



August 1, 2011

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Honorable Shaun Donovan
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Mr. John G. Walsh
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Re: Interagency Proposed Rule on Credit Risk-retention

OCC: Docket No. OCC-2011-0002 regs.comments@occ.treas.gov

Federal Reserve: Docket No. R-1411 regs.comments@federalreserve.gov

FDIC: RIN 3064-AD74 comments@FDIC.gov

SEC: File Number S7-14-11 Rule-comments@sec.gov

FHFA: RIN 2590-AA43 RegComments@FHFA.gov

Ladies and Gentlemen:

The Center for Responsible Lending (CRL) appreciates the opportunity to comment on the rules on credit risk-retention (Risk-Retention Rule) proposed by the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), U.S. Securities and Exchange Commission (SEC), Federal Housing Finance Agency (FHFA), and Department of Housing and Urban Development (HUD) (collectively the Agencies), pursuant to section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act).

I.

Introduction and Summary

The Dodd-Frank Act employs several complementary strategies for fundamentally reforming the market for residential mortgage loans. The most important of these are in Title XIV, which includes prohibitions related to the mortgage origination abuses that set off the recent financial crisis. Title XIV also creates incentives for lenders to originate “Qualified Mortgage” (QM) loans—mortgages without risky features such as balloon payments, interest-only periods, or rapidly-exploding interest rates—and requires lenders to fully underwrite the loans to verify that the borrower’s documented income suffices to repay the loan. Congress included these standards in QM because these factors separate the safe and sustainable conventional lending of the more distant past from the catastrophic lending practices of the last decade. Dodd-Frank’s risk retention rules in Title IX complement Title XIV. The Qualified Residential Mortgage (QRM) exception to the risk-retention requirements provides further incentives for originators to offer QM loans by providing that only QMs can qualify for the QRM exemption.

A. The proposed QRM definition is too narrow

The Agencies face an important choice in determining parameters of QRMs: They could make QRM loans ultra safe “gold-plated” loans that meet standards well in excess of responsible lending norms. Alternatively, they could make QRMs safe and sensible loans like the well-performing conventional loans that fueled a healthy housing market for three decades. It is unfortunate that the Agencies have decided to take the former path rather than the latter because this undermines the goal of extending responsible loans to the largest possible population of homeowners. In this Comment we identify the provisions of the proposed rule that would unduly restrict the market and suggest modifications to the proposed rule. With these changes, the rule would help incentivize sustainable mortgage lending without adding unnecessary costs and undue barriers to market access.

The proposed rule focuses on the loan factors that create default risk in order to identify loans that are close to risk-free. It would enable a small group of relatively wealthy consumers to receive the cost advantages associated with the exemption from risk-retention. It would also allow investors to easily identify securities backed by “gold-plated” mortgage loans and to enjoy the cost advantages associated with the exemption. Weighted against these possible benefits are the costs and disadvantages that the Agencies’ approach would impose on most mortgage borrowers and investors. The proposed rule would disproportionately burden the middle class, first-time homebuyers, and families of color, and it would further strain the housing market and economic recovery.

Instead of using such a narrowly-defined QRM, the Agencies should in their final rule eliminate down-payment as a factor in the definition of a QRM. This would ensure that QRM loans are not only sustainable and properly underwritten, but also affordable to most homebuyers. A healthy market finds an acceptable level of default risk that balances liquidity needs against the need to prohibit abusive or irresponsible practices. Accordingly, the Agencies should broaden the loans that qualify under the QRM definition to achieve this healthy balance. Doing so also

would align the rule with the Congressional intent, as Dodd-Frank’s language, structure, and legislative history call for a balanced approach to QRM.

B. Overview of CRL’s recommendations

- The Agencies should delay finalizing the QRM rule until after the final QM rule has been issued. The QRM final rule should be harmonized with the QM final rule to facilitate compliance.
- QRM loans should meet all QM requirements.
- Just as the QM requirements will not, and should not, include down-payment or LTV, neither should the QRM requirements. The point is not that down-payments should not be required, but rather that they should be set by the market. QRM loans should be available to credit-worthy borrowers who demonstrate a documented ability to repay the loans and can afford the loan’s down-payment requirements, without government-imposed wealth-based barriers such as down-payment requirements.
- The final rule defining QM loans will include debt-to-income ratio (DTI)/residual income standards of Dodd-Frank’s ability to repay requirements. To avoid unnecessary regulatory complexity, the Agencies should await the final rule on QM and adopt the same approach for QRM.
- Similarly, the Agencies should defer to the QM final rule on underwriting standards and should not include separate credit history requirements. At all events, the final rule should not limit credit qualifications to the exclusive “best of the market” standards set out in the proposed rule.
- The Agencies correctly suggest caps on interest rate increases in order to guard against payment shock and follow the statute. However, the proposed caps do not, on their own, provide sufficient protection. The rule also should prohibit QRM ARM loans from including rate increases in excess of one percent per year and five percent over the life of the loan.
- We support the Agencies’ servicing standards in the proposed rule.

II.

Badly-structured loans and lack of underwriting, not low down-payments, caused the foreclosure crisis

Loans with loan-to-value ratios above 80 percent have been originated safely for over 50 years, but they expanded in volume with the growth of the secondary mortgage market in the 1980s. Over 27 million of these low down-payment loans were made between 1990 and 2009 (in addition to those originated by the Federal Housing Administration (FHA) and Veterans’

Administration (VA)).¹ This represents almost one-quarter of the loans purchased by Fannie Mae and Freddie Mac and 13 percent of total mortgage originations during this period. Because of these low down-payment loans, millions of low-to-moderate income families became successful homeowners. These mortgages generally performed well, producing limited losses for lenders, investors and taxpayers, while expanding the middle class.

The risks associated with subprime and Alt-A loans of recent years derived not from small down-payments so much as from the failure to evaluate the borrower's ability to repay even a "teaser rate," much less the period of the loan after the teaser rate expires; the failure to document income; and the presence of other risky loan features, such as explosive payment increases and exorbitant prepayment penalties that made it difficult for struggling homeowners to exit the loan, particularly when housing values ceased to rise. Low down-payment loans without these risky features have generally performed well. Studies have shown that for these responsible loans, low down-payments are not an important driver of default, at least so long as there is some down-payment.² In a recent review of loan performance based on various loan attributes, Mark Zandi observed, "Even loans with only three percent down at origination have experienced a surprisingly modest 4.7 percent foreclosure rate" during the recent period of extreme financial stress, where the loans were otherwise well structured and underwritten.³

This century's first decade saw the rise of a mortgage lending model financed by investors in private label securities (PLS). Loans were characterized by excessively risky features including:

- **Exploding Adjustable Rate Mortgages (ARMs):** The most common loan in the subprime mortgage market was the so-called hybrid adjustable rate 2/28 or 3/27 loan, with an interest rate that was fixed for two or three years out of a 30-year term. The interest rate would increase sharply at the end of the fixed rate period, even if interest rates in the economy stayed constant.⁴
- **Staggering Prepayment Penalties:** To avoid default, the typical borrower had to sell or refinance before the rate reset. This produced prepayment penalties, generally equal to six months' interest—typically 3.5 percent to 4 percent of the loan balance. Alt A loans also commonly had prepayment penalties. Because the average borrower did not have the cash on hand sufficient to cover the prepayment penalties and refinancing fees, they had to pay them from the proceeds of the new loan. This produced ever-declining equity even when

¹ Private mortgage insurance volume as reported by Inside Mortgage Finance, *Mortgage Market 2009 Statistical Annual*.

² Mark Zandi, "Special Report: The Skinny on Skin in the Game," *Moody's Analytics* (Mar. 11, 2011) at 3, available at www.economy.com/mark-zandi/documents/QRM_030911.pdf.

³ Id.

⁴ A typical loan originated in 2006, for example, would start at the rate of roughly eight percent, would rise to ten percent two years later, and, depending upon the movement of interest rates generally, would continue to rise every six months up to a cap of roughly 13 percent. See Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Treasury, and National Credit Union Administration, "Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products," (Docket No. OTS-2008-0003) (Apr. 25, 2008), at note 7 and text; *Inside B&C Lending* (Dec. 8, 2006); see also testimony of Michael Calhoun before the Financial Services and General Government Subcommittee of the U.S. House Appropriations Committee: "Consumer Protection in Financial Services: Subprime Lending" (February 28, 2008), available at http://www.responsiblelending.org/pdfs/m-calhoun-2-28-08_testimony-final.pdf.

home prices were rising. Once home prices declined, foreclosure risk climbed catastrophically.

- **Broker Compensation such as Yield Spread Premiums Incentivized Brokers to Steer Borrowers into Loans that were More Expensive and Less Stable than they Qualified for:** Most borrowers who received subprime loans qualified for better, more sustainable loans. Many qualified for lower-cost prime loans;⁵ those who did not often would have qualified for sustainable, 30-year fixed-rate subprime loans for at most 50-80 basis points above the introductory rate on the unsustainable exploding ARM loans they were given.⁶ This 50-80 basis point increase is modest compared with the 350 to 400 basis point prepayment penalty (plus additional refinancing fees) that the borrower had to pay to refinance the typical 2/28 loan before the end of the second year.
- **No Escrows for Taxes and Insurance:** Subprime lenders commonly did not escrow for taxes and insurance, attracting borrowers with the deceptive lure of lower monthly payments.⁷ For example, a marketing flier from that period produced by Chase Home Finance touted: “Taxes and Insurance Escrows are NOT required at any LTV, and there’s NO rate add!”⁸ This practice increased the risk of default when the tax and insurance bills came due and produced further equity-stripping cash-out refinancings where the borrower had the equity to cover the bills and refinancing fees and penalties.
- **Underwriting Without Regard to Borrower Ability to Repay after Rate Reset:** Underwriting failures went beyond the failure to consider ability to repay; subprime lenders fully understood that most borrowers could not afford the loan when the rate reset.⁹ When

⁵ For example, a *Wall Street Journal* study found that 61 percent of the subprime loans originated in 2006 that were packaged into securities and sold to investors “went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms.” See Rick Brooks and Ruth Simon, *Subprime Debauchery Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, WALL ST. J., Dec 3, 2007, at A1. Freddie Mac estimated in 2005 that more than 20 percent of borrowers with subprime loans could have qualified for prime. See Mike Hudson and E. Scott Reckard, *More Homeowners With Good Credit Getting Stuck With Higher-Rate Loans*, L.A. TIMES, Oct. 25, 2005, available at <http://articles.latimes.com/2005/oct/24/business/fi-subprime24>.

⁶ January 25, 2007 letter from the Coalition for Fair and Affordable Lending (“CFAL”) to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3. CFAL was an industry group representing subprime lenders.

⁷ A review of the Federal Reserve Board’s 2001 survey of Consumer Finances Survey found that “Only 40 percent of lower-income borrowers have an escrow account, compared to 46 percent of all non-FHA borrowers with loans between \$25,000 and \$300,000. Only 19 percent of borrowers with mortgage rates of nine percent or higher have escrow accounts. Twelve percent of lower-income borrowers have escrow accounts, compared to 26 percent of higher-income borrowers with rates in that same range.” See Neighborhood Housing Services of Chicago, Inc., *Home Ownership Preservation Initiative, Partnership Lessons and Results: Three Year Final Report* (July 17, 2006), at 31.

⁸ Chase Home Finance Subprime Lending marketing flier, “Attractive Underwriting Niches”, at www.chase2b.com (available as of 9/18/2006). This finance company was not affiliated with JPMorgan Chase & Co.

⁹ During the crisis, DTIs went through the roof, commonly qualifying borrowers who would have to spend more than half of their gross monthly income toward their mortgage payment. Making matters worse, these calculations frequently did not include monthly escrows for taxes and insurance, so that even the staggeringly high DTIs of 50-55 percent understated the monthly housing expense. And even this “standard” was not always applied in a meaningful way. For example, an Option One prospectus from 2005 disclosed that Option One underwrote its loans to the lesser of the fully indexed rate or one percentage point over the start rate. For a typical 2/28 loan of that

the banking agencies finally proposed in 2007 to require lenders to determine whether borrowers could afford their loans once the monthly payments increased, industry opposed the standard because many existing borrowers could not meet it. Countrywide estimated that 70 percent of the company's recent loans would not meet this standard.¹⁰

- **Underwriting Without Verifying or Documenting Borrower's Income:** During the lending boom, lenders commonly originated subprime and Alt-A loans without documenting the borrower's income.¹¹ These loans were frequently underwritten with inflated statements of the borrower's income.¹² Lawyers representing borrowers in predatory lending cases often found the borrower's tax returns included in the file of those who were nevertheless given "no doc" or "low doc" loans. Unbeknownst to these borrowers, they paid extra points in their interest rate for the "privilege" of receiving a no doc loan, even where they provided full documentation to the broker.

In response to the foreclosure crisis, many commentators blamed homeowners for mortgage failures, saying that lower-income borrowers were not ready for homeownership or that government homeownership policies dictated the writing of risky loans.¹³ The data refute this claim. Empirical research shows that the elevated risk of foreclosure was inherent in the structure of the loan products that dominated the subprime and Alt-A markets, and that many of these same borrowers could easily have qualified for less risky mortgages that were far less likely to end in default. These data are discussed more fully in the next section of this comment.

A QRM definition that excludes loans with these features will help return the market to the stable lending norms of years past. Large down-payments, extreme credit restrictions, and severe debt-to-income limits are not required to ensure safe and sound mortgage and financial markets.

period, the fully indexed rate would almost invariably exceed one-percentage point above the start rate, so using this approach to determine the debt-to-income ratio did not even fully capture the interest payments. See Option One Prospectus, Option One MTG LN TR ASSET BK SER 2005 2 424B5 May 3, 2005, S.E.C. Filing 05794712 at S-50.

¹⁰ Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," Oct. 26, 2007.

¹¹ In the height of the subprime boom, more than 50 percent of the subprime sector was composed of loans underwritten using less than full documentation standards. Structured Finance: U.S. Subprime RMBS in Structured Finance CDOs, FITCH RATINGS CREDIT POLICY (New York, N.Y.), August 21, 2006, at 4.

¹² Over ninety percent of a sample of stated income loans exaggerated income by 5 percent% or more and almost 60 percent exaggerated income by over 50 percent. Mortgage Asset Research Institute, Inc, Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association, p. 12, available at <http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf> (April 2006).

¹³ It is popular, although incorrect, to blame the Community Reinvestment Act (CRA) and Fannie Mae and Freddie Mac (the GSEs) for the foreclosure crisis, notwithstanding significant failures at the GSEs that have exposed taxpayers to huge losses. For a complete discussion of why CRA and the GSEs did not cause the crisis, see Testimony of Eric Stein, Center for Responsible Lending, before the Senate Committee on Banking (Oct. 16, 2008), available at <http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf>.

III.

Eliminating Risky Loan Features and Requiring Basic Underwriting Standards Will Return the Mortgage Market to Favorable Performance Rates

A. Historical data reveal a more equitable way of returning the market to acceptable performance.

Performance data for loans originated during the last decade show that simply eliminating risky loan features is itself sufficient to return default levels to acceptable levels. Figure 1 includes loan performance information for various types of loan products originated between 2000 and 2008. The last row estimates what the default rate would have been on “QRM” loans that simply eliminated the riskiest loan features (no or low documentation of income, prepayment penalties, balloon payments, interest-only payments, negative amortization, or adjustable rate loans with fixed rate periods of less than five years). Even without imposing any limits at all on debt-to-income ratios, loan-to-value ratios, or credit history, loans meeting just the product feature standards of QRM would have performed acceptably well—with a five percent default rate during the worst foreclosure crisis in the last 70 years. Even largely high LTV FHA loans, excluding those with seller-financed second mortgages, had acceptable default rates over this period. The QRM product-level loan default rate is below the rate for prime loans (which included loans with risky features). This level of loan performance would neither threaten the safety and soundness of the financial system, nor expose investors to unacceptable or unexpected losses.

This result is striking because it demonstrates that acceptable default rates could be achieved without restrictions that disproportionately exclude lower wealth or lower income borrowers. Of course, adding limitations on debt-to-income and/or credit history would reduce default rates further—but further reductions are not necessary for investor protection or systemic stability and would unnecessarily burden many credit-worthy borrowers and the nation’s economic recovery.

In short, if a sensible QRM definition without a down-payment requirement had been in place between 2000 and 2008, these loans would be expected to have had acceptable default rates, while still preserving the ability of low- and moderate-income families and families of color to enjoy the benefits of homeownership. Significantly, this chart covers that worst years of the lending crisis; in normal times, default rates would be expected to be even lower.

**Figure 1:
Product-Level-Only QRM Requirements Create Acceptable Default Rates,
Without Regard to LTV, Credit Score or DTI Requirements.
(Reviewing Loans Originated from 2000-2008)**

Loan Type	# of Loans in the Sample	Percentage of Loans 90+ Days Delinquent or Foreclosed Upon by February 2011 ¹⁴
All Loans (Conventional Prime+Alt-A+Subprime+FHA)	39,544,931	8.3
Subprime	3,827,451	23.0
ALT-A	1,651,751	20.9
Federal Housing Administration, Excluding Seller-Funded Down-payment Assistance (SFDPA) ¹⁵	2,566,958	7.1
Conventional Prime	30,023,276	5.5
Loans meeting QRM product feature limits only (i.e., no limits on LTV, credit score, or DTI) ¹⁶	8,569,315	5.0

Source: LPS Analytics loan level database and Blackbox Logic loan level database.

These data demonstrate the wisdom of focusing the QRM definition on product-level restrictions that do not exclude credit-worthy borrowers.

B. A QRM definition that eliminates risky loan features would result in well-performing loans even to higher-risk borrowers.

As further evidence that eliminating risky product features without requiring high down-payments leads to lower default rates, Figure 2 below demonstrates the difference in default rates between subprime and FHA loans among borrowers with similar credit scores and debt-to-income ratios. All these loans have LTVs of greater than 90 percent and FICO scores between

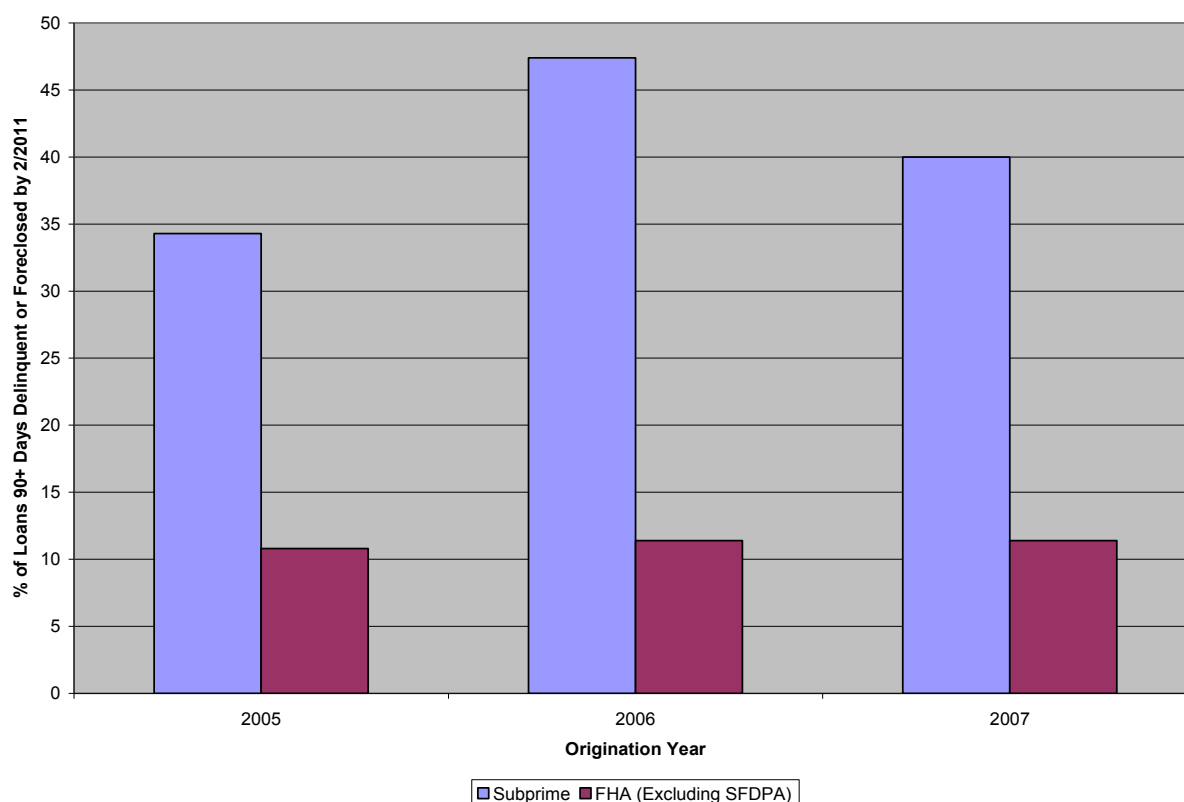
¹⁴ Defined as delinquency of 90 or more days or in the process of foreclosure, mortgages previously foreclosed upon, or real-estate owned properties (resulting from a foreclosure, a deed-in-lieu of foreclosure, or short sale).

¹⁵ For FHA loans, over 10 percent of loans are currently 90 or more days in default or in foreclosure, or ever foreclosed upon, as of February 2011. These include loans made through the since-terminated Seller-Finance Down-payment Assistance Program (SFDPA). The program was fraught with abuse, including seller fraud, that severely increased default rates for reasons unrelated to the borrower’s creditworthiness or actual loan-to-value ratios. For this reason, we have excluded SFDPA loans from the pool shown here; they are no longer permitted. According to the *Federal Register* (Vol. 73, No. 116), the ratio of SFDPA loans to other FHA loans on expected lifetime claim rate is 2.33. SFDPA loans accounted for 37 percent of all FHA purchase loans with LTV>90 percent in FY 2007. Therefore, we estimate that for FHA loans excluding SFDPA, their default rate is estimated as the default rate of all FHA divided by 1.4858.

¹⁶ Loans with interest-only or negatively amortizing payments, balloons, prepayment penalties, low or no income documentation, or adjustable interest rates with fixed terms under five years were excluded to create a “QRM” loan sample.

580 and 680. Generally speaking, these subprime loans contained a battery of risky loan features, including lack of underwriting to fully indexed or maximum interest rates, lack of documentation of income, prepayment penalties, and zero-interest or negatively amortizing payments. FHA loans, on the other hand, lacked these risky features, though they too had low down-payment requirements of 3.5 percent. The FHA loans have performed much better than the subprime loans.

Figure 2: Comparison of Subprime and FHA loans (Excluding Seller-Financed Down-payment Assistance Program Loans), Demonstrating that Limiting Risky Product Features Without High Down-payment Requirements is Associated with Lower Default Rates



Source: LPS Analytics loan level database and Blackbox Logic loan level database. See data footnotes from figure 1.

The chart above considers FHA and subprime loan performance for loans originated in the three worst years of the crisis, when soaring home price appreciation was no longer available to mask the poor performance of unsustainable loans. For each of 2005, 2006 and 2007, the default rate on FHA loans was a small fraction of the default rate on risky product feature subprime loans to borrowers with comparable credit characteristics. The rates here reflect the performance of loans originated just before the bursting of a historic housing bubble, which led to the most severe recession since World War II. The default rates on both sets of loans are significantly higher than in normal times.

A number of studies provide further evidence that loan performance and loan structure are strongly correlated. For example, Vertical Capital Solutions found that the least risky loans based on product characteristics significantly outperformed riskier mortgages during every year that was studied (2002-2008), regardless of the prevailing economic conditions.¹⁷ This held true in every one of the top 25 metropolitan statistical areas, holding borrower characteristics constant. This study also confirmed that loan originators frequently steered customers to loans with higher interest rates than those rates for which they qualified and to loans loaded with risky features (such as exploding adjustable interest rates and high prepayment penalties). In fact, 30 percent of the borrowers in the sample (which included all types of loans and borrowers) could have qualified for a safer loan. This finding is consistent with those discussed above showing the large proportion of borrowers steered into subprime loans who had credit credentials that could have qualified them for better, less costly loans.

A 2008 study from the University of North Carolina at Chapel Hill supports the conclusion that risk was inherent in the structure of the loans themselves.¹⁸ The study reviewed the experience of non-profit community development lender Self-Help (an affiliate of the Center for Responsible Lending), whose Community Advantage Program (CAP) provides thirty-year fixed rate mortgage loans with no prepayment penalties to low-to-moderate income families who make modest down-payments (over 64 percent of CAP loans had LTVs of 97 percent or greater). These families often have blemished credit histories as well. The authors found that the cumulative default rate for recent borrowers with subprime loans even with documented incomes was *more than three times* that of comparable borrowers with CAP loans. They also found that adjustable interest rates, prepayment penalties, and mortgages sold by brokers were all associated with higher loan defaults. In fact, when these three risky features were layered into the same loan, the resulting risk of default for a subprime borrower was *four to five times higher* than for a comparable borrower with the lower-rate and fixed-rate CAP mortgage from a retail lender.

Figure 3 below demonstrates that the delinquency rates for CAP borrowers has been low—far lower than subprime delinquency rates for borrowers with similar characteristics—and even performed well in comparison with prime market loans. This was true even in the midst of the foreclosure crisis. For example, as of the second quarter of 2008, only 3.21 percent of CAP loans were in default (defined as 90-days delinquent or in foreclosure process). This is only slightly higher than the 2.35 percent default rate on prime loans during this period, at a time when the subprime default rate was at 17.8 percent.¹⁹ Even today, after two years of extraordinary recession and high unemployment rates have disproportionately strained low

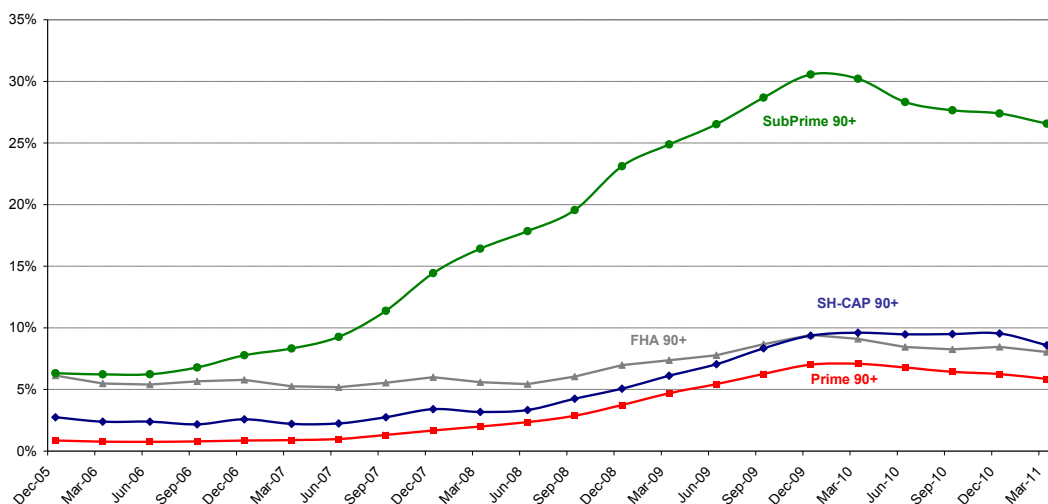
¹⁷ Vertical Capital Solutions, Historical Performance of Qualified vs. Non-Qualified Mortgage Loans (February 2010) (on file with CRL). These were loans with the following characteristics: debt-to-income ratios lower than 41 percent; fixed rate or loans with at least a seven-year fixed period; a term of 30 years or fewer; no balloon payments; no interest-only or negative amortization loans; full income documentation; and either an LTV under 80 percent or with mortgage insurance.

¹⁸ See Lei Ding, Roberto G. Quercia, Wei Li, & Janneke Ratcliffe (2010), “Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,” Center for Community Capital, The Univ. of North Carolina, Chapel Hill. For CAP loans, characteristics included, “first-lien, owner occupied, fixed-rate conforming home purchase loans with full or alternative documentation.” For subprime loans, the characteristics were “first-lien, single-family, purchase money, and conforming loans with full or alternative documentation” Id. at 14, Exhibit 1.

¹⁹ Id. at 15, Exhibit 3.

income families, 8.6 percent of CAP loans were seriously delinquent, as compared with 25.6 percent of subprime and 5.9 percent of prime loans.

**Figure 3:
Comparison of Loan Performance of Self-Help Community Advantage Program (CAP) 30
Year Fixed-rate Loans and Other Loan Types**



Source: Self-Help; Mortgage Bankers Association, National Delinquency Survey Q1 2011

The graph above compares the relative rates of serious delinquency among CAP loans, prime and sub-prime loans, and FHA loans, from December 2005 through March 2011.

IV.

A narrow rule will increase the cost of lending to borrowers who can least afford it: low- to moderate-income families and families of color.

Risk-retention will come at a cost that will be passed onto borrowers, and that cost will be borne by those who can least afford it: first-time homebuyers, lower wealth borrowers, and families of color. Mark Zandi and Cristian deRitis of Moodys Analytics estimate that risk retention will add 75 to 100 basis points to the cost of a 30-year fixed rate loan.²⁰ Economists at the National Association of Realtors estimate a cost increase of 80 to 185 basis points.²¹ These estimates assume that non-QRM loans will remain available and do not include the costs associated with any lender or investor stigma resulting from the loan being deemed non-qualified.

²⁰ Mark Zandi and Cristian deRitis, “Reworking Risk Retention,” *Moody’s Analytics* (June 20, 2011) at 2, available at <http://www.economy.com/mark-zandi/documents/Reworking-Risk-Retention-062011.pdf>

²¹ See Ken Fears, National Association of Realtors, “QRM: Higher Mortgage Rates on the Horizon” (June 17, 2011), available at <http://economistsoutlook.blogs.realtor.org/2011/06/17/qrm-higher-mortgage-rates-on-the-horizon/>.

Another substantial cost will be the loss of homeownership as the most significant wealth-building tool for American families. Overall, real estate holdings comprise the greatest share of assets held by U.S. households. Beyond the well-documented social and community benefits of owning a home,²² as a leveraged investment with a built-in forced-savings mechanism, homeownership remains the primary way in which American households accumulate wealth.²³ In 2000, home equity accounted for 32 percent of aggregate household wealth for all Americans. For families of color, this percentage is even higher: For African Americans, home equity accounted for 62 percent of aggregate wealth, and for Hispanics, 51 percent.²⁴ Some recent studies have concluded that for low-income families, not only is homeownership an important means of wealth accumulation, but for most of these households it is the *only* form of wealth accumulation.²⁵ Indeed, among households earning between \$20,000 and \$50,000, those who own homes have 19 times the wealth of those who rent.²⁶

Race-based wealth disparities have been exacerbated by the subprime lending boom and the resulting foreclosure crisis. It is well documented that African-American and Latino families disproportionately received the most expensive and dangerous types of loans during the heyday of the subprime market.²⁷

²² These include better educational achievement (including higher high school graduation rates and higher rates of post-secondary education), and more stable communities. See Christopher E. Herbert and Eric S. Belsky, "The Homeownership Experience of Low-Income and Minority Households: A Review and Synthesis of the Literature," *Cityscape: A Journal of Policy Development and Research*, Vol. 10, No. 2, U. S. Dep't of Housing and Urban Development, Office of Policy Development and Research (2008) at 40, 43-46; see also Raphael Bostic and Kwan Ok Lee, "Homeownership: America's Dream" (Oct. 2007) at 10 (surveying literature).

²³ Testimony by Janneke Ratcliffe, UNC Center for Community Capital before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, US House of Representatives, Hearing on Future of Housing Finance: The Role of Private Mortgage Insurance. July 29, 2010.

²⁴ Christopher E. Herbert and Eric S. Belsky, The Homeownership Experience of Low-Income and Minority Households: A Review and Synthesis of the Literature, *Cityscape: A Journal of Policy Development and Research*, Vol. 10, No. 2, U. S. Dep't of Housing and Urban Development, Office of Policy Development and Research (2008) at 8, citing Orzechowski and Sepielli (2003).

²⁵ Herbert & Belsky (2008) at 40 (citing Boehm and Schlottmann (1999, 2004)).

²⁶ *The State of the Nation's Housing 2010 – Key Facts*. Joint Center for Housing Studies, Harvard University, available at http://www.jchs.harvard.edu/publications/markets/son2010/son2010_key_facts.pdf.

²⁷ R.B. Avery, G.B. Canner, and R.E. Cook, Summer 2005. "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," *Federal Reserve Bulletin* (available at http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf); http://www.federalreserve.gov/pubs/bulletin/2005/summer05_hmda.pdf); R.B. Avery, K.P. Brevoort, and G.B. Canner, September 2006. "Higher-Priced Home Lending and the 2005 HMDA Data," *Federal Reserve Bulletin* (available at <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>); <http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf>); R.B. Avery, K.P. Brevoort, and G.B. Canner, December 2007. "The 2006 HMDA Data" *Federal Reserve Bulletin* (available at <http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf>); <http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf>); R.B. Avery, K.P. Brevoort, G.B. Canner, December 2008. "The 2007 HMDA Data," *Federal Reserve Bulletin* (available at <http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf>); <http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf>); R.B. Avery, K.P. Brevoort, G.B. Canner, September 2009, "The 2008 HMDA Data", forthcoming in *Federal Reserve Bulletin* (available at <http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft2.pdf>). See also Debbie Gruenstein Bocian, Keith Ernst and Wei Li, "Race, Ethnicity and Subprime Loan Pricing." *Journal of Economics and Business*, Vol. 60, Issues 1-2, Jan.-Feb. 2008, at 110-124; Debbie Gruenstein Bocian and Richard Zhai, "Borrowers in High Minority

CRL research demonstrates that, not surprisingly, communities of color are now disproportionately experiencing foreclosure. In June 2010, our report, “Foreclosures by Race and Ethnicity: The Demographics of a Crisis” found that African-Americans and Latinos have experienced completed foreclosures at much higher rates than whites, even after controlling for income.²⁸ Although the majority (56 percent) of foreclosures involved a white family, nearly eight percent of both African-Americans and Latinos had already lost a home, compared with only 4.5 percent of whites.

We conservatively estimate that, among people who were homeowners in 2006, 17 percent of Latino and 11 percent of African-American homeowners have lost or are at imminent risk of losing their homes, compared with seven percent of non-Hispanic white homeowners. Further losses extend beyond the families who lose their home: From 2009 to 2012, those living near a foreclosed property in African American and Latino communities will have seen their home values drop more than \$350 billion. Another CRL report issued in August 2010, “Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis,” shows that more than half of all foreclosures in that state involved Latinos and African Americans.²⁹

The result is that the bursting of housing bubble and subsequent recession have disproportionately diminished the wealth of families of color. According to a Pew Research Center study released last week, from 2005 to 2009, inflation-adjusted median wealth fell by 66 percent among Hispanic households and 53 percent among black households, compared with just 16 percent among white households, largely due to effects of the foreclosure crisis. A rule that disproportionately bars access to the best loan terms by credit-worthy families of color will exact a high cost in increasing the wealth gap between families of color and whites, and in placing additional hurdles in the way of lower wealth families seeking to join the middle class.³⁰

According to the Pew study, the median wealth of white households is 20 times that of black households and 18 times that of Hispanic households.³¹ The racial wealth gap between whites and African Americans has already quadrupled over the course of a single generation.³²

Areas More Likely to Receive Prepayment Penalties on Subprime Loans,” Center for Responsible Lending (Jan. 2005), available at http://www.responsiblelending.org/mediacenter/press-releases/archives/rr004-PPP_Minority_Neighborhoods-0105.pdf.

²⁸ See Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, “Foreclosures by Race and Ethnicity: The Demographics of a Foreclosure Crisis,” Center for Responsible Lending (June 2010), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf>. Center for Responsible Lending (June 2010), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf>.

²⁹ Debbie Gruenstein Bocian, Peter Smith, Ginna Green and Paul Leonard, “Dreams Deferred: Impacts and Characteristics of the California Mortgage Crisis.” Center for Responsible Lending (August 2010), available at <http://www.responsiblelending.org/california/ca-mortgage/research-analysis/dreams-deferred-CA-foreclosure-report-August-2010.pdf>.

³⁰ Rakesh Kochhar, Richard Fry and Paul Taylor, “Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics,” Pew Research Center (July 26, 2011).

³¹ Id.

³² Thomas M. Shapiro, Tatjana Meschede, and Laura Sullivan, “The Racial Wealth Gap Increases Fourfold,” Institute on Assets and Social Policy, Research and Policy Brief (May 2010) at 1 (citing data from the Panel Survey of Income Dynamics and noting that the wealth gap had quadrupled over the last 25 years).

Restricting access to homeownership based on wealth accumulation will exacerbate the racial wealth gap across the United States.

The cost side of the ledger also includes prolonged instability in the housing market. Home sellers need home buyers, who in turn need access to mortgages they can afford. Impeding market access for credit-worthy home buyers will harm existing homeowners who need to sell the home in order to relocate for a job, to accommodate a growing family, or to scale back in retirement. Unduly restricting the number of possible buyers will make it harder for families to sell their home and harder for them to realize its value. At last measure in 2007, minorities accounted for fully 35 percent of first-time homebuyers and 20 percent of repeat buyers even in the middle of the housing bust. The immigrant share of first-time buyers was 19 percent and of repeat buyers was 12 percent.³³ Thus, impeding market access for credit-worthy families of color and white families who fall outside the gold-plated QRM box has consequences for all would-be home-sellers and the market as a whole.

V.

Congress intended the QRM definition to be much more inclusive than the proposed rule provides.

A. QRM was just one mechanism in Dodd-Frank to improve the mortgage origination and securitization process.

In establishing the risk retention and QRM rules, the Agencies should bear in mind that this rule is not Dodd-Frank's sole, or even primary, mechanism for stabilizing the mortgage market or the capital markets. Title XIV is the primary vehicle for improving residential mortgage originations. Although the risk retention rules generally are designed to lead to improved underwriting standards for all asset classes,³⁴ for residential mortgage loans, Congress specified the necessary standards and created the QRM designation for loans meeting these standards. These largely correspond to Title XIV's definition of QM loans, which are loans that do not contain the risky features described above.³⁵ QM loans were given favored legal treatment under Title XIV's ability-to-repay rules in order to incentivize lenders to make these loans.³⁶ Title XIV also limits prepayment penalties, bans single premium credit insurance, and prohibits improper steering and originator payments based on the terms of loans.³⁷

³³ *The State of the Nation's Housing 2010 – Key Facts*, available at http://www.jchs.harvard.edu/publications/markets/son2010/son2010_key_facts.pdf.

³⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). Pub. L. No. 111-203, Stat. 1376 (2010), § 941.

³⁵ The QM definition requires verification and documentation of income, as well as underwriting to ensure the borrower's ability to repay using a fully amortizing repayment schedule (assuming the maximum allowable rate over the first five years for an adjustable rate loan and the fully amortizing repayment schedule over the loan term for a fixed rate loan, taking applicable taxes, insurance and assessments into account. It also generally prohibits balloon payments, deferral of interest or principal, loan terms of more than 30 years, and points and fees in excess of three percent of the loan amount. In addition, it requires compliance with any debt-to-income ratios or alternative ability-to-repay standards established by the Board. Dodd-Frank § 1412(b)(2)(A).

³⁶ QM loans get the benefit of a rebuttable presumption that they meet the requirement that the lender establish the borrower's ability to repay the loan in accordance with its terms. § 1412.

³⁷ Dodd-Frank § 1414.

B. Congress directed the agencies to balance the need for lending standards against the imperative of improving access to credit.

Congress directed the regulatory agencies to balance the need for improved standards against the need to improve access to affordable credit on reasonable terms. Title IX provides that exceptions to the risk retention rules shall “... improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.”³⁸ Congress similarly empowered the Board to “revise, add to or subtract” from the definition of QM “upon a finding that such regulations are necessary or proper to ensure that responsible, affordable mortgage credit remains available to consumers.”³⁹ The clear Congressional objective was to achieve the balance between ensuring that mortgages are safe and sound and within a reasonable range of default risk and ensuring that good, affordable credit is accessible to credit-worthy borrowers.

C. The purpose and language of the risk retention and QRM provisions urge that QRM loans become the market standard.

The purpose of risk retention is to better align the interests and incentives of loan securitizers with those of investors and to improve loan quality by encouraging decent underwriting standards associated for securitized loans.⁴⁰

For residential mortgages, Congress took a direct approach and specifically determined the standards that should apply in Title XIV. Residential mortgage loans are the only asset class that are subject to specific substantive reforms elsewhere in the Act—indeed, they have an entire Title dedicated to this purpose. Moreover, rather than rely primarily on risk-retention to improve origination standards, for mortgage loans only, Congress instead sought to incentivize the securitization of loans that meet standards that complement the Act’s substantive mortgage provisions through establishing the Qualified Residential Mortgage standard.

Both QM and QRM are intended to provide incentives for good lending practices. For this reason, it is important that the two provisions work together to promote the same kind of well-structured, responsibly-underwritten loans. As such the standards for QM and QRM in the Act are substantially similar, and Congress expressly required that the QRM definition be “no broader than” the QM definition; that is, only QM loans can qualify as QRMs.

³⁸ Dodd-Frank § 941(e)(2).

³⁹ Dodd-Frank § 1412(b)(3)(B).

⁴⁰ Timothy F. Geithner, Chairman, Financial Stability Oversight Council, “Macroeconomic Effects of Risk-retention Requirements” (Jan. 2011), pursuant to § 946 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, available at

[http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20\(FIN%20AL\).pdf](http://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FIN%20AL).pdf) at 16 (“Risk-retention requirements may reduce risks to financial stability arising from incentive and informational asymmetries between the investor and earlier securitization chain participants. They may also improve loan quality because participants might better internalize the costs of poor underwriting, as they must now hold a portion of the underlying risk”).

Compliance with QM/QRM standards is very likely to afford much better investor protection than relying on a five percent risk retention to incentivize securitizers to insist upon loan origination standards. In fact, many badly-structured and poorly-underwritten loans that have defaulted in the current crisis were securitized in investment pools where the issuer retained the equity portion of the securitization pool.⁴¹ Notwithstanding this level of risk retention, securitizers did not adopt the loan standards that were shown to significantly reduce risk of default. The absence of these standards in the overwhelming majority of the subprime and Alt-A private label securities pools belies the suggestion that risk-retention itself could produce better loans than compliance with QRM standards.

Given these facts, there is little support for the view that Congress intended risk-retention, rather than QRM compliance, to become the market norm for residential mortgages. On the contrary, it seems far more likely that Congress intended that loans meeting QRM standard would become the norm in the market place.

D. The legislative history of the QRM provision confirms this view—and specifically rejects the inclusion of mandated minimum down-payments.

The QRM exception to risk-retention was added to the Dodd-Frank Act as a floor amendment during the Senate debate on the bill.⁴² During the debate, there was bipartisan concern that risk-retention would unduly restrict the securitization market and make credit less available.⁴³ One of the lead sponsors of the QRM amendment, Senator Johnny Isakson, explained that the amendment was offered out of concern that risk-retention would not work in practice and that without a QRM there would be limited credit available for mortgages. His idea was that the amendment would force lenders to go back to making loans responsibly, with the goal that “the only risk-retention that will be required is when someone is making a bad loan, which means people will stop making bad loans.”⁴⁴ The amendment was made with bipartisan sponsorship⁴⁵ and passed without opposition. In a floor statement following final passage, Senator Isakson said: “It is my hope that these regulators will follow the intent of the legislation, by ensuring a broad spectrum of qualified borrowers will fit under the umbrella of protection under the qualified residential mortgage safety and soundness provisions.”⁴⁶

The purpose and history of the risk-retention and QRM provisions unambiguously call for QRM standards to apply broadly across the market.

With respect to mandated minimum down-payments, Congress’s rejection of this suggestion was even more explicit. Section 941 of Dodd-Frank lists the underwriting and product feature requirements the agencies are to consider in defining QRM. Prior to the introduction of the

⁴¹ See Zandi, “Special Report: The Skinny on Skin in the Game,” at 2.

⁴² Amendment No. 3956, 156 *Congressional Record* S 3575 (May 12, 2010).

⁴³ See, e.g., statements of Senators Corker and Isakson, at 156 *Congressional Record* S3514 (May 11, 2010). For a detailed discussion of the legislative history, see Ray Natter, “What Was the Legislative Intent Behind the QRM?” Barnett, Sivon & Natter PC, Our Perspectives (June 2011), available at http://www.bsnlawfirm.com/newsletter/OP0611_3.pdf.

⁴⁴ 156 *Congressional Record* S3576, S3575 (May 12, 2010).

⁴⁵ Co-sponsors included Senators Hagan, Warner, Menendez, Tester, Lincoln, Levin, Burr and Hutchison.

⁴⁶ 156 *Congressional Record* S10441 (Dec. 17, 2010).

QRM amendment, Senator Corker proposed replacing the risk-retention rules with the requirement that borrowers make at least a five percent down-payment, plus a study of securitization by the Board. Several Senators spoke against the Corker amendment on the grounds that an inflexible five percent down-payment requirement would be unduly restrictive. Senator Chris Dodd noted that many insured depositories “have mortgage programs that require less than 5 percent down-payment. They are performing well and have done so in the past.”⁴⁷ As an alternative to the Corker amendment, Senators Merkley and Klobuchar offered one with more flexible underwriting standards. The “critical point of distinction” between the two amendments was that, whereas the Corker amendment had a “five-percent underwriting absolute line,” the Merkley-Klobuchar amendment had no minimum down-payment requirement. The Corker amendment was defeated by a vote of 42-57, and the Merkley-Klobuchar amendment was adopted by a vote of 63-36.⁴⁸

These two amendments clearly posed the question of whether to include a minimum down-payment requirement on mortgage loans, and by clear margins, bipartisan groups of senators rejected the idea of mandated minimum down-payments. When the Senate then considered the amendment offered by Senator Isakson and others, the omission of minimum down-payment requirements from the definition of QRM was plainly intentional.

As Senators Johnny Isakson, Kay Hagan, and Mary Landrieu, the three lead Senate sponsors of the QRM provision, have stated, “although there was discussion about whether the QRM should have a minimum down-payment, in negotiations during the drafting of our provision, we intentionally omitted such a requirement.”⁴⁹

VI.

Analysis of the Proposed Rule.

The proposed rule would impose several substantial requirements on QRM loans. These provisions, as proposed, are overly restrictive. Both individually and collectively they would add large unnecessary costs and push many worthy borrowers out of the mortgage market. However, with the changes we recommend, the QRM rule would substantially further sustainable lending without these avoidable negative consequences.

A. The LTV requirements for home loans are much too restrictive and should be eliminated altogether.

The proposed rule suggests a down-payment requirement of 20 percent for a QRM home purchase loan, and even higher down-payments—25 and 30 percent—for term and cash-out refinances. These requirements would erect substantial, unnecessary barriers to homeownership for many credit-worthy families.

⁴⁷ 156 *Congressional Record* S3518 and S3520 (May 11, 2010).

⁴⁸ 156 *Congressional Record* S3552, S3516, and S3574 (May 11 and 12, 2010).

⁴⁹ See Feb. 16, 2011 letter from Senators Mary Landrieu, Kay Hagan, and Johnny Isakson to the Agencies; see also Feb. 11, 2011 op-ed by Sen. Isakson in *The Hill*: “In fact, we debated and specifically rejected a minimum down-payment standard for the Qualified Residential Mortgage.”

The chart below estimates the number of years it would take for typical working families to accumulate the savings necessary to purchase a home with a ten percent down-payment. The chart assumes an annual savings rate of approximately five percent of gross income, an estimate based upon data from the U.S. Bureau of Economic Analysis. It further assumes that the consumer will direct fully half of all savings to the home purchase, (leaving the other half to cover all other savings needs—e.g., retirement, college tuition, unreimbursed medical expenses, and “rainy day” fund). It demonstrates the substantial struggle most ordinary families would face in trying to raise the funds for a ten percent down-payment on a median priced home.

Figure 4: Years to Save for a \$173,000 Median Priced Home with a Ten Percent Down-Payment

	Median Annual Salary (wages) ¹	Annual Savings for Down-Payment ²	Years to save ten percent down-payment plus five percent closing and settlement costs, assuming savings at average savings rate, with half of savings directed to housing (leaving other half for retirement, college tuition and emergencies) (\$25,071) ³	Front-End Debt to Income Ratio ⁴
Lawyer	\$112,760	\$2,932	9	13%
Airline Pilot	\$103,210	\$2,683	9	14%
Computer Programmer	\$71,380	\$1,856	14	20%
Registered Nurse	\$64,690	\$1,682	15	22%
Accountant	\$61,690	\$1,604	16	23%
Police officer	\$53,540	\$1,392	18	27%
Elementary School Teacher	\$51,660	\$1,343	19	28%
Firefighter	\$45,250	\$1,177	21	31%
Residential Construction Worker	\$40,650	\$1,057	24	35%
Social Worker (family/school)	\$40,210	\$1,045	24	35%

¹ Source: Bureau of Labor Statistics “Occupational Employment and Wages, May 2010” (latest available)
² Half of total 5.2 percent savings of gross income
³ Based on 2010 US median home price of \$172,900 (National Association of Realtors)
⁴ Based on \$155,610 mortgage at 6 percent APR, plus estimated property taxes (1.5 percent/yr) and insurance (\$480/yr)

Even for a \$100,000 home, it would take the median income firefighter 12 years to save for the down-payment and closing costs, if half of annual savings were directed to the home purchase, and 6 years if all annual savings are so directed.

For first-time homebuyers, a ten percent down-payment requirement would pose a severe barrier to market entry. Among renters (from whom the pool of first-time homebuyers is drawn), only the wealthiest 25 percent of white, non-Hispanics nationwide have cash savings in excess of about \$5,000. For renters of color, only the wealthiest 25 percent have more than \$2,000.⁵⁰ Even a ten percent down-payment requirement would put homeownership beyond the reach of many credit-worthy families who would otherwise have succeeded in homeownership, and built wealth for their families.

The agencies' proposed down-payment requirements for refinance loans are even more extreme—25 percent for refinances in which the homeowner takes no cash out, and 30 percent for “cash out” refinances. This means that a family current on its mortgage payments would be barred from refinancing into a lower-cost QRM loan simply because they had less than a 25 percent equity stake in the home. This would disqualify many current homeowners whose equity has been wiped out in the recent crisis, as demonstrated by the examples of varying equity levels among homeowners nationwide and in individual states.

Figure 5: Equity Positions of U.S. Homeowners with a Mortgage

	Percent of homeowners with a mortgage with home equity of less than 30 percent	Percent of homeowners with a mortgage with home equity of less than 25 percent	Percent of homeowners with a mortgage with home equity of less than 20 percent	Percent of homeowners with a mortgage with home equity of less than 10 percent	Percent of homeowners with a mortgage with home equity of less than 5 percent
Nation-wide	57	52	46	34	28
California	58	54	49	41	36
Florida	70	66	63	55	51
Illinois	58	52	46	33	27
New Jersey	46	41	35	25	21

Source: Community Mortgage Banking Project, based on data from CoreLogic Inc.

More than half of current homeowners with a mortgage would be disqualified by the proposed QRM definition from even a rate-reducing refinance loan unless they can come up with a cash down-payment.

While down-payment undeniably affects loan performance, it does not do so sufficiently to justify its inclusion in QRM, as demonstrated by the data discussed in section III above.

⁵⁰ Harvard University Joint Center for Housing Studies tabulations of 2007 Survey of Consumer Finances.

Similarly, geography has a strong relationship to default rates.⁵¹ But limiting QRM loans based on geographic criteria would negatively impact access to credit for borrowers in certain states and cities. Mandated minimum down-payments are similarly inappropriate. We are not suggesting that loans should be made without any down-payment; there should be down-payments required. Rather, we believe that the government shouldn't set what that down-payment should be; lenders and investors should be able set down-payment requirements as market forces dictate.

B. The proposed rule's debt-to-income requirement is unduly restrictive, and is redundant in light of standards being set in the QM rule.

During the run-up to the recent crisis, subprime loans regularly permitted debt-to-income ratios of 50 or 55 percent. Ratios this high leave families with little residual income for necessary living expenses, rendering their mortgages unsustainable. Unquestionably, measurements of the borrowers' debt, income, and residual income are essential to an understanding of the borrower's ability to handle the loan. Nevertheless, the proposed debt-to-income standards—28 percent for mortgage debt and 36 percent for all debt—are extremely restrictive, as befits a standard aimed at selecting only “gold-plated” borrowers. For instance, using an illustrative DTI standard of 41 percent for prime, near-prime, and government-issued mortgages originated even in the extremely conservative origination years of 2009 and 2010, when Fannie Mae and Freddie Mac significantly tightened guidelines and the PLS market shut down, 35 percent of borrowers would not have met the criterion.⁵² The standards could be expanded without adding unnecessary risk.

Standards regarding DTI and residual borrower income will be incorporated into the final QM rule. Rather than create a separate standard layered on top of the QM standard, the Agencies should await the issuance of the final QM rule, and incorporate its standards in to the QRM definition. Forcing smaller lenders to comply with two separate federal DTI/residual income standards will not improve underwriting practices and will introduce unnecessary regulatory complexity.

C. The proposed credit history requirements are similarly inappropriate.

The proposed rule imposes unduly limiting credit requirements. The agencies have proposed a set of credit derogatory elements with a goal of approximating a 690 credit history score.⁵³ Several concerns militate against this approach.

First, an implicit 690 credit score standard would exclude many credit-worthy potential homeowners. Fair Isaac Corporation (FICO) estimates that 47 percent of U.S. consumers have

⁵¹ Data released in March 2011 show that Florida, Nevada, Mississippi, New Jersey and Georgia have the highest rates of non-current loans, while Montana, Wyoming, Arkansas, and the Dakotas have the lowest. (Lender Processing Services, Inc. (LPS) Mortgage Monitor (May 2, 2011)).

⁵² U.S. Gov't Accountability Office, GAO-11-656, Mortgage Reform: Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market 26 (2011) at p. 72.

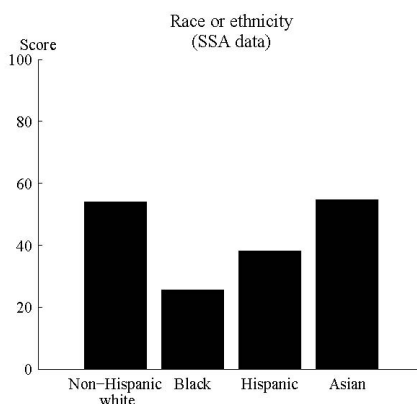
⁵³ FHFA Mortgage Market Note 11-02: Qualified Residential Mortgages. (Apr. 2011), available at http://www.fhfa.gov/webfiles/20686/QRM_FINAL_ALL_R41111.pdf.

credit scores below 700, including 12 percent with scores of 650-699, and 10 percent with scores of 600-649.⁵⁴

Second, setting so high a target credit score imposes disparate disadvantages on demographic groups, such as African Americans and Latinos, who have on average lower credit scores than other demographic groups.⁵⁵ The proposed “gold-plated” credit standards also would impose disparate burdens on groups such as individuals younger than age 30 have lower credit scores than older individuals and recent immigrants, who tend to have somewhat lower credit scores because their credit history profiles resemble those of younger individuals. Such families are not necessarily less credit-worthy; they may simply have shorter credit histories.

The charts below show the relative difference in credit scores for selected demographic groups, as found in research by the Board.⁵⁶

Figure 6: Difference in Credit Scores By Race or Ethnicity



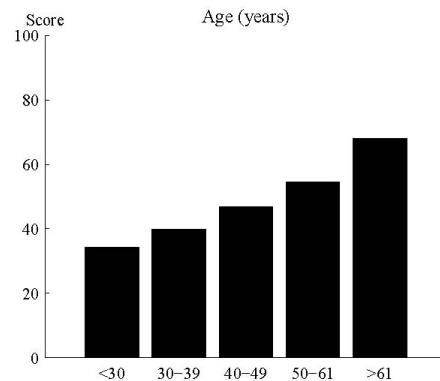
⁵⁴ Joanne Gaskin, Analysis of Proposed QRM Standards (unpublished). Fair Isaac Corporation (July 2011), on file with CRL.

⁵⁵ Credit records maintained by credit bureaus—which are the basis of most credit-scoring models—do not include personal demographic data other than birth dates. Demographic differences in credit scores were found in Federal Reserve Board research in which personal demographic data from Social Security records were combined with a large sample of credit bureau records. See *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, Board of Governors of the Federal Reserve System (August 2007). Available at <http://www.transunion.com/docs/rev/business/clientSupport/legislativeUpdate/CreditScoreRpt.pdf>.

Available at <http://www.transunion.com/docs/rev/business/clientSupport/legislativeUpdate/CreditScoreRpt.pdf>

⁵⁶ Id. The Board created the 100-point scale reflected in the chart, rather than select from the proprietary scoring matrices of the various credit bureaus.

Figure 7: Difference in Credit Scores By Age



Third, the Agencies' selected approach violates the Dodd-Frank requirement of weighing impact on access to credit against the gains in default risk. This is because actual default risk caused by creditworthiness as determined by credit reporting agencies and basic lender underwriting norms take into account numerous characteristics, not just the payment history factors in the Agencies' proposed rule. For example, payment history, the sole factor considered, accounts for only 35 percent of the weight in credit scoring models. The proposed standards ignore other important risk elements such as amount of credit owed (30 percent weighting), length of credit history (15 percent weighting), and types of credit used and new credit sought (each with 10 percent weighting).⁵⁷

The Agencies treat all delinquencies equally—e.g., a 60-day delinquency on a \$10 Sears card would have the same impact as a 60-day delinquency on a mortgage payment—even though the two types of delinquencies are not equal predictors of default on a mortgage loan. In fact, FICO estimates that 7.65 million consumers with FICO scores of above 690 who got loans between 2005 and 2008 would have failed to meet the QRM credit history criteria.⁵⁸ FICO's analysis of the proposed credit history requirement shows that the Agencies' approach is both under- and over-inclusive: some borrowers with credit scores around 500 would meet QRM credit standards, while other borrowers with scores over 800 would not.⁵⁹

Underwriting standards are covered by the QM definition, and we recommend that the Agencies omit any further credit history requirement here. As demonstrated above, by simply eliminating risky loan features, the Agencies can bring default rates to acceptable levels. The problem during the recent crisis was layering too many risk factors, both at the product and underwriting levels. QRM already deals with product-level risk factors. Investors can understand and price for credit quality, given that extreme risk layering causing default rates to increase more than the sum of the factors would indicate during the bubble period. They can further protect themselves with greater disclosure of loan characteristics that will be part of the new PLS landscape, plus representations and warranties, where lenders agree to purchase loans back if the loans violate

⁵⁷ Gaskin, *supra*.

⁵⁸ *Id.*

⁵⁹ *Id.*

standards. For these reasons, *we urge the Agencies not to include a credit history requirement in the QRM definition, but rather to defer to QM on underwriting factors.*

If the Agencies reject this suggestion, however, we recommend that the Agencies adopt the following two-part alternative:

- Revise the delinquency test to take account of important differences in different types of credit delinquencies. We agree that borrowers who are currently 30 days delinquent should not be able to receive a QRM loan, with the exception of debts that are the subject of a good-faith dispute or medical collections, which in our experience dating back twenty-five years are not reflective of propensity to default. Regarding delinquency history, the Agencies' proposal considers all debts as equally predictive of mortgage default, which they are not; mortgage debts, major debts, and those that are more recent than two years old are much more relevant. We therefore think the delinquency history rule should be revised to exclude only borrowers who, within the last 12 months, have been 60 days past due either on a mortgage obligation or on two other major debts (those with balances of \$5,000 or greater).
- In addition, provide lenders with another way to qualify borrowers if lenders can demonstrate having applied an empirically-validated model that incorporates all the other product-level and underwriting QRM factors that the regulators adopt. This model would need to demonstrate a propensity to default that meets whatever default rate that the Agencies establish as acceptable, e.g., a cumulative portfolio default expectation of nine percent or below (which is 80 percent of the projected 11.24 percent cumulative default rate for FHA loans from 1981 to 2010).⁶⁰ In other words, the lender would plug into a verified model a loan that includes all the QRM product-related factors, such as verified income, 30-year term, fully amortizing, no prepayment penalties, etc., plus any underwriting factors the Agencies adopt related to LTV or DTI. This model would solve for a credit score as predicting a particular default rate, and borrowers who receive a score that meets or exceeds this baseline level could become QRM borrowers, even if they failed the 12 month delinquency test above. The delinquency test should still be available even if this scoring test is adopted.

D. The narrow QRM impedes Congressional objectives of eliminating “too big to fail” and of reducing the government’s role in housing finance.

The Agencies' proposal also impedes two clear objectives of Congress in reforming the mortgage market—first, to avoid further concentration of economic might in the hands of a few “too big to fail” banks, and second, to reduce the role of government in mortgage lending. A narrow QRM exemption will make it necessary for securitizers to retain excess capital to satisfy the risk-retention requirements. This will likely narrow the number of entities that are able to issue mortgage-backed securities to the few largest banks. This would restrict originators' choice of execution for the mortgages they offer, and likely increase market concentration of the banks affiliated with the issuers. Moreover, by increasing costs and denying access to a large portion of the private lending market, this rule would push more borrowers toward FHA and

⁶⁰ Actuarial Review of the 2010 Mutual Mortgage Insurance Fund, Excluding HECMs, p. 161 (IFE Group F-3), simple average of actual (1981) and projected (1982 - 2010) cumulative claim rates; http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu.

Fannie Mae and Freddie Mac while they are in conservatorship, thereby undermining the Congressional objective of reducing the government footprint in mortgage lending.

VII. Caps and Collars and Servicing Standards

A. **An adjustable rate QRM should be limited to a one percent annual rate change and a five percent lifetime change to reduce the risk of default from payment shock.**

The Agencies have correctly proposed to limit the rate increases on adjustable rate mortgages included in the QRM standard. The proposal suggests that such rate increases be limited to adjustments of two percent annually and six percent over the life of the loan. Although “caps and collars” are appropriately built into QRM requirements, we believe those proposed by the Agencies are too high to adequately limit the payment shock that creates default risk. Specifically, we recommend that the annual rate change be limited to one percent and the lifetime cap to five percent. These caps are consistent with historical and current norms; for example, from the early to mid-1990s, prior to the subprime lending boom, ARM loans often carried one percent annual caps.⁶¹ A five percent lifetime cap is in line with what is common today; in fact, conventional prime ARM loans originated from 2008 to the present have had median lifetime caps of five percent.⁶²

Such limits would provide a fair balance between protecting lenders and investors from rising interest rates risk on the one hand, and on the other hand protecting them from the higher default risk that results when families with ARM loans face unmanageable payment shock as a result of rate hikes. Meaningful limits on annual increases are especially important, as homeowners are far less able than investors and lenders to manage interest rate risk. Limiting the amount a payment can increase in any year improves the chances that a homeowner struggling with a rate increase can exit the loan or sell the home before default becomes inevitable.

Payment shocks, particularly large ones, matter to borrowers, lenders, and investors. One study found that initial payment shocks of over 30 percent increase the risk of default *by 90 percent within the first year* following the adjustment. The study also found that payment shocks of less than 20 percent raised the default hazard by 40 percent.⁶³

Because it is common for ARM borrowers to incur rate increases of two percent in their first adjustment period on one- to three-year ARMS, we can assess how well the Agencies’ proposed two percent annual cap would address potential payment shock. A Fannie Mae study in 2004 looking at ARM rate adjustments found that from early 1994 through the end of 2000, “the ARM

⁶¹ One-quarter of conventional prime ARM loans originated from 1992 to 1994 had annual caps of 1 percent, while for 1991 one-quarter of such loans had annual caps of 1.250 percent. Source: LPS analytics loan level database.

⁶² Source: LPS analytics loan level database,

⁶³ Sewin Chan, Michael Gedal, Vicki Been, and Andrew Haughwout, “The Role of Neighborhood Characteristics in Mortgage Default Risk: Evidence from New York City,” NYU Wagner School and Furman Center for Real Estate & Urban Policy (June 29, 2010) at 16, available at http://furmancenter.org/files/publications/working_paper.pdf).

rate [on one-year ARMs] would have *almost always* increased by the maximum 200 basis points.⁶⁴

These periodic caps are limited in their protection since borrowers are still exposed to high levels of payment shock. Using the most recently published rates from Freddie Mac’s *Weekly Primary Mortgage Market Survey*, we illustrate below the level of payment shock under a variety of cap structures. With an increase to a two percent periodic cap, the payment on a one-year ARM would increase by 28 percent. If the five-year ARM increased to a maximum of five percent at the first adjustment (typical initial cap for five-year ARMS), the payment shock would be 72 percent.

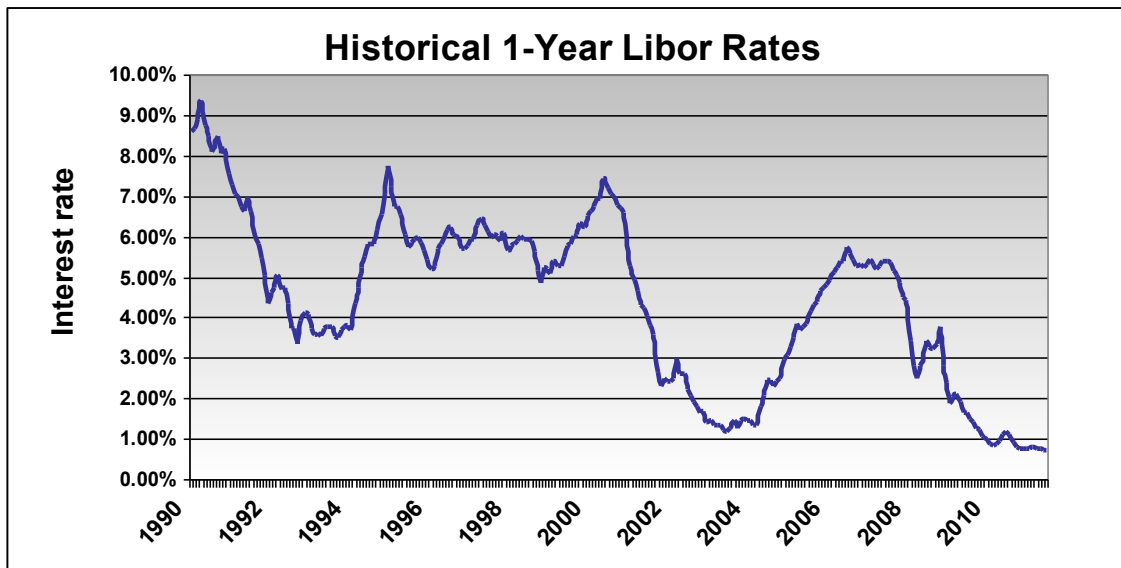
As illustrated in Figure 8, periodic cap increases lead to corresponding rises in payment shock levels; Figure 9 tracks LIBOR rates over time.

Figure 8: Payment Shock Percentages and Cap Structures

Note rate plus one percent			Note rate plus two percent			Note rate plus five percent			Note rate plus six percent		
rate	payment	payment shock	rate	payment	payment shock	rate	payment	payment shock	rate	payment	payment shock
4.30	\$618.59	13%	5.30	\$694.13	27%	8.30	\$943.48	72%	9.30	\$1,032.88	89%
4.01	\$597.49	13%	5.01	\$671.79	27%	8.01	\$918.08	74%	9.01	\$1,006.68	91%

Freddie Mac’s *Weekly Primary Mortgage Market Survey* and CRL calculations

Figure 9: Historical One-Year LIBOR Rates



⁶⁴ J. Noel Fahey, “The Pluses and Minuses of Adjustable-Rate Mortgages,” *Fannie Mae Papers*, Volume III, Issue 4, (Dec. 2004).

B. Servicing standards

It is by now widely recognized that servicers are failing in their role to serve as intermediaries between borrowers and investors. Some borrowers face default or even foreclosure because of improperly applied payments by servicers, or pay thousands of dollars for force-placed hazard insurance when they already have their own policies. Other borrowers who are truly in default but appear to qualify for modifications are denied (or not even considered for) such modifications because of servicer incapacity, servicer conflicts-of-interests (e.g., when the servicer is the second-lien holder or earns more by foreclosing by imposing fees), or conflicts among investors (e.g., investors overall would do better with a modification rather than a foreclosure, but certain investors would lose).⁶⁵

Poor servicing leads to unnecessary defaults. Thus, we support the Agencies' proposed servicing standards as part of QRM regarding loss mitigation actions, subordinate liens, and responsibility for assumption of these requirements if servicing rights are transferred.

VIII.

Conclusion

A healthy national economy depends on a healthy housing sector, which relies on a pool of qualified buyers. Our suggested changes to the proposed rule would ensure that QRM maximizes the reach of responsible mortgage loans, while minimizing undue risk to market participants. Revised in this way, the QRM rule could have a significant, favorable impact on the housing market. But an unduly restrictive final rule would impose cost burdens on borrowers, who can least afford them, and would drive many from the market altogether. Equally troubling, the proposed rule would set an unfortunate precedent regarding responsible lending parameters that will apply to the market more broadly. While Agencies may intend QRM to define a small proportion of "gold-plated" mortgages, the rule's restrictions will be retained long after this original intent is forgotten.

Respectfully submitted,

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Ellen Harnick
Senior Policy Counsel

⁶⁵ See Testimony of Mike Calhoun, House Financial Services Committee's Subcommittee on Financial Institutions and Consumer Credit and Subcommittee on Oversight and Investigations on Mortgage Servicing, July 7, 2011, <http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/Final-Calhoun-Servicing-Testimony-7-7-11.pdf>.