
80.1 to 90%	26.0	28.6	23.9	-4.7
90.1 to 95%	13.2	14.0	12.4	-1.6
Above 95%	15.3	12.9	17.3	4.4
White buyers				
80% or less	44.4	45.1	43.0	-2.1
80.1 to 90%	23.7	25.0	22.2	-2.8
90.1 to 95%	13.0	12.7	13.4	0.7
Above 95%	19.0	17.2	21.4	4.2
African-American buyers				
80% or less	37.8	36.7	37.9	1.1
80.1 to 90%	19.9	20.1	20.4	0.3
90.1 to 95%	15.4	16.2	15.0	-1.2
Above 95%	26.8	27.0	26.7	-0.2
Hispanic buyers				
80% or less	40.5	42.1	41.0	-1.0
80.1 to 90%	20.4	23.8	18.6	-5.2
90.1 to 95%	14.9	11.6	15.3	3.7
Above 95%	24.2	22.5	25.0	2.5

- The table to the left shows that low-income and minority first-time homebuyers have consistently turned to high LTV loans in greater proportions.
- The table shows data from 1989-2005 calculated from the American Housing Survey (AHS) conducted by the Census Bureau.
- AHS data for 2009 shows:

	All Households	African-American Buyers	Hispanic Buyers
80% or less	26%	14%	20%
80.1%-90%	17%	13%	17%
90.1%-95%	14%	21%	19%
Above 95%	31%	51%	44%

Source: MBA analysis of AHS data.

LTV = loan-to-value

* Low-income homebuyers are defined as those whose incomes are less than 80 percent of the area median income.

Source: Tabulations from the 1991-2005 American Housing Surveys

Table from Belsky and Herbert, "Initial Housing Choices Made by Low-Income and Minority Homebuyers," *Cityscape*, 2008.

Data show that the principal determinant in the rate of default is the quality of underwriting standards, not solely the down payment. Data also shows the danger of arbitrarily raising the down payment requirement for a QRM loan. An increase in the minimum down payment from five percent to 10 percent would likely have only a negligible impact on default rates (reducing them by less than one percent), but would significantly reduce the number of eligible borrowers (anywhere from a seven percent to 15 percent reduction), and increasing the minimum down payment to 20 percent would reduce eligible borrowers by 17 percent to 28 percent, again with a negligible reduction in default rates.

Underwriting a residential mortgage is a process requiring solid data analysis, accurate and complete verification of the borrower's financial situation, coupled with good objective underwriting judgment. Part of sound underwriting judgment is the ability to analyze many compensating factors that determine the borrower's ability to pay. There are many factors in the loan process that need to be weighed and evaluated, down payment is only one consideration when underwriting a loan and it is important not to overemphasize its contribution to the final likelihood of loan performance. More compelling factors for successful home ownership and avoidance of default are the

demonstrated ability to meet financial obligations, stable employment and a commitment to home ownership. According to the *FHA Handbook section* 1633 (3) "the quality of the real estate security, or a low ratio of loan-to-value cannot compensate for an unacceptable mortgagor." MBA's detailed analysis regarding the regulation of underwriting quality versus credit quality through risk retention requirements is included in the **Appendix** accompanying this letter.

We therefore request the mandatory down payment and LTV provisions be eliminated. At a minimum, MBA requests the QRM provisions be aligned with the proposed QM parameters.

<u>Eliminate the QRM's Mandatory Front-End and Back-End DTI Ratios</u>
In conjunction with the LTV requirements, the DTI ratios will bar the door to even more borrowers who may have offsetting resources and payment behavior that under the Proposal cannot be considered. While DTI ratios were to be considered under Dodd-Frank, Congress did not intend for them to be unduly restrictive. We therefore reiterate our request for the Proposal to be revised in a manner that permits underwriters to consider factors compensating for a higher DTI such as the borrower's assets. Historically, the reason underwriters focused on DTI ratios was to ensure that households had sufficient resources for necessities such as food, household utilities and transportation. For lower income households this is particularly important. However, for middle and higher income households the same DTI ratio may not be as burdensome. For example, consider a borrower whose monthly income is $4,000 or $48,000 annually. A $1,600 monthly mortgage payment, resulting in a 40 percent DTI would clearly be a burden, as it would leave only $2,400 for all other monthly expenses. Now consider a borrower who makes $144,000 annually, or $12,000 a month. A 40 percent DTI is equivalent to a $4,800 mortgage payment which may well be feasible for a strong credit borrower as it leaves $7,200 for other expenses. Moreover, the residual income on a $50,000 loan in Oklahoma (for example) with a 45 percent DTI is considerably different from loan from a $625,000 loan in Honolulu (for example) with a 45 percent DTI. Underwriters are carefully trained to consider compensating factors in determining whether to approve a prospective borrower. Making DTI ratios unduly restrictive, as clearly shown in FHFA's analysis of the data, will prevent many borrowers from getting lower cost financing.

We therefore request the mandatory DTI provision be eliminated. At a minimum, MBA requests the QRM provisions be aligned with the proposed QM definition.

<u>Points and Fees</u>
Under the Proposal, in order for a mortgage to be a QRM, the total points and fees payable by the borrower in connection with the mortgage transaction may not exceed three percent of the loan amount, which would be calculated in the same manner as in Regulation Z.[10] MBA notes the points and fees parameters proposed for QRM eligibility are narrower than those set by the Federal Reserve for the purposes of the proposed

[10] See 12 CFR 226.32(a)(1)(ii) and (b)(1).

QM definition. For example, the Proposal does not include the proposed QM's exclusion for "bona fide discount points," or the adjustment for smaller loans.

MBA opposes excessive points and fees as unfair to borrowers and unnecessarily increasing loan costs MBA has provided a separate detailed comment in response to the proposed "Ability to Repay" regulations issued by the Federal Reserve.[11] We have suggested significant revisions to the proposed QM points and fees parameters, and we incorporate those suggested revisions by reference here as part of our request to align the QRM and QM points and fees parameters.

For example, the Proposal overlooks the fact that the three percent cap disproportionately and negatively impacts homebuyers with lower loan amounts. Despite a reduction in loan amount, closing costs are generally fixed and thus represent a greater percentage of lower loan amounts than higher loan amounts. Therefore, MBA requests the Agencies consider adjusting the QRM's points and fees limits for lower loan amounts and/or geographic areas with lower housing costs.. Based on data that has been developed by lenders, MBA believes the definition of smaller loans should be set at $150,000.

Moreover, whether the customer chooses to use an affiliated provider of the lender or not, the bona fide charges for such non-lender services should be excluded from the calculation. The Real Estate Settlement Procedures Act (RESPA), as amended by Congress in 1983, explicitly permits affiliated business arrangements and excepts them from RESPA's restrictions under Section 8's prohibitions against kickbacks and referral fees so long as certain consumer protection and other requirements are satisfied.[12] These protections include a prohibition against requiring the use of an affiliated settlement service provider, a disclosure to the consumer at the time of any referral of the business relationship, and a limitation that the only thing of value received in the arrangement be a return on ownership interest.[13] These requirements help ensure that consumers have choices and are not simply referred to affiliates for compensation.

Virtually all of these fees are for reasons outside the creditors' control. Market forces determine the costs of most third-party services ranging from flood surveys to pest inspections. Additionally, Dodd-Frank establishes a new mandate for appraisal fees to be "customary and reasonable."[14] Notably, the largest third-party fees are often for title insurance and title services which are "filed fees" or fees filed with the states over which the lender has little discretion.

Merely keeping track of which fees are included, and which are not, will present very significant compliance burdens, lessen credit availability and ultimately increase consumer costs. Wholesale lenders and loan purchasers will also face difficulties in

[11] 76 Fed. Reg. 27492 (May 11, 2011).
[12] 12. U.S.C. Sec. 2601-2617.
[13] 12. U.S.C. Sec. 2607.
[14] Sec. 1472, Pub. L. 111-203, July 21, 2010.

determining whether the third parties used by a broker or creditor were affiliates and what, if any, compensation to employees was included.

Today a significant number of consumers opt for the use of affiliated settlement services. Advocates of affiliated business arrangements assert that they provide benefits to consumers in that the cost efficiencies are passed through to them. On the other hand, independent providers argue that their costs are lower. MBA believes consumers should have the option of either approach and a competitive market should offer both. Including affiliate fees in the three percent will have the effect, however, of stemming the use of affiliates, thus skewing the market and depriving consumers of choice.

Additionally, MBA believes compensation to individual employees should be excluded. Both the payments by borrowers to creditors and brokerages as well as the compensation they in turn permit their originators should not both be counted. Double counting in this manner is simply unfair.

MBA therefore requests the QRM permit an exclusion for certain up-front mortgage insurance premiums, up to two discount points, and allow the bona fide third-party fee exemption to apply to affiliated businesses, similar to the proposed QM eligibility criteria.

Mortgage Insurance or Other Credit Enhancements

If the Agencies determine that some restriction on LTV must be included under the QRM exemption in the final rule, then we would encourage the agencies to allow for credit enhancements to be considered when determining such a requirement. Specifically, MBA suggests allowing the use of mortgage insurance or other state-regulated financial guaranty and credit insurance products to offset part of the down payment requirement for QRMs. Other forms of credit enhancement, such as those permitted under the GSEs' charters, should be allowed as well. This will help close the gap between QRM and FHA eligibility. We do believe that all borrowers should have some financial investment in the property in the form of down payment or tangible equity and that the amount should be based on the lesser of purchase price or appraised value. Private mortgage insurance is an appropriate credit enhancement tool that allows consumers to obtain financing with lower down payments or equity investment and effectively lowers the credit risk associated with the loan. A useful feature of private mortgage insurance is that borrowers must essentially be qualified under two sets of underwriting standards. The first is the originator's underwriting standards as will be amended by the ability to repay standards, including the ability to make the mortgage insurance premium payment. The second is the underwriting standards of the mortgage insurance company itself, whose goal is to mitigate risk of non-payment. If a borrower meets the underwriting standards of both parties, they should not be penalized in the form of higher rates or lesser credit options merely because they do not have a minimum 20 percent down payment or built up equity. Other important private sector credit enhancement tools that reduce default risk, for example financial guaranty and credit insurance that protect borrowers should also be encouraged through the QRM

exemption mechanism as a means to reduce the 20 percent down payment requirement and mitigate risk.

Credit History

MBA notes the Agencies do not propose to use a specific credit score threshold as part of the QRM definition. MBA supports this approach particularly given the fact that several different commercial scores are available and the significance of credit score values change over time. However, MBA also believes the proposed "derogatory factors" are equally problematic because they consider only a small subset of a consumer's credit report, and the proposed factors could only be considered in a binary fashion. This approach is unfair to consumers in that the proposed thresholds could disproportionately penalize consumers for potentially minor offenses.

MBA believes there is merit to the use of empirically derived, demonstrably and statistically sound mathematical algorithms to evaluate a borrower's creditworthiness. Such models increase the consistency and objectivity of credit evaluation and thus may help diminish the possibility that credit decisions will be influenced by personal characteristics or other factors prohibited by law, including race or ethnicity.

Therefore, MBA believes the optimal approach would be to incorporate into the QRM eligibility criteria the proposed QM criteria authorizing lenders to review and verify a borrower's credit history using widely accepted governmental and non-governmental standards.

Servicing Standards

In order to be considered a QRM and exempt from risk retention requirements, the Proposal would require that "the originator of a QRM incorporate into the mortgage transaction documents certain requirements regarding servicing policies and procedures for the mortgage, including requirements regarding loss mitigation action, subordinate liens, and responsibilities for assumption of these requirements if servicing rights with respect to the QRM are sold or transferred."[15] The originator must disclose the creditor's default mitigation policies and procedures to the borrower at or prior to closing. The Proposal also calls for originators to disclose to investors, prior to sale of the MBS, the policies and procedures for addressing a whole loan subordinate lien on the same property secured by a QRM first mortgage that becomes 90 days delinquent.

Intent of Congress

MBA is extremely concerned with the inclusion of servicing standards in a QRM definition that was very clearly intended under Dodd-Frank to comprise a set of loan origination standards and to discourage the offering of certain loan product features. The specific language of the act directs the Agencies to define the QRM by taking into consideration "underwriting and product features that historical loan performance data indicate lower the risk of default." Servicing standards are neither "underwriting" nor "product features." Nowhere in the legislative language or Committee Reports is there

[15] 76 Fed. Reg. 83, 24127, (Apr. 29, 2011).

any language to indicate that servicing was the target of the QRM provision. Had Congress intended to include servicing provisions within the scope of the risk retention and QRM provisions, it could have easily and expressly done so; as it did in Title XIV, with the many servicing provisions addressed therein.

Accordingly, MBA strongly believes servicing standards have no place in this Proposal and should be removed.

Benefits of the Proposed Servicing Requirements are Unclear
It is unclear what the benefits of including loss mitigation policies and procedures in the mortgage documents are. Servicers today employ loss mitigation strategies and thus the Proposal does not cause any servicer to *begin* implementing foreclosure prevention strategies. The Proposal does not promote uniformity. In fact, it destroys uniformity by not allowing servicers to change their practices and procedures as needs change. By embedding requirements in the legal documents, loss mitigation policies cannot change as investor guidelines, enforcement actions, and public policies change.

The Proposal, however, does cause significant operational challenges, compliance difficulties, increased risk and costs to servicers, investors, and borrowers. Given that federal regulators are engaged in developing uniform servicing standards through a separate rulemaking, and the Bureau of Consumer Financial Protection will be implementing the servicing provisions in Dodd-Frank, the problems created by this Proposal outweigh any limited benefits.

Loss Mitigation Addresses Severity of Loss not Frequency of Default
While we agree that loss mitigation can in certain circumstances reduce the loss severity associated with defaults-- hence why servicers perform it--loss mitigation does not materially reduce the borrower's decision to default in the first place. The Agencies have concluded, however, that efforts to reduce loss severity play no role in the QRM exemption. For example, the Proposal dismisses the relevancy of policies and products that reduce loss severity by failing to recognize private mortgage insurance and other credit enhancements. The Proposal states:

"While this [mortgage guaranty] insurance protects creditors from losses when borrowers default, the Agencies have not identified studies or historical loan performance data adequately demonstrating that mortgages with such credit enhancements are less likely to default than other mortgages, after adequately controlling for loan underwriting or other factors known to influence credit performance, especially considering the important role of LTV ratios in predicting default."[16] (brackets added).

The Agencies offer no data or studies to support their conclusion that loss mitigation reduces the *frequency of default,* outside of other underwriting features. Instead, broad statements are made, including a statement that loss mitigation impacts subsequent

[16] 76 Fed. Reg. 24119, (Apr. 29, 2011).

defaults, an entirely different matter not considered anywhere else in the Proposal. Moreover, in order for someone to re-default, the borrower must have defaulted in the first place and then must have cured (usually through loss mitigation efforts). The argument is circular and an attempt to place servicing standards within the "underwriting" principles established by the Proposal when they should not be.

Impact of Rule

Including servicing standards in what is functionally an origination standard creates numerous problems for servicers including operational difficulties, legal and regulatory conflicts, overwhelming compliance burdens, and litigation and buy-back risks. These difficulties permeate through to investors by introducing greater uncertainty, pricing challenges, greater cost burdens, less uniformity and potentially call or prepayment risk.

Servicing standards are ill-suited for inclusion in what is an origination standard. While loan origination standards and product features can be complied with and tested for compliance at origination, servicing standards cannot. Servicing does not begin until after closing and such obligations continue for up to 30 years. As a result, compliance with the servicing standards cannot be tested at loan closing or even at MBS issuance. Although unclear, it appears the Proposal inappropriately creates a long-term obligation requiring life-long compliance monitoring and investor reporting. This adds to the cost of the MBS transaction and may increase performance risk to the underlying mortgage pool.

It is also unclear whether a violation of a servicer's loss mitigation standards renders the loan non-QRM and requires repurchase. If so, the Proposal places the pool at risk of unnecessary call or prepayment risk. Given that servicing is a standardized business, a minor infraction would likely permeate more than one loan, and may permeate part of a pool or a whole pool—calling due large sections of the pool and impacting the investor's yield. Investors would clearly be harmed by such a result and may avoid or demand higher yields for private-label securitization (PLS) transactions with QRM loans. Sponsors (and ultimately originators or servicers) may also not have the capital or borrowing facilities to handle such repurchases. MBA believes that under no circumstances should a violation of a servicing standard cause the loans to be non-QRM compliant.

In addition to compliance and performance risk, the Proposal adds new and unnecessary risk to mortgage transactions and MBS pools. While the Proposal does not define "transaction documents," we interpret this term to mean the note and mortgage.

Placing loss mitigation standards in the note and mortgage raises many other concerns:

- Today, loan documents do not identify the loss mitigation practices of the servicer. As a result, it is unclear whether there will be a market for mortgages

that include servicing standards. If a market exists, we presume a premium will be applied to these loans.

- The Proposal destroys uniformity in the legal documents, an important factor in mortgage securitization. The GSEs produce a standard note and mortgage for each product and each state. These documents are often used for loans that are not delivered to the GSEs. This uniformity is important for the MBS markets as investors need not discern all the variances in the underlying mortgages and price for these variances. The Proposal would shatter this uniformity by requiring a new mortgage every time a loss mitigation standard changes. While Fannie Mae and Freddie Mac are exempt from risk retention while in conservatorship or receivership, this problem could apply to them in the future. It would apply to PLS immediately. Recently, the GSEs have changed loss mitigation standards multiple times a year. Given that hundreds of changes and clarifications have been made to the Home Affordable Modification Program (HAMP), Home Affordable Foreclosure Alternatives Program (HAFA), the Home Affordable Unemployment Program (UP), and Fannie Mae's and Freddie Mac's versions of these programs as well as their own proprietary modifications, one can only imagine how many different mortgages may need to be created and tracked. This will not only make it extremely difficult to price MBS, but will create significant operational challenges for servicers.
- The Proposal will require more detailed and customized PSAs. Today most PSAs do not detail every servicing duty. Instead PSAs require the servicers to perform according to standards adopted by industry leaders, such as Fannie Mae or Freddie Mac, or to abide by "standard industry practices." This may no longer be possible if the note and mortgage must specify policies and procedures for loss mitigation. PSAs cannot point to a GSE standard because "current standards" will at some point conflict with the mortgage documents. The cost of customizing PSA and tracking differences will impact securitization and the cost of servicing PLS. Moreover, the extent to which the individual servicing standards in each originator's loan documents differ from each other also decreases the ability of investors to easily understand the pools they are buying and greatly increases their due diligence costs.
- The Proposal adds significant litigation risk by possibly creating a private right of action. Embedding specific alternatives to foreclosure into the mortgage and note arguably and inappropriately grants a right of action to the borrower, which – perversely -- is triggered upon the borrower's non-performance. Given the highly litigious environment in which financial institutions operate, this possible private right of action will increase the frequency of litigation as almost any borrower will be able to claim non-performance by the servicer. Such factual claims, whether true or not, impact the servicer's ability to foreclose and impose additional advancing costs, attorney fees and court costs. Ultimately, MBS investors must absorb these increased costs. Investors must also predict the added litigation cost, which historically has proven difficult. If they predict inaccurately, investors will lose more than they bargained for and seek more predictable yields elsewhere (e.g. non-mortgage investments). If they overstate the litigation cost,

it will drive up mortgage costs. This lack of predictability also will impact the level of credit enhancement required. As discussed in greater detail below, this additional cost/risk/uncertainty is likely to be passed through to the consumer in the form of higher interest rates and fees.

- The Proposal will negatively affect wholesale and correspondent transactions. The Proposal calls for the "originator" to include the creditor's default mitigation policies and procedures in the mortgage transaction documents and disclosures. However, the originator may not know these servicing standards at origination, especially in wholesale and correspondent loan transactions. Brokers and correspondent lenders will have substantial operational challenges in determining the ultimate servicer of the loan and which servicing standards to embed in the documents. Given that servicers will not purchase loans or servicing that does not reference their own servicing standards, MBA is concerned that brokers and correspondents may avoid non-government lending because of the risk of non-delivery.
- The Proposal will cause conflict between investor requirements and the servicer's duties under the mortgage documents. Such conflict will be especially evident in GSE servicing if the GSEs become subject to risk retention rules. Today, GSE servicers are contractually obligated to follow GSE requirements as established by the GSE guidebooks and numerous updates. If the servicer is required to detail current loss mitigation policies in the mortgage documents, servicers will be unable to also comply with changes to the GSE policies. This places servicers in the middle of contractual disputes, which most likely will be litigated.
- The Proposal also creates conflict between the regulators and their efforts to seek national servicing standards. If servicers are required to detail their loss mitigation practices in contracts with borrowers, it is unclear how servicers will be able to adjust these contracts to incorporate future regulatory enforcement actions or national servicing policies. In order not to conflict with existing borrower contracts, such enforcement actions or rules would have to be prospective to newly originated loans. MBA foresees significant legal challenges by embedding policies and procedures in notes and mortgages.
- The Proposal requires loss mitigation policies and procedures to be contracted at the time of origination, despite the fact that servicers administer the loan for up to 30 years. While servicers today have loss mitigation policies to address financially distressed borrowers, these policies continue to evolve as regulators' concerns, borrowers' needs, loan products, technology and economic conditions evolve. One need only look at the variety of recent efforts that have emerged such as the HAMP, HAFA, UP, FHA HAMP, VA HAMP, and enhanced proprietary modifications. A further example of the need for flexibility is the different set of loss mitigation efforts necessitated by Hurricane Katrina and today's economic crisis. In both situations, static loss mitigation standards would not have been in the best interest of the public or investors. Borrowers may ultimately suffer if loss mitigation rules remain static.

- The Proposal renders servicing assets illiquid by prohibiting the transfer of servicing unless the transferee abides by the provisions of the originator. Our members indicate that they will not purchase an asset or servicing that embeds servicing standards different from their own. This is logical given the difficulty and cost of servicing each pool differently. The size of servicing portfolios today and limitations of technology and staffing necessitate uniformity in processes. This rule does not achieve uniformity and, in fact, prohibits it by requiring policies and procedures to be set in transaction documents and disclosed to borrowers upfront. The lack of liquidity will impact not only servicers and other market participants, but will impact the FDIC, who will find it difficult to sell servicing and other assets from failed institutions. Purchasers of such assets will expect indemnification and significant funds or discounts given the liability of taking over such assets.

Financial regulators and other enforcement authorities are engaged in a separate effort addressing national standards that address numerous mortgage servicing issues including customer service, the processing of payments, foreclosure processing, operational and internal controls, and servicer compensation and payment obligations. This effort is the proper venue to deal with servicing standards. Assuming a balanced approach is taken, this effort will ensure uniformity in application, reduce regulatory burden and risk for mortgage servicers, and provide certainty to the PLS market while ultimately achieving the objective of comprehensive, consistent enforceable standards. As a result, we urge the Agencies to remove servicing provisions from the Proposal.

Written Appraisal

Another QRM eligibility requirement included in the Proposal but not contemplated by Congress is the requirement for the loan to have a written appraisal of the underlying property. MBA supports the objectives of enhancing underwriting practices, reducing mortgage fraud and making home valuations more reliable. MBA believes appraisals that overstate and/or understate the market value of properties are harmful to lenders and unsuspecting consumers alike. However, we believe the Proposal overlooks and prevents the use of safe and sound technological advancements in property valuations such as automated valuation models (AVMs). AVMs are statistically-based computer programs that use real estate information such as comparable sales, property characteristics, tax assessments, and price trends to provide an estimate of value for a specific property. AVMs provide streamlined property valuation recommendations and inspection options which benefit lenders and borrowers by reducing the costs and effort typically associated with the traditional property appraisal process, without sacrificing quality. Federal financial institution supervisory appraisal guidelines permit an institution to use an AVM in lieu of an appraisal for certain transactions, provided the institution can demonstrate that the valuation method is consistent with safe and sound banking practices.[17]

[17] 75 Fed. Reg. 237, 77450-77473, (Dec. 10, 2010).

We therefore request the Agencies consider establishing exceptions to the QRM's written appraisal requirement and permit other property valuation methods such as AVMs.

Eliminate the Loan Assumption Prohibition

The Proposal prohibits assumability of a QRM by any person that was not a borrower under the mortgage transaction at closing. We believe this provision is unnecessarily restrictive given other means to underwrite the borrower for creditworthiness.

Underwriting Standards for Assumptions

Although most conventional loans are not assumable today, some are. An assumption provision is an attractive feature and may facilitate property sales, especially when the mortgage rate is low compared to the prevailing market rate. Assumability may also be an attractive feature that can be used as a loss mitigation tool when the borrower is unable to retain the home and would otherwise be granted a short sale or deed in lieu of foreclosure.

The Agencies recognize that any risk associated with a new borrower can be mitigated by applying underwriting standards consistent with QRM standards. A requirement to underwrite the new borrower is valid and done today. However, the Agencies should revisit the appropriateness of imposing all QRM requirements on assumptions (e.g. LTV and appraisal requirements if the Agencies move forward with these requirements). Unfortunately, this underwriting approach is dismissed by the Agencies because it would impose significant costs on the holder or servicer of the mortgages that would increase the cost and reduce the liquidity of the QRMs. Servicers process and underwrite assumptions today and do not object to performing these services in the future.

The Agencies do not reference any research validating that loans assumed in the past defaulted at a higher rate than other mortgages. We presume the opposite--that mortgages formally assumed by others may perform better because the assuming borrower is not only underwritten as to creditworthiness, but the interest rate may be lower than the prevailing market rate and the buyer could be purchasing a property at risk (e.g. the original borrower is selling the property for a reason: job transfer, divorce, death, lack of income, etc).

Whether an assumption feature will ultimately become a popular loan feature in the future is unknown. However, it does not seem prudent to eliminate flexibility in the market.

The Garn-St. Germain Act[18]

The Agencies should also consider the interplay between assumptions and the Garn-St. Germain Act, which provides that certain classes of people are protected against the

[18] Pub.L. 97-320, H.R. 6267, October 15, 1982.

due-on-sale clause found in most fixed rate conventional mortgages.[19] Under that Act, a lien holder cannot exercise a due-on-sale clause and accelerate the mortgage if the borrower transfers the property to an individual protected by the Garn-St. Germain Act. In some cases, protected persons who are added to title also request to be added to or otherwise assume the mortgage. Generally, individuals protected by the Garn-St. Germain Act who seek assumption of the mortgage are underwritten for creditworthiness. However, given that they already have title to the property in whole or in part, they may not be required to follow the same standards as a non-covered individual, especially if the protected individual (e.g., spouse) is being added to the debt and the original borrower is not released from the obligation. Unfortunately, the Proposal also may cause the QRM status for a mortgage to be lost upon an assumption by a protected individual under the Garn-St. Germain Act. This may obligate the sponsor to repurchase the asset from an MBS pool. It is unclear how this requirement "protects investors" as suggested by the Proposal given that repurchase would eliminate performing, cash-yielding assets from the pool and the investor's yield.

In sum, we request that the Proposal be modified to eliminate the QRM eligibility requirement that prohibits loan assumptions. Moreover, we recommend that the Agencies consider the appropriate underwriting criteria for assumptions.

Alternate QRM Approach

MBA appreciates the fact that the Agencies offered an alternative approach to defining the QRM. Nevertheless, we believe the alternative approach lacks sufficient clarity and specificity in order for it to be evaluated with any degree of completeness. Moreover, we do not believe the fundamental flaws of the primary QRM definition in the Proposal can be overcome simply by adjusting the levels of the QRM definition's DTI, LTV and other criteria as in the alternative approach.

2. Premium Capture Cash Reserve Account

The proposed PCCRA provisions would require that in addition to the amount of credit risk that a sponsor is required to retain under other provisions of the Proposal, a sponsor must establish and fund a PCCRA in an amount equal to any amount by which the gross proceeds, net of closing costs paid by the sponsor(s) or issuing entity to unaffiliated parties, received from the sale of MBS interests in the issuing entity to

[19] "With respect to a real property loan secured by a lien on residential real property containing less than five dwelling units, including a lien on the stock allocated to a dwelling unit in a cooperative housing corporation, or on a residential manufactured home, a lender may not exercise its option pursuant to a due-on-sale clause upon—

(1) the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;
(2) the creation of a purchase money security interest for household appliances;
(3) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;
(4) the granting of a leasehold interest of three years or less not containing an option to purchase;
(5) a transfer to a relative resulting from the death of a borrower;
(6) a transfer where the spouse or children of the borrower become an owner of the property;
(7) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;
(8) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or
(9) any other transfer or disposition described in regulations prescribed by the Federal Home Loan Bank Board." 12 USC 1701j–3.

persons other than the retaining sponsor exceed 95 percent of the par value of all MBS interests in the issuing entity issued as part of the securitization transaction (if the sponsor uses the vertical, horizontal, L-shaped or master trust seller's interest method of risk retention) or 100 percent of the par value of all MBS interests in the issuing entity issued as part of the securitization transaction (if the representative sample method of risk retention is used).

The account would be subordinated to all other interests in the securitization, could only be invested in a limited range of permitted investments and would have to remain in place for the entire term of the transaction except to the extent used to satisfy losses.

According to the Agencies, the PCCRA is intended to minimize the possibility that a sponsor could negate or reduce the economic exposure it is required to retain under the rule.

MBA believes the proposed PCCRA requirements exceed the mandate and legislative intent of Dodd-Frank. The inclusion of the PCCRA in the Proposal converts it from a rule providing for the retention of credit risk to a rule limiting the timing and priority for recovery of costs and realizing gains when loans are sold into the private MBS market. Unfortunately, for the reasons explained below, this effectively makes private MBS an uncompetitive source of funding for most mortgage loans. As a result, MBA believes the rule as proposed would have pervasive negative effects on the prospects for the restoration of a private MBS market and, absent high levels of secondary market activity by the GSEs and federal government, the cost and availability of credit to borrowers. The PCCRA also would adversely impact the cost and/or availability of interest rate locks and incentivize the use of up-front points and fees in lieu of payments of origination expenses through mortgage rates. Even more troubling is the disparate impact this aspect of the Proposal will have on borrowers with lower incomes and fewer resources for a down payment.

Fundamental Elements of Loan Pricing

Lenders set mortgage interest rates relative to the costs to originate the mortgage plus their minimum return on investment. Origination costs include "hard" costs such as fees for appraisals and title policies. Origination costs also include overhead costs such as employee benefits and compensation, facilities upkeep, regulatory fees and other compliance costs. Therefore, a lender's cost basis in a loan at origination is almost always more than par (i.e. the lender has expended more cash to originate the loan than the loan's principal balance). Because lenders cannot be expected to originate every loan at a loss, any viable execution must allow them to recoup their basis in the loan, which will almost always require premium (above par) sale proceeds.

Before a lender sets its offering rates, it must determine both its basis in a loan (as described above) and the most efficient execution available for that loan. In the broadest terms there are basically two execution options available: keep the loan in portfolio or sell it. Assuming a lender has sufficient balance sheet capacity, it will weigh

the return it receives by holding the loan in portfolio against competing executions. Most commonly, if an originator sells a loan it will either (i) sell the loan unpackaged as a "whole loan," (ii) deliver the loan to Ginnie Mae or a GSE (assuming the loan conforms to those standards), or (iii) sell the loan into a private label securitization. In a properly functioning market, there are relatively liquid markets for each of these executions. Therefore, originators can estimate the proceeds (i.e. price) related to the sale of a mortgage loan with a given note rate into each of these executions.

In effect, when a lender reviews these options, the portfolio and/or each sale option are in virtual competition for that loan. That is to say, the required return on the portfolio is weighed against the GSE execution and the private label securitization price. As the costs of any of these executions rise (e.g. required return, GSE guarantee fee, or cost to securitize) the relative value of the associated alternative will decrease. As a result, the seller will be less likely to price to that execution and the borrower would have an impliedly higher "par rate" into that execution. Because rate is a primary means by which lenders compete, they will be unable to offer this execution unless and until it is at near parity with competing alternatives.

To set its offering rate, a lender simply estimates its basis in the loan plus its required return on investment and offers the note rate that corresponds to this price as its "par rate." "Par rate," as used in the mortgage lending industry is therefore somewhat of a misnomer as par rate originations almost always results in a premium dollar price.[20] It is also common for borrowers to choose to "buy up" (take additional cash at closing typically used to pay for closing costs) or "buy down" (pay the lender a fixed amount in exchange for a lower interest rate) the par rate on their mortgage loan. It should be noted that these transactions are virtually neutral from an execution standpoint. That is to say that the buy up/down typically has a proportional relationship to the increase or decrease in sales proceeds in secondary market transactions.

The fact that different borrowers may receive different par offering rates reflects the unique credit characteristics of individual borrowers which translate into higher or lower dollar prices at the time of sale.

Because prevailing interest rates in the broader markets will change the par rate from day to day (or, more accurately, minute to minute), originators of loans will typically "hedge" the rate they offer the borrower by selling an equivalent note rate forward. By doing so, originators allow borrowers to "lock" their rate against fluctuation prior to closing. This feature is almost universally desired by borrowers.

<u>Private MBS Execution Will Not be Competitive with Other Funding Sources if the PCCRA Is Included in the Final Risk Retention Rule</u>

The proposed PCCRA provisions would require sponsors to subordinate costs associated with overhead and return on capital, thus lessening the value of these

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[20] The "par rate" refers to the interest rate borrowers receive if they pay no points to reduce the rate and should not be confused with the price for a loan that trades in the secondary market for one hundred cents on the dollar.

proceeds. This causes the private label securitization funding channel to be a less competitive execution, and requires a loan's "par rate" to rise in an amount sufficient to offset the costs of the PCCRA. It has been reported that the PCCRA requirement would incrementally increase the borrowing costs for non-QRM mortgages by two to five percentage points.[21] While this pricing impact could be significantly mitigated by decreasing the "par rate" through payment of points at the time of origination, the Qualified Mortgage eligibility requirements severely restrict the use of points. This will obviously make private label securitizations subject to the PCCRA requirement less competitive with alternative funding sources and limit the availability of the private securitization market as a funding source for the residential mortgage market.

The proposed PCCRA provisions also cause a significant cash flow mismatch because they would require per loan income to be received over time, notwithstanding per loan expenses must be paid in a lump sum. MBA recognizes that the PCCRA requirements were designed to ensure that investors in a mortgage originator receive their profits over time. However, lenders cannot pay their staff, utilities and other bills over time with the proceeds from long-dated retained securitization interests. Without the ability to recover costs embedded in the rate at the time of securitization, originators would not be able to match their current assets and liabilities. This would mean that only originators attached to large funding sources, such as large depository institutions would be able to be mortgage lenders which can access the capital markets via securitization for premium loans. Smaller lenders, and even large depository institutions once their appetite for mortgage risk has been filled, may not originate premium loans at all. This would be troubling for borrowers as most loans are originated at a premium in order to keep up front costs to the borrower low. Further, MBA is concerned that this may lead to further restraints on the availability of affordable housing financing options because smaller lenders will no longer be able to access the capital markets and compete with larger lenders.

Prior to the 1970's, the primary source of residential mortgage credit was savings and loan associations that originated and serviced mortgage loans, and generally held them in their portfolios until maturity or prepayment/default. The funding for these portfolios was primarily savings deposits. This created localized markets, with a high degree of variation in rates and the availability of credit; a mismatch between the short-term (adjustable rate) funding provided by deposits and long-term (fixed-rate) mortgage loans; and an extreme concentration of mortgage risk in the thrift industry. The result was a market which was limited, segmented and unpredictable. The disaggregation of origination and mortgage finance/investing is one of the principal benefits of securitization. Disaggregation allows originators to do what they do best and provides for more efficient matched funding, via the capital markets, for fixed-income instruments which comprise mortgage notes. Since mortgage terms are generally fairly long term, a capital market execution permits both time and credit tranching to permit investment at all points along the risk/return/duration spectrum thus providing a broader capital base.

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[21] "Re: Credit Risk Retention Proposed Rule" Comment Letter submitted by Bank of America, July 13, 2011.

The PCCRA requirements undermine fundamental aspects of private MBS that make them economically efficient and competitive sources of funding. Private MBS are ordinarily structured as issuances of securities that are bankruptcy-remote from the seller, which permits the securities to receive a higher credit rating than the corporate debt obligations of the seller, and to provide for the seller to treat the transaction as including sale of the related mortgage loans for accounting purposes. MBA is concerned that the proposed PCCRA provisions will likely cause the amount of retained interests in a private MBS to be significant because it is in a first loss position. MBA also understands that the combined effect of the PCCRA and the five percent base risk retention requirement will likely prevent private MBS from receiving legal or accounting sale treatment. That result would eliminate virtually all incentives to securitize for institutions other than those that securitize purely for financing. Institutions with other sources of funding will move away from securitization altogether, resulting in a constriction of credit and an increased cost of capital.

The Proposed PCCRA Requirements Would Adversely Affect the Rate and Terms for Residential Mortgage Credit Offered to Consumers

In order for securitization subject to the proposed PCCRA requirement to be considered as a viable source of liquidity or selected as a funding alternative, the cost of the premium capture would have to be imposed on the borrower in the form of higher points or a higher interest rate. This imposes another financial obstacle for borrowers to pay more out of pocket to cover this fee, at a time when the borrower is incurring other transaction costs and providing a down payment on the property. Moreover, charging points in excess of three percent would cause the loan to not be a Qualified Mortgage, which would be a strong disincentive from the lender's perspective.

In addition, the PCCRA would interfere with an originator's or sponsor's ability to use interest rate hedges during the period between origination and securitization, which would likely prevent originators from offering borrowers rate locks. As an example, assume the lender provides a rate lock and enters into a concurrent hedge against its own exposure to rate movements. If the value of the loan goes down, the value of the hedge will go up; conversely, if the value of the loan goes up, the value of the hedge will go down. If the increase in the value of the loan is treated as a "premium," notwithstanding the concurrent loss on the hedge, and is required to be captured in a reserve account, the lender will not receive the return it needs from the sale to offset the loss on the hedge. Restructuring the securitization to avoid monetizing this amount at closing does not resolve this issue, because the loss on the hedge will be immediate and the offsetting gain on the loan will have been transformed into an at-risk, long-term investment in the securitization. In other words, the proposed PCCRA provisions will have not only negated the benefits of the hedge, but will have arguably made it completely uneconomical.

MBA is concerned that the impact of the proposed PCCRA provisions will be felt the most by low and moderate income borrowers with less than prime credit histories, because securitizations of loans to such borrowers create significant amounts of excess

spread. This will result in credit being less available to, and more expensive for, low to moderate income mortgage borrowers.

We also note the GSEs are not required to maintain a PCCRA, which gives them a significant competitive advantage relative to private label securities issuers.

MBA concurs that reasonable restrictions designed to prevent transaction structures that artificially reduce the allocation of credit losses incurred by sponsors may be appropriate, if properly tailored. Such is not the case with the proposed PCCRA provisions. Accordingly, MBA requests that they be withdrawn. In the alternative, MBA suggests the proposed PCCRA provisions be revised by excluding any transactions in which the retained risk constitutes a proportionate interest in the securitized assets. We specifically request an exclusion for risk retention structured in the form of a percentage interest in each class of securities (i.e. “vertical slice” retention) or ownership of a representative sample of like assets because it is impossible to design a transaction that would artificially reduce credit losses allocable to these forms of risk retention. MBA believes this modification of the PCCRA provisions will enable private MBS securitizations to become an economically competitive funding source for loans subject to the risk retention rules while still ensuring that the residual interest retained by the sponsor are commensurate with its risk retention obligations.

3. Risk Retention Duration Requirement Needed

MBA is concerned about the lack of a risk retention duration limit in the Proposal. The purpose of the so-called “skin in the game” requirement is to hold originators and securitizers accountable for the quality of the loans they underwrite and securitize. Historical data indicates that any underwriting deficiencies will likely present themselves within a relatively short time following origination of the loan. During that time, it will be clear whether the loan was underwritten poorly, or the borrower misrepresented key information. After that point, the way a loan was underwritten has little bearing on the incidence of default. Instead, economic or life events that were unforeseeable at origination become the primary default determinants. Any risk retention requirement beyond this timeframe is essentially overcollateralization and a constraint on funds that could be redeployed into funding more loans to creditworthy borrowers.

Originators and securitizers should not be held accountable for the performance of a loan if it met the investor’s guidelines and all applicable laws and regulations, but failed due to changing economic circumstances. For these reasons, MBA believes the Agencies should clearly limit the duration of a securitizer’s risk retention requirements to two to three years following the origination date. MBA’s detailed analysis regarding the regulation of underwriting quality versus credit quality through risk retention requirements is included in the **Appendix** accompanying this letter.

4. Seasoned Loans

The proposed QRM risk retention requirements do not make any distinction between newly originated loans and those that have seasoned in an originator’s or

correspondent's portfolio prior to pooling. As noted above, in "Risk Retention Duration Requirement Needed," underwriting deficiencies typically present themselves within a relatively short time following origination of the loan regardless of whether the loan was securitized or retained in the originator's loan portfolio during that time. Therefore, MBA requests that fixed rate loans be exempt from the proposed risk retention requirements if its date of origination is two to three years prior to the date the loan is placed into a securitized pool and the loan has been current at all times between the origination date and the date the loan is placed into a securitized pool. We request a similar "seasoning" exemption for otherwise QRM-eligible adjustable rate mortgages that have been current at all times between the origination date and two to three years after the first "reset" date. Holding risk in this manner would be in line with the objectives of the risk retention requirements.

5. Permit Commingled QRM and non-QRM Mortgage Pools With Risk Retention Determined at the Asset Level

Under the Proposal, all loans in an MBS must satisfy the QRM criteria in order to be eligible for the exemption from the proposed risk retention requirements. MBA is concerned that this may cause liquidity constraints for QRM loans. For example, creating a sufficient volume of QRM loans to sustain a securitization market will not be feasible until a considerable time after the regulations are issued in final form simply because no QRM loans currently exist. This may lead to a perverse outcome whereby QRM loans become viewed as unfavorable if securitizers or originators must bear the cost of holding and financing QRM loans for extended periods prior to amassing a sufficient amount to pool and securitize. We believe a better approach is to permit QRM loans to be included in non-QRM loan pools and vice versa so long as securitizers retain the requisite five percent risk of the credit risk with respect to the non-QRM loans included in a securitization transaction.

MBA recognizes Dodd-Frank's statutory provisions regarding risk retention requirements for QRM and non-QRM securities. However, Dodd-Frank includes two separate provisions that confer broad discretion on the Agencies to adopt or issue exemptions, exceptions or adjustments to the risk retention requirements. In the first instance, the Agencies are authorized to provide a total or partial exemption as may be appropriate in the public interest and for the protection of investors. In the second instance, the Agencies are authorized to adopt exemptions, exceptions or adjustments to the rules, including the risk retention requirements. Exemptions, exceptions or adjustments authorized by this provision must help ensure quality underwriting and encourage appropriate risk management. MBA believes adjusting the risk retention requirements to permit blended pools of QRM and non-QRM loans satisfies both statutory criteria. Creating greater liquidity in residential MBS is in the public interest because it permits the capture of efficiencies that the securitization process provides, which then, in turn, are passed on to consumers in the form of lower borrowing costs. Moreover, authorizing blended pools of QRM and non-QRM loans would retain the incentive to underwrite high quality loans because the higher risk retention requirement will still be maintained for non-QRM loans. We therefore request that securitizers be

allowed to create securities backed by a mix of both QRM and non-QRM loans that meet the QM parameters, so long as they retain the appropriate amount of risk for each underlying loan.

6. Other Considerations

FHA, Fannie Mae, and Freddie Mac

Impact on FHA
It is not at all clear from the Proposal whether the Agencies reflected on the relationship between the proposed QRM definition and FHA's eligibility requirements in light of FHA's exemption from risk retention requirements. If the rule maintains its high 10-20 percent down payment and low LTV and DTI requirements, demands for FHA, VA and other government financing will continue to grow and increase the government's share of the market. Qualified borrowers with less money to put down and who are successfully paying a greater share of their income for housing will have few non-governmental alternatives for affordable rates.

The proposed QRM definition also appears to conflict directly with the Obama administration's plan for reforming the housing finance system. In its report to Congress, "Reforming America's Housing Finance Market," the administration made clear that it intends to shrink FHA from its current role of financing one-third of all mortgages, and one-half of all purchase mortgages.

We support FHA's role as a source of financing for first-time homebuyers and other underserved groups. However, because of the wide disparity between FHA's down payment requirement of 3.5 percent and the proposed QRM requirement of 20 percent, MBA is concerned that FHA programs will be over-utilized. While FHA should continue to play a critical role in our housing finance system, MBA firmly believes that it is not in the public interest for a government insurance program like FHA to dominate the market, especially if private capital is available to finance and insure mortgages that exhibit a low risk of borrower default.

MBA suggests a better solution is to allow the use of credit enhancements to offset part of the down payment requirement for QRMs to provide some of the financing for low down payment loans that FHA would provide.

Fannie Mae and Freddie Mac
According to the Agencies, the proposed risk retention requirements would not apply to securities issued by Fannie Mae or Freddie Mac so long as these two GSEs are in conservatorship or receivership.

It is well-recognized that the mortgage market is functioning today because of heavy government support – a position that is neither sustainable nor desirable long-term. With Fannie Mae and Freddie Mac securitizing, and government agencies including

FHA, Veterans Administration and the Department of Agriculture insuring or financing most of the nation's mortgages, private investment capital remains largely on the sidelines. The rule, as proposed, could make it even harder for that to change. In fact, if finalized as proposed, the rule is likely to actually increase both the GSEs' and FHA's roles during a time when a discussion of the future of the GSEs' and the government's role in housing has yet to be resolved. While the proposed GSE "exemption" is appropriate at this time, as long as GSE securitizations enjoy an exemption, private investors subject to risk retention would have great difficulty competing given their extra capital costs and applicable risk retention requirements. As the economy recovers, the GSEs' share of loans would continue to grow.

MBA also is concerned that the GSEs or the FHFA might unilaterally change the GSEs' loan eligibility requirements, possibly making the requirements even narrower than the QRM-eligibility criteria. This is a concern because while the QRM definition is being developed on an interagency basis with the opportunity for public comment, the GSEs on the other hand may alter their loan eligibility criteria at their own discretion.

Use MISMO Standards for Data Definitions and Any Proposed Reporting Requirements

The Agencies refer to specific data elements throughout the Proposal. MBA urges that the Agencies utilize existing MISMO data standards when referring to these elements, and these open, non-proprietary, voluntary consensus standards should be utilized for any new reporting requirements.

Within the real estate finance industry MISMO XML standards are widely implemented. For example, Fannie Mae and Freddie Mac have adopted MISMO for the Uniform Loan Delivery Dataset, which is a common reporting dataset for loans delivered to the GSEs. The adoption of MISMO Standards will permit timelier implementation of new rules and will make it more cost effective for lenders to fulfill any new reporting requirements under the regulations.

Electronic Commerce

Consumers are displaying a growing preference to utilize electronic commerce for all kinds of activities, including financial transactions. MBA requests the Agencies to ensure that rules are written in language that does not limit the utilization of electronic commerce options, including electronic signatures.

Regulatory Coordination

The complexity, scope and novelty of the Proposal inevitably will lead to questions regarding interpretation and applicability. The logistical requirement that such interpretations and modifications must be issued jointly by six federal regulators further complicates the rulemaking process. MBA requests the Agencies to establish a specific framework for ensuring consistency in interpretation and issue resolution. Without specific agreement on how issues will be resolved, there is likely to be confusion, inefficiency, delay and uncertainty.

7. Re-Issue a Modified Proposal and Include a Detailed Impact Analysis

Economic Impact and Market Assumptions in the Proposal are Questionable
History is replete with instances where distortions were caused by well-intentioned government intervention in the credit markets, whether with the promotion of under-priced credit through vehicles such as GSE affordable housing goals, depository institution Community Reinvestment Act requirements, or the restriction of credit through regulations such as those implementing the Home Ownership Equity Protection Act. In all of these examples, the crucial decision was whether the regulations actually addressed the root cause of the problems and whether the cost of the distortion is offset by other benefits to the public and the markets. MBA believes the Proposal fails on both measures.

Cumulative Impact of Regulatory Activity
It is important to keep in mind that the risk retention regulations are not the only changes taking place in the financial services industry. We note that the Federal Reserve's report to Congress on risk retention urged regulators to consider the credit risk retention requirements in the context of all the rulemakings required under Dodd-Frank, some of which might influence the optimal form of credit risk retention requirements. MBA notes that the SEC's proposed modifications to Regulation AB, the new version of the Basel Capital Accord and the interagency mortgage servicing reform initiative also overlap elements of the Proposal. Individually, each one of these actions increases the costs of credit, which in turn imposes further restrictions on the availability of affordable real estate financing. We urge regulators to coordinate these separate rulemakings so that the cumulative impact does not forestall the recovery in the housing finance sector.

The layering effect of multiple regulations on similar topics causes market disruptions in a number of ways. Multiple rulemakings perpetuate uncertainty in the market. For example, the Proposal overlaps the Federal Reserve's proposed regulations defining the QM eligibility criteria. As a result, uncertainty will persist until both of these issues are resolved.

Multiple rulemakings also raise the level of difficulty from a compliance perspective. As mentioned above, the entire financial services regulatory landscape is being transformed and the changes are likely to stretch the capacity of even the largest financial institutions. The burden could prompt many smaller community lenders to exit the business.

MBA also urges the Agencies to consider the interplay between individual components of the Proposal. For example, the more onerous the PCCRA provisions are, and therefore the more that those provisions would operate to discourage securitization of residential mortgage loans subject to risk retention, the greater the significance of the QRM exemption will be to the MBS markets. Although some of these topics are mentioned individually in the supplemental information accompanying the Proposal, a

comprehensive review of the interplay between the Proposal and these other regulatory matters is lacking.

While it is true that the Agencies reviewed the Proposal's impact on small entities pursuant to the Regulatory Flexibility Act, MBA questions the value of the results of the review given its limited scope. For example, MBA believes the Agencies make the assertion that small entities will not be affected by the Proposal because the Agencies focused solely on the technical issue of whether the covered institutions would be subject to risk retention. The Agencies also apparently did not explore the extent to which securitizers are likely to pass along the costs of risk retention requirements to originators in the form of higher fees. Additionally, the Agencies do not address the practical implications of a potential contraction in the secondary mortgage market caused by the Proposal. Also, in this regard, it seems inappropriate for the Agencies to assert that these institutions would not be affected because they "sell their loans to Fannie Mae or Freddie Mac, which retain credit risk through agency guarantees and would not be able to allocate credit risk to originators under this proposed rule,"[22] while at the same time acknowledging plans to transition away from Fannie Mae and Freddie Mac.

Therefore, MBA requests the Agencies conduct a rigorous evaluation of the general efficacy of the Proposal, and the combined impact of each element of the Proposal on consumer financing availability and affordability, particularly in the likely scenario where the costs of compliance are passed from securitizers, to lenders, and ultimately to consumers. A detailed economic analysis of risk retention requirements is included in the **Appendix**.

We also encourage the Agencies to assess whether the distortions caused by the proposed risk retention framework and QRM exemption will have a disparate impact on borrowers of different demographic characteristics. It is quite possible that some lenders will manage their interest rate risk and liquidity by limiting their non-QRM offerings. Such lenders will face the dilemma that reducing their exposure to such risks increases their exposure to litigation risk stemming from allegations of discrimination.

MBA also believes a competitive impact analysis should explore whether the risk retention and QRM regulatory frameworks inadvertently create an advantage for unregulated entities. In particular, MBA requests the Agencies to consider whether a narrow QRM exemption increases the attractiveness of participation in the non-QRM market by entities that can operate without proper and adequate capital requirements, contingency reserves, and state or federal oversight.

Conclusion

MBA believes that without substantial revisions, the Proposal will have a significant negative impact on credit availability and affordability for first-time, minority, low-to-moderate income homebuyers as well as others in the marketplace. While we endorse

[22] 76 Fed. Reg. 83, 24144, (Apr. 29, 2011).

the promotion of safe and sound lending standards through the statutory QRM exemption, we urge that the proposed exemption be redrawn to more closely follow the contours of the parameters set by Congress.

This proposal is of the utmost importance to restoring a strong and stable housing market. MBA urges the Agencies to carefully consider our request to conduct a more substantive economic impact analysis and publish a revised Proposal in order to give interested parties another opportunity to review and comment.

Sincerely,

David H. Stevens
President and Chief Executive Officer

Attachment

Appendix
Economics of Risk Retention

Adverse Market Effects and Misallocation of Capital
There are clear and predictable negative market impacts from retained risk requirements as proposed. These arise from the discrete nature of the requirement and the moral hazard effect of requiring originators to hold capital against risk over which they have no control. (Note that while the Proposal specifies risk retention requirements for securitizers and originators above a certain contribution level to a pool, this section will refer only to originators for purposes of simplicity.) The results of higher costs are the same whether originators/securitizers end up holding a horizontal or vertical strip in risk retention, although the reasons differ somewhat. Simply put, originators/securitizers have a higher overall cost of capital and weighted average cost of funds that will drive up prices if they retain the horizontal strip. If they retain the vertical strip, they will be price takers at levels that will not provide adequate returns, and possibly negative returns, based on their funding costs. They will respond by not doing those loans or significantly increasing pricing at origination to subsidize the returns on the vertical strip. In either case, the result is significant increases in costs to borrowers at the discrete point where risk retention requirements are triggered.

The first case examined is what happens when the retained risk is held as a horizontal, first-loss position and why the total capital (investor and originator combined) will be greater for non-QRM mortgages than the market would demand for those mortgages with the same risk characteristics but without risk retention. The total capital that must be held against the risk of a mortgage is a function of that risk, with the amount of capital increasing as risk increases.

$$Total\ Capital_{No\ risk\ retention} = f(Risk_{Mortgage})$$

Under risk retention, capital is held by both the investor and the originator and total capital held is the sum of the two:

$$Total\ Capital_{Risk\ Retention} = RRCapital_{Investor} + RRCapital_{Originator}$$

The question is whether the total capital held with risk retention is the same as the amount of capital that would be held without risk retention. In other words, will the reduction in the amount of capital held by the investor because it now holds only 95 percent of the potential loss, and in a second loss position, be offset by the capital held by the originator. The answer is clearly due to the different set of risks faced by the originator and the multiple claims against the originator’s capital.

The originator would have to hold at least the same amount of capital as the market would demand for a first loss position on a mortgage with a given set of risks. The amount of capital could be reduced if the market and investors actually believed that the quality of the mortgages would improve with risk retention, all other credit factors held

equal. This is likely true for factors where the originator must exercise judgment, such as stated income loans, but is not true for objective factors like loan to value ratios or debt to income ratios. There are, however, two other factors that would increase the amount of capital the originator would have to hold. The first factor is the fact that not only does the originator not have control over the credit criteria, but also the originator is subject to potential gaming of the system by the investor that does determine the criteria. It is possible that the investor, knowing that the originator will have to bear the first five percent of any loss, will weaken its credit criteria. If the investor is able to put the first five percent of any loss for any reason to the originator, the investor would likely be willing to accept riskier loans than it would if it had to absorb all of the loss. Since it is unlikely that the originator has access to all of the credit experience that the investor uses in its models or the true performance of a particular combination of credit criteria, the originator will logically assume that this is the case and act accordingly. Under game theory the originator will react based just on the potential that it is true. The originator will either put credit overlays on the mortgages it is willing to originate for that investor, raise its fees for holding that potential portion of unknown risk, and/or increase the amount of capital it holds against that unknown risk.

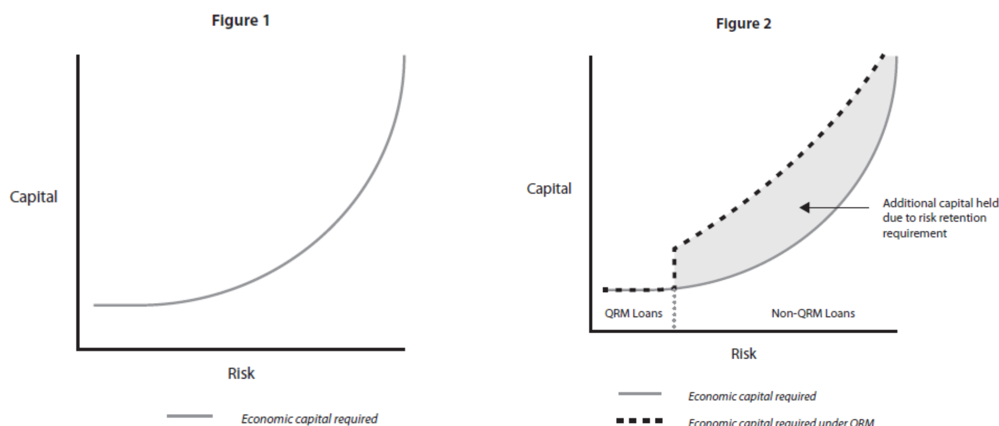
The second factor is that the originator's ability to maintain warehouse lines and counterparty agreements is dependent on the originator's ability to maintain sufficient capital. Originators already face a multitude of risks in the origination process. While the capital held for the horizontal piece of the retained risk would be on top of the capital held for all other risks, it would not be segregated from it. Any counterparty to the originator would realize that the capital held by the originator as requirement to do business with the counterparty could be wiped out by unexpected losses in the horizontal retained risk piece. While the counterparty could conceivably run detailed performance models against the originator's retained risk portfolio, the cost of any such exercise and the reliability of the results would lead the counterparty simply to demand that a higher overall level of capital be held by the originator, higher than what is demanded by the originator's operations alone plus the capital demanded by the mortgage risk alone.

In the same vein, originators face the problem that a decision by warehouse lenders to pull their warehouse lines, or cutoffs by other counterparties, would put them out of business immediately. Originators face the possibility that a mere drop in capital as opposed to actual insolvency could result in the end of the business as a going concern. Since lenders need loan volume to stay in business, they do not have the option of hunkering down and allowing earnings to fill the hole left in capital by loan defaults. This is simply not an option for many mortgage originators the way it has traditionally been for large banks. The result is that originators would have to hold more capital against the same credit loss, not so much due to the risk of insolvency but due to the risk of being shut down as a going concern before the point of insolvency.

Therefore, the market impact of the Proposal is that the capital required under risk retention becomes higher than the economic capital required by the underlying risk of the mortgage:

$$Total\ Capital_{No\ Risk\ Retention} < Total\ Capital_{Risk\ retention}$$

In addition, the required capital jumps above economic capital at the discrete point at which risk retention is triggered. The figures below illustrate the point:



The cost of mortgages would not necessarily go up if the originator's weighted average cost of capital with risk retention was less than the weight average cost of capital of investors holding mortgage securities. However, this is clearly not the case. Each of the components of an originator's weighted average cost of capital is higher than what an investor faces. Defining the originator's weighted average cost of capital as:

$$Weighted\ Average\ Cost\ of\ Capital_{Originator} = \alpha(Cost\ of\ Equity_{Originator}) + \beta(Cost\ of\ Debt_{Originator})$$

Where α is the percentage of equity and β is the percentage of debt. According to MBA's Quarterly Performance Report, the tangible capital to assets ratio for mortgage banks generally runs between 30 percent and 40 percent while for leveraged holders of mortgage securities like banks, the ratios run from around 6 percent to as high as 15 percent.[23] Since the capital to asset ratio for mortgage bankers is already higher, there is no reason to believe that ratio would fall to equal that of investors for the reasons already stated. Similarly, the originator's cost of debt would likely be higher since the providers of that debt face a portfolio of risks not necessarily faced by other investors, or in the case of banks, protected in part by FDIC insurance and depositor preference laws. There is no reason to believe the originator's cost of equity would be any lower and several reasons, already enumerated, as to why it would be higher.

[23] The capital to asset ratio for Fannie Mae and Freddie Mac was 2.5 percent but that was clearly too low, as were the highly leveraged positions of the investment banks that failed after the meltdown.

Therefore, the high cost of capital faced by the originator would cause mortgage rates to make a discrete jump at the point where risk retention kicks in. That means that the return on the 5 percent horizontal strip would have to be high enough to cover the much higher cost of capital of the originator. Not only will this likely increase mortgage interest rates, but also, as will be discussed below, borrowers will likely switch to other types of mortgages or pay large upfront transaction fees. Another likely impact is that those mortgages would be made by lenders who do not rely on securitization. Note that this increase in required capital, and the increase in rates, has nothing to do with the change in the risk of the underlying mortgages.

The above analysis dealt with the results of forcing originators to hold the first five percent of losses with a horizontal strip of the securitization. The obvious question is whether the problem is eliminated by requiring instead a vertical strip, that is, where originators share *pari passu* in the risk of the mortgages. While this solves the problem of originators potentially being gamed by being forced to take on risks of which they are not aware, it does not solve the problem of the higher overall cost of capital for originators. In the case of the vertical slice, however, originators cannot impact the yield on the securities. With a horizontal, they can attempt to adjust the yield on the horizontal strip to provide an adequate compensation. With the vertical strip, however, originators have to accept the yields demanded by the rest of the market. This leaves the originator with three not very good choices. First, the originator can accept returns on capital that are below market but eventually be forced to suspend operations when it can no longer attract the capital needed to operate. Second, the originator can attempt to charge higher upfront fees to compensate for the inadequate yield on the five percent vertical strip. Third, the lender can simply refuse to originate loans that provide inadequate returns due to risk retention.

Figure 2 has profound implications for the future shape of the mortgage industry under the narrow QRM box in the Proposal, regardless of whether the retained risk is held as a vertical or horizontal strip. Prices for loans sold into securities will go up at discrete points that have nothing to do with the actual risk of the mortgages but are driven explicitly by regulatory decisions. Since markets often find ways to adapt to regulatory interventions, we are likely to see two results from the impact of risk retention on price. First, alternative lenders such as Real Estate Investment Trusts (REITs) and hedge funds would step into this space and under price the securitized market for the fixed rate loans. Therefore, any effort by originators to charge rates that reflect the economic realities of risk retention rather than the economic realities of the mortgage will simply create competitive pricing advantages for lenders not delivering loans into securities. Second, just as we see with the loans that exceed the regulatory, non-market-driven GSE loan limits, borrowers just outside the QRM would shift to ARMs and hybrid loans held in bank portfolios.

The result will not be a liquid secondary market that covers the entire credit continuum as some have suggested. The loans that trade in the secondary market will be those that fall within the QRM box and those that fall far outside of it. REITs and hedge funds

are likely to have risk appetites that are limited to loans just outside the QRM box, not loans far outside the QRM box. If originators cannot obtain adequate returns on the capital they would have to put up for loans that are just outside the QRM box, they will originate riskier loans beginning at the point where returns on equity can compete with portfolio lenders.

The ultimate result will be a bi-modal distribution for loans in the securitized market based on risk, very safe loans and much riskier loans, but nothing in the middle. The bifurcation of the market will negatively impact pricing due to problems with liquidity and price discovery between the two markets. As the riskier portion of the market is seen as something approaching subprime lending, it is likely a number of institutional, pension fund and international investors will simply adopt guidelines prohibiting investing in that segment. Banks and other regulated institutions may not have the option either to portfolio non-QRM loans if the definition and restrictions eventually work their way into bank credit and capital regulation.

Finally, the question has been raised regarding the difference in rate between a securitized fixed-rate 30-year QRM and a non-QRM. While it is clear that there will be a discrete, discontinuous jump in additional required capital at the point where the risk retention requirements come into play, and an increase in price to cover the required return on that capital, it has been shown that few if any securitized non-QRM loans will be made immediately outside the QRM box. These loans will go elsewhere so the pricing on those loans will be driven by pricing in the non-securitized market. The non-QRM loans that are securitized will be much riskier than their QRM counterparts. At that point the pricing differentials will be driven as much by credit quality as how shallow the market is for potential investors in those securities. It is important to note in this analysis that the proposed PCCRA requirements add an estimated two to five percentage points to interest rates on securitized non- QRM loans, further compounding this disparity.[24]

Underwriting Quality Versus Credit Quality

The central flaw in the QRM is that it is a tool intended to address underwriting quality that is being used to regulate credit quality. Underwriting quality is a function of the capacity of processes and procedures to document and verify the extent to which a prospective borrower meets a specific credit risk profile, and identify fraud. On the other hand, the QRM's DTI, LTV and credit history requirements attempt to impose industry-wide credit parameters. As a result, the QRM unnecessarily limits the loan performance continuum used by lenders and investors to match products and investments to their risk appetites. Unless this fundamental flaw is addressed, the proposed risk retention framework will result in significant market distortions.

MBA's concern relates to the fact that the Proposal does not recognize the differences between what risks an originator can control in the underwriting process and what credit risks an originator cannot control. (Note that while the Proposal specifies risk retention

[24] Re: Credit Risk Retention Proposed Rule" Comment Letter submitted by Bank of America, July 13, 2011.

requirements for securitizers and originators above a certain contribution level to a pool, this section will refer only to originators for purposes of simplicity.) The underwriting process involves verifying the income of the borrower, the borrower's total assets, the borrower's credit history and the current value of the home. In other words, the originator needs to verify that everything on the loan documentation is true because the credit assessment will be based on the numbers in the loan file. Even though some of these credit factors, such as current income are easy to identify and others, such as total debts, are more difficult, the originator must stand behind his or her findings and put his or her capital behind the certification that the information is true.

In addition to gathering the credit information, the originator must certify that the loan fits within the investor's credit concept. This is a crucial distinction. The investor sets the credit parameters. The originator's role is only to certify that the loan falls within those parameters, not to play a role in setting the credit parameters. Finally, the originator ensures that all applicable laws and regulations at the federal, state and local level have been followed and that all of the necessary documents have been properly drawn, executed and sent to the investor.

This is an expensive process. The originator has the expense of hiring and training underwriters, running fraud checks, paying outside vendors to verify information and reviewing the validity of appraisals. While some of the direct costs, such as the cost of appraisals, are passed on to the applicant, most come directly out of the lender's profits. The important point is that while quality underwriting can reduce fraud and mistakes, it cannot change the underlying credit quality of the applicant. In other words, the originator can determine how much to spend on verifying and re-verifying the information in the credit file, how much to dig into the applicant's past, up to the point of doing a full forensic audit of every penny that applicant has spent over the previous ten years. The originator could spend $500, $1,000 or $5,000 verifying the fact that the applicant wants to borrow 95 percent of current value of a particular loan and has the income and assets to support the loan, but the loan's performance will still crucially depend upon factors that are totally outside the control of the originator, unless, of course, credit models are developed that can predict divorce, job loss, serious illness or the borrower voluntarily running up large amounts of debt after the loan is closed. In addition, the originator has no control over subsequent changes in the value of the home. The shutdown of a principal industry in the town where the house is located or the sudden over-building of new homes and subdivisions would all negatively impact the value of the home and expose the originator to loss, but are beyond the ability of the originator to control.

Certain loan and borrower attributes are straightforward to document and verify and can be disclosed to investors in a standardized format. Other attributes are necessarily more difficult to disclose in a standardized manner, and these are areas where risk retention can be beneficial to the market. These attributes are those where the originator's judgment is required rather than simply the collection and verification of information. Therefore, the types of loans on which the originator should retain some

risk exposure are those where the originator's judgment is involved. Stated income or low-documentation loans are prime examples of loans where the originator's judgment comes into play. It is the originator's responsibility to judge whether the applicant has a valid reason not to document income and whether the applicant's profession, source of income or other circumstances merit a loan where income is not fully documented, and whether the stated income is reasonable given the applicant's job, age and experience. Similarly, interest only and pay option-ARM loans require a somewhat greater degree of sophistication on the part of the borrower to be successful. Since the investor must take the originator's word for the fact that the borrower's circumstances and sophistication merit these types of loans, the originator should reasonably be expected to put up capital to support its judgment.

The originator does not set the credit standards. The investor does. The originator may choose not to make loans with credit standards as weak as the investors are willing to accept because they do not want to accept the risk. An important example where this has already occurred is in the FHA market. Many lenders, aware of their potential financial and reputational liability from lending to higher risk borrowers, have not fully utilized the credit standards published by FHA, but rather used their own judgment to lend based upon more conservative standards. These credit overlays were criticized by some, but lenders forcefully argued that if they bore a portion of the risk, they would act to curtail their risk.

In summary, the failure to recognize the fundamental differences between quality underwriting and credit quality, that is, the differences between what the originator can and cannot control, is the central flaw in the retained risk requirement in the proposed rule. The clear purpose of the statute was to address the issue of originators misrepresenting the true quality of the loans being sold into the secondary market, as well as the failure of securitizers to exercise sufficient due diligence over the quality of what was being delivered. The Proposal however, goes well beyond what was intended in the legislation. It establishes de facto credit standards for mortgages through the risk retention requirement.