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July 28, 2011

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 2-3
Washington, DC 20219
Docket No. OCC-2011-0002

Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549-1090
Attn.: Elizabeth M. Murphy, Secretary
File No. 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, Richard 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 No. FR-5504-P-01

Re: Credit Risk Retention; Proposed Rule

Policy makers and regulatory bodies are currently rethinking the structure of the US mortgage finance system, in particular those practices and institutions engaged in credit risk management. The risk retention rule called for in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is just one of many reforms in process. Although few mortgages made *today* would be affected by the rule, its potential to have significant impact on the market *as it evolves* is substantial. Because of these other moving parts, it is a challenge to predict the consequences of this one rule– to wit, some argue that a strong rule is necessary to restore confidence[1]; others say it could impede the recovery of the fragile market if it is too restrictive: Mark Zandi of Moody's Analytics estimates that, conservatively, the typical non-QRM borrower could see mortgage rates rise between 75 and 100 basis points and associates such an increase with 423,000 fewer home sales per year an 8.5% decline in house prices.[2]

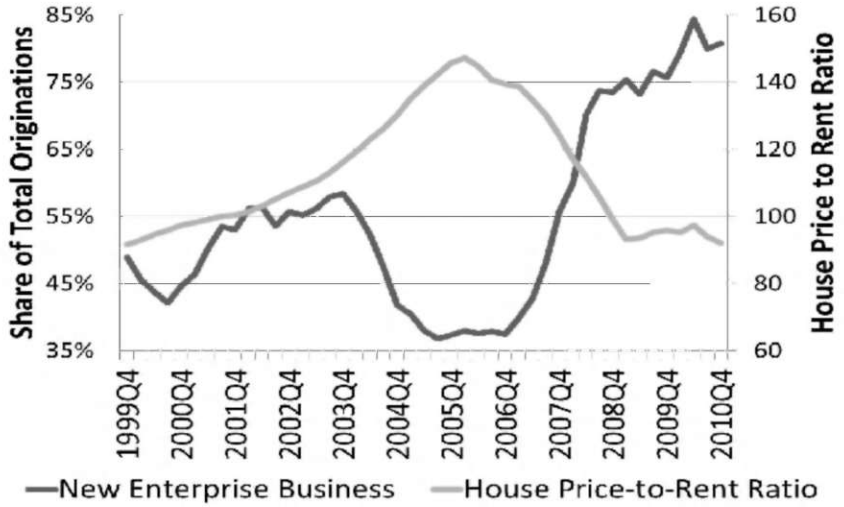
The risk retention framework laid out in the regulators' Notice of Proposed Rule Making (NPR) proposes a definition of Qualified Residential Mortgages (QRM) that would be exempt from risk retention. This

[1] For example, see "Guide to Restoring Private-Sector Residential Mortgage Securitization." Redwood Trust. November 2010.
[2] Mark Zandi and Christian deRitis. "Reworking Risk Retention." Moody's Analytics. June 20, 2011.

discussion focuses primarily on the QRM rule and the analysis presented by the regulators for estimating its impact. We caution that the data used in that analysis, since it covers only Enterprise-acquired loans, is neither a good proxy for the historic risky practices that drove the system to the brink, nor is it a good predictor of how a post-*ability-to-repay*-rule market would behave. In addition to cautioning against policy making based on a look-back on Enterprise-only data, we examine the problems that stem from applying borrower-based characteristics as categorical and one-dimensional risk factors. We urge regulators to carefully reconsider the balance between certain applying risk factors that could greatly and disparately limit market access, but that frankly have questionable effectiveness in reducing overall system risk. We propose alternative risk mitigants for high LTV lending (such as private mortgage insurance, down payment assistance and other programs offered by non-profits) that are likely to be at least as effective as risk retention, if not more.

First, we urge caution in basing regulatory policy for the entire mortgage market on just the experience of the Fannie Mae and Freddie Mac which are not representative of the 2005-2007 mortgage market, when the destabilizing lending predominantly took place.

The analysis of Enterprise-acquired mortgages that is presented as a rationale for the suggested definition of QRM omits many segments of the mortgage market, particularly loans financed through private label securitization. Such segments dominated the mortgage market in the heyday of the housing bubble. New Enterprise business accounted for just 44% of conventional mortgage originations by dollar volume between 2005 and 2007.[3] During the period of greatest excesses in the housing and mortgage market (shown below by the inflated house price to rent ratio which peaked in 2006), Fannie and Freddie played an uncharacteristically small part in the housing finance system (as seen by the fall in their market share in 2004 into 2007).



Notes: House price index is scaled by owners' equivalent rent of residences and indexed to the average of 1987 to 2010 equals 100. New mortgage business and total originations calculated as 4-quarter moving totals.
Sources: *Inside Mortgage Finance*; S&P/Case-Shiller National Home Price Index; Bureau of Labor Statistics

Importantly, the loans purchased by Fannie and Freddie are much less likely to be disqualified by the proposed QRM. For example, loans with LTV ratios over 80% and FICO scores under 660 accounted for

[3] *Inside Mortgage Finance*, Mortgage Market Statistical Annuals

just 5.4% of Enterprise purchases between 2005 and 2007, compared to 17% of loans financed by private label securities.[4]

Along nearly every dimension analyzed, whether credit score, LTV ratio, year of origination, or fixed- versus adjustable-rate, Enterprise financed mortgages have performed better than private-label securities.[5] In aggregate, private-label securitized mortgages originated from 2005 to 2007 experienced an ever 90-day default rate of 36.4%, compared to only 12.1% for Enterprise-acquired loans.

By examining only the business of Fannie and Freddie, the analysis excludes much of the risky mortgage lending that dominated the market during the bubble and destabilized the market, precisely the loans that new regulations should aim to curb.

Moreover, the NPR analysis does not consider the toxic market environment that prevailed in the mid 2000's and pending complementary product regulation.

Historical mortgage data must also be put into perspective. The catalyst for the financial crisis was contagion from credit losses on a subset of mortgages defaulting earlier and more frequently than anticipated. About a third of subprime loans originated in late 2006 and early 2007 were becoming seriously delinquent within the first two years.[6] The skyrocketing defaults among these loans, starting in 2007, and the resultant risk of insolvency among several financial institutions led to a credit freeze and deleveraging, and subsequently to the economic slowdown, job losses and value declines. These secondary, systemic effects led to defaults across even the most well underwritten loans.

There are two clear phases to the mortgage "bust." As illustrated in the chart below, in the first part (Bust Part 1), defaults among risker subprime, Alt-A and other such mortgages led to turmoil in the financial market. When the S&P/Case-Shiller National Home Price Index peaked in the second quarter of 2006, the serious delinquency rate of subprime loans stood at 6.2%. Two years later, just before the collapse of Lehman Brothers, the subprime delinquency rate had already risen to 17.9%. The comparable rate for prime loans was still less than 2.4% and just 1.2% for the portfolios of Fannie and Freddie. The unemployment rate was below 5.3%.

Eventually, economic weakness triggered by Phase 1 defaults negatively impacted the housing market and overall economy generally, (Bust Part 2), including even responsibly underwritten mortgages. By the end of 2009, when unemployment surpassed 10%, prime delinquencies reached over 7%.

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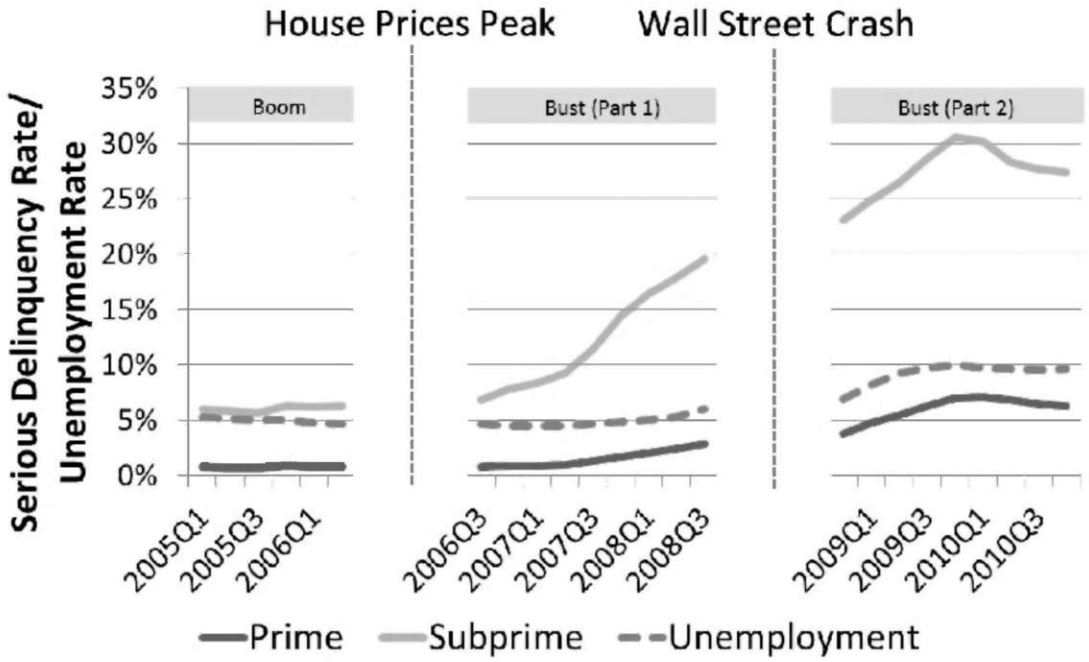
[4] Federal Housing Finance Agency, "Data on the Risk Characteristics and Performance of Single-Family Mortgages Originated in 2001 – 2008 and Financed in the Secondary Market." September 13, 2010.

[5] Ibid.
Of the categories presented in Tables 3a and 3b of the published report, the only instance before 2008 in which loans acquired by Fannie or Freddie had a higher ever 90-day delinquency rate than loans financed through private-label securities is adjustable-rate mortgages in 2007 with LTV ratios exceeding 90% and borrower FICO score below 620.

[6] Federal Reserve Bank of New York, "Charts: Serious Delinquency, Subprime First-Lien." U.S. Credit Conditions. http://data.newyorkfed.org/creditconditionsmap/images/image001.gif



Sources: Mortgage Bankers Association; Bureau of Labor Statistics

The absolute performance of conventional mortgages is impossible to assess independent of the toxic environment created by exotic loan products and the under-regulated secondary market for them. Recognizing the damage caused by these financial instruments, Congress and regulators have adopted numerous reforms. To name a few, the Federal Reserve used its authority to ban yield spread premiums and other forms of "steering" consumers into loans not in their best interests. Dodd-Frank will bring greater regulation, standardization and transparency to derivatives. The Consumer Financial Protection Bureau will be created to provide ongoing oversight of consumer financial products. Most Importantly for our discussion, Section 1411 of Dodd-Frank creates a new minimum ability to repay standard for all mortgages. Specifically, the legislation amends the Truth in Lending Act (TILA) with the provision that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." The section also requires that the calculation of ability to repay be based on a fully amortizing repayment schedule.

Consequently, while the data needed to appropriately discuss the impact of QRM is broader than that available for the analysis, it should be adjusted for the toxic lending *that existed during the housing bubble* because complementary regulations will hopefully prohibit the abusive lending which created the volatility in the market.

Internal analysis shared by Genworth Mortgage Insurance Company[7] using First American CoreLogic data, which is more representative of the entire mortgage market by including private-label and portfolio funded mortgages as well as Enterprise loans, indicates that one-third of mortgages originated between

[7] These are results of internal analyses prepared by Genworth Mortgage Insurance Company using data from First American CoreLogic.

2001 and 2008 would have been disqualified by the ability to repay rules. Simply by eliminating these truly irresponsible loans, the overall default rate falls nearly 40%, from 5.13% to 3.19%. Moreover, the default rate on the remaining loans would likely have been even lower if the toxic loans had never been made.

From this starting point, we have already reduced the absolute level of risk substantially. Now we can more accurately reveal the extent to which each additional QRM factor incrementally minimizes the remaining default risk.

QRM eligibility criteria: There is a strong case for applying the proposed product risk factors, but borrower-based risk factors are more problematic.

The components of the QRM can be broken into two categories: product characteristics and borrower characteristics.

Safer products make safer borrowers

Product features are strongly associated with default risk. Moreover, as our prior research and that of others has confirmed, product characteristics in and of themselves *contribute* to risk. Center for Community Capital research finds the prepayment penalties, adjustable interest rates and balloon payments substantially increase the likelihood of default even when controlling for borrower characteristics like credit score and LTV ratio.[8] In fact, subprime loans were *three to five* times more likely to default than loans to comparable borrowers originated under a community reinvestment program.[9] The compounding risk to loan products was also supported by research from the Federal Reserve Bank of San Francisco, which found that higher-priced loans tripled the likelihood of foreclosure after controlling for borrower characteristics.[10] Exotic loan products can turn creditworthy borrowers into risks. Moreover, stricter guidelines on borrower characteristics alone would not prevent the availability of dangerous loan products to qualified borrowers. First American LoanPerformance on behalf of the Wall Street Journal found that more than half of subprime loans went to borrowers with credit scores over 620, including a third to borrowers with credit scores over 660.[11]

Second, product features are binary or categorical (not continuous) and can be clearly identified, without having to draw arbitrary lines. The presence or absence of an adjustable-interest rate or less than full amortization is binary: either a loan has these features or it does not. Prepayment penalties can be shown to increase independently the risk of default and should therefore be prohibited in the definition of QRM and even more generally for the entire market.

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[8] Quercia, Roberto G., Michael A. Stegman, and Walter R. Davis. "The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments." *Housing Policy Debate*. 18.2 (2007), 311-346.

[9] Ding, Lei, Roberto G. Quercia, Wei Li, and Janneke Ratcliffe. "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models." *Journal of Real Estate Research*. 33.2 (2011).

[10] Laderman, Elizabeth and Carolina Reid. "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown." Federal Reserve Bank of San Francisco, 2008, Working Paper 2008-05.

[11] Rick Brooks and Ruth Simon. "Subprime Debacle Traps Even Very Credit-Worthy." *Wall Street Journal*. December 3, 2007. http://online.wsj.com/article/SB119662974358911035.html

Third, if a lender extends a loan with features that intrinsically increase the risk of default, the retention of a modicum of risk will appropriately align the lenders' risk with the borrowers' likelihood of sustaining the loan. Risk retention thus helps resolve the principal-agent problems that were rampant in the build up to the crisis.[12]

In addition to the ability to repay criteria under the Qualified Mortgage (QM) rules, once the product features of the QRM are applied, the future landscape of the mortgage market is already substantially less risky than that of the Wild West years of 2005 to 2007.

The problems with borrower-based criteria

The supporting analysis to the NPR (based on Enterprise-only data) states that "Ever-90-day delinquencies for non-QRM loans originated during the 13-years considered here were 6 to 12 times as frequent as ever-90-day delinquencies for QRM loans." While impressive sounding, such relative comparisons have several problems, each discussed below.

Problem 1: The relative comparison loses sight of the absolute – and very low – default rate of mortgages that would not qualify under the proposed QRM definition in an environment that was not impacted by exotic and toxic mortgage products.

For perspective, among *non-qualified* mortgages originated between 2001 and 2003 and acquired by Fannie or Freddie, the analysis provided with the NPR shows that more than 96% still did not default. While that is eight times the default rate for Enterprise-acquired mortgages that would have met the proposed definition, it is also less than one-quarter the default rate for *all loans* financed by private-label securities over the same period.[13] The crisis was not triggered by cohorts of loans exhibiting 5% default rates in the worst economic period since the Great Depression, but by 15%, 20%, 30% or more of subprime and Alt-A loans financed through private-label securities that defaulted.

Problem 2: Treating borrower risk factors as if they are categorical is deceptive, for such risks run along a continuum.

For illustration, among the universe of fixed rate, Enterprises-acquired or private-label-financed mortgages originated between 2001 and 2008, the default rate for those with at least a 20% down payment was 4.8%.[14] Yet even among these loans, default rates ranged from below 2% for borrowers with high credit scores to over 17% for borrowers with low credit scores. Now consider anyone of a number of dividing lines drawn: If the definition of a qualified loan is set to a credit score of 700, non-qualified mortgages defaulted at 4.4 times the rate of qualified mortgages (10.3% to 2.3%); If the cutoff were moved lower– for example, to a credit score of 680, the ratio of default rates would still be a comparable

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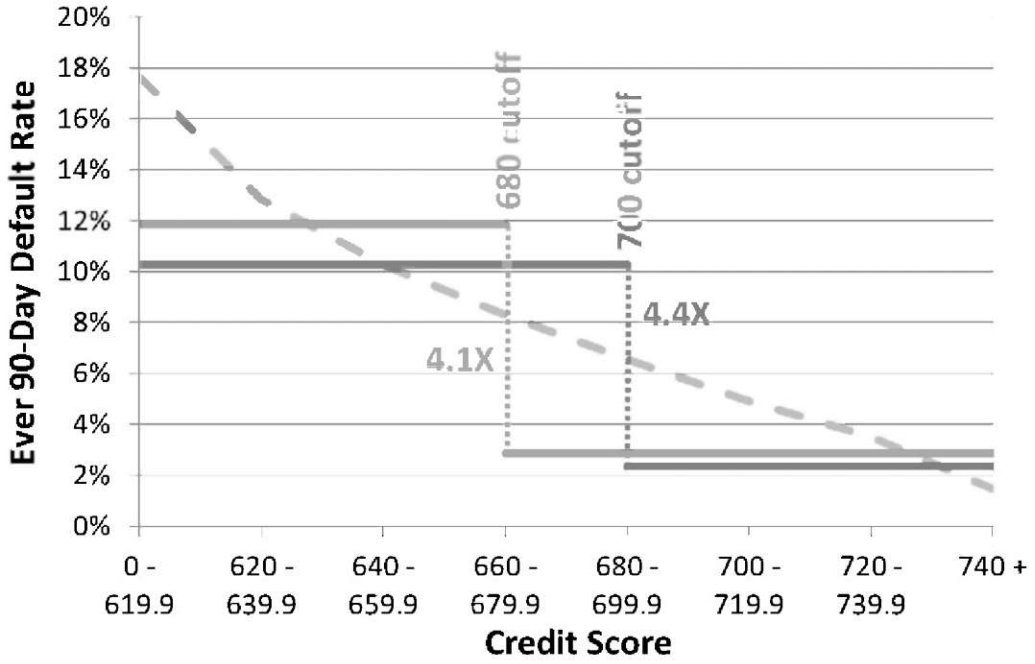
[12] For further discussion on these principal-agent problems, see Janneke Ratcliffe, statement before the Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs, United States House of Representatives, Hearing on Transparency as an Alternative to Risk Retention. May 11, 2011. or, Amherst Mortgage Insight. May 20, 2010. Lori Goodman, Roger Ashworth, Brian Landy and Lidan Yang. "The Elephant in the Room—Conflicts of Interest in Residential Mortgage Securitizations." Amherst Securities Group LP.

[13] FHFA "Data on the Risk Characteristics and Performance of Single-Family Mortgages originated in 2001-2008 and Financed in the Secondary Market," September 13, 2010. Although this analysis pre-dates that cited in the first previous sentence, the ever 90-day delinquency rates for the private label securities can only have gone up in the intervening period, making the gap even larger.

[14] UNC Center for Community Capital tabulations of data tables provided by Federal Housing Finance Agency, "Data on the Risk Characteristics and Performance of Single-Family Mortgages Originated in 2001 – 2008 and Financed in the Secondary Market." September 13, 2010.

4.1 (11.8% to 2.9%), but the dollar volume of qualified mortgages would increase 14%, translating to expanded access to homeownership. Does this mean the cutoff should be 680, or even something lower? One can always draw a number of lines and observe similar contrasts, because the marginal change in risk is obscured by the ultra-safe and ultra-risky mortgages at the extreme ends of the spectrum.



Notes: Fixed-rate mortgages originated between 2001 and 2008 with loan-to-value (LTV) ratios no greater than 80%.
Source: UNC Center for Community Capital tabulations of Federal Housing Finance Agency data.

This continuum effect applies to many other borrower-based factors and the similar relative performance gaps would result from various and arbitrary dividing points.

Problem 3: There are additional, specific concerns associated with each of the big three: debt-to-income, credit score and loan-to-value, some of which the NPR addresses, some of which it ignores.

Debt-to-Income Ratio

Intuitively, the ratio of debt payments-to-income (DTI) would seem a good predictor of default risk; in practice, the ratio has been unreliable. In our research on a portfolio of low to moderate income, low down payment borrowers, UNC Center for Community Capital research found mixed results using a continuous measure of front-end debt-to-income to predict default, and have found it non-significant within income category.[15] Another of our studies found DTI statistically significant for loans originated between 2003 and 2004 but not for loans originated between 2005 and 2006.[16] Further, our research is consistent with others who have analyzed the determinants of mortgage default.[17]

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[15] Roberto G. Quercia, Anthony Pennington-Cross and Chao Yue Tian. "Mortgage Default and Prepayment Risks among Moderate- and Low-Income Households." Working Paper, September 2010. Table 6.
[16] Lei Ding, Roberto G. Querica, Wei Li and Janneke Ratcliffe. "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models." *Journal of Real Estate Research*. 33:2, 2011. Exhibit 9.
[17] For example, Berkovec, J., G. Canner, S. Gabriel, T. Hannan. "Discrimination, Competition, and Loan Performance in FHA Mortgage Lending." *Review of Economics and Statistics*. 80:2, 1998, divides DTI into four

The poor predictive power of DTI is because of several factors, including a high degree of "squishiness" and variability within a narrow typical range. DTI is neither precise, accurate, nor constant.

By squishiness, we mean that both income (denominator) and debt payments (numerator) are not as straightforward to calculate as it would seem. On the income side, issues may arise when there is more than one borrower or when income is partly derived from sources other than steady W-2 wages. Moreover, no- and low-documentation in the past allowed borrowers to overstate income. Conversely, borrowers and lenders do not have an incentive to document more income than required to qualify for a given DTI standard. On the debt payments side, revolving and open-ended credit, short term or non-standard obligations, or deferred loans such as student loans, muddy the picture. Payments related to such debt can change substantially over relatively short periods. For example, many homeowners take on new debt right after buying a house for furnishings and customizations-- debt which, ironically, could disqualify homeowners immediately after the mortgage is originated.

Another reason for the weak association between DTI and default is the comprehensive nature of loan underwriting. Lenders may allow higher DTI when they see otherwise strong risk profiles, which makes the situation complicated for statisticians.

The proposed QRM standard for front-end DTI is just 28%, but nearly half of *renters* spend over 30% of their income on housing costs according to Harvard University's Joint Center for Housing Studies.[18] On the back-end, the proposed QRM standard is 36%, but Moody's Analytics estimates that total DTI ratios in excess of *45%* only increase foreclosure risk by half compared to all loans with less severe debt burdens, an effect smaller than receiving even an amortizing adjustable-rate mortgage.[19]

Here we directly confront the balance between risk and access. FHFA notes that DTI ratios are the most restrictive factor within the proposed QRM definition.[20] According to the analysis that accompanies the NPR, eliminating the DTI requirement entirely would nearly double the share of Fannie and Freddie acquired loans that would have qualified for QRM status, from 19.79% to 37.15% between 1997 and 2009 while the historic ever seriously delinquent rate would only increase 1.38 percentage points. A looser DTI standard could have a more optimal tradeoff between risk and access.

Credit Score

Credit score is a predictor of delinquency, but the relationship is often exacerbated by the types of loan products historically extended to less creditworthy borrowers. For example, research from the Federal Reserve Bank of San Francisco finds that borrowers with FICO score of less than 640 are over 12 times more likely to be in foreclosure than a borrower with a FICO score over 720, but after controlling for loan

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categories, in three year estimations. Two categories are significant at three different years in total. In "Risk-Based Pricing and the Enhancement of Mortgage Credit, Availability among Underserved and Higher Credit-Risk Populations." Deng, Yongheng, and Gabriel, Stuart A. (*Journal of Money, Credit, and Banking*, 38:6, 2006) divide DTI into three categories, in three different models, yet the performance of the variable is very poor. In another example, Calem P. S. and S. M. Wachter's "Community Reinvestment and Credit Risk: Evidence from an Affordable-Home-Loan Program." *Real Estate Economics*, 27:1, 1999, uses front-end-ratio greater than 28% as a dummy and find that though this variable was significant in a model predicting 60+ delinquency, it was not significant in predicting 90+ delinquency.

[18] "State of the Nation's Housing 2011" Joint Center for Housing Studies, Harvard University. Table A.4.

[19] Mark Zandi and Christian deRitis. "The Skinny on Skin in the Game." Moody's Analytics. March 11, 2011.

[20] "Mortgage Market Note 11-02." Federal Housing Finance Agency. April 11, 2011.

terms, borrowers with lower FICO scores are only 4 times more likely to be in foreclosure—still substantially higher, but less than the headline difference suggests.[21] Moreover, there is evidence that the predictive power of credit scores diminished at the height of the housing bubble. A Fitch study found a 31-point difference in 2001 between borrowers who stopped making payments and those who were current, but by 2006 the difference had narrowed to just 10 points.[22]

Credit scores rose between 2001 and 2005, even as the housing market became increasingly over-leveraged.[23] Then as the financial crisis struck, credit scores fell. Sometimes, borrowers' scores were hurt through no fault of their own, as lenders reduced their exposure by lowering credit limits, which results in increased rates of credit utilization (a component of the credit score) at the same level of debt.

Fortunately, the NPR recommendation is not based on proprietary black-box scoring models, and should encourage lenders to review the actual credit history of borrowers, a traditional underwriting practice that was replaced by increasing reliance on FICO scores beginning in the mid 1990's.[24] However, we are not aware of any evidence to support the proposed, and rather rigid, single 60-day late exclusion, and suggest regulators draw on previously established guidelines for review of credit history.

Loan-to-Value Ratio

Though also continuous, the correlation between loan-to-value ratio and default is clearer than for debt-to-income. High loan-to-value (LTV) mortgages have long been recognized as greater credit risks.[25] At the very least, higher equity makes it less likely that borrowers will fall "underwater" (i.e. negative equity) if house prices fall, and, in the case of income shocks such as job loss, provides a cushion so that the borrower can sell the home for at least enough to pay the mortgage and selling expenses, rather than default.

Yet at the same time, down payments represent a major barrier to homeownership for many families. The median sales price of an existing single-family house in 2010 was $173,300, making a 20% down payment would require $34,660 in assets, greater than the annual income of roughly 40 million U.S. households, or about 35% of all households, including 44% of Hispanic households and the majority of African-American households. Minorities already have lower rates of homeownership (46.8% of Hispanic households and 44.8% of African-American households compared to 74.1% of non-Hispanic white households), additional obstacles to wealth creation will only further institutionalize a tiered society. Recognizing the importance of low down payment lending, a maximum LTV requirement was deliberately excluded from Dodd-Frank and the intent reiterated in a letter dated February 16, 2011 from Senators Mary L. Landrieu (D-LA), Kay R. Hagan (D-NC) and Johnny Isakson (R-GA)

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[21] Laderman, Elizabeth and Carolina Reid. "Lending in Low- and Moderate-Income Neighborhoods in California: The Performance of CRA Lending During the Subprime Meltdown." Federal Reserve Bank of San Francisco, 2008, Working Paper 2008-05.

[22] Dean Foust and Aaron Pressman. "Credit Scores: Not-So-Magic Numbers." *BusinessWeek*. February 7, 2008.

[23] Yuliya S. Demyanyk and Otto Van Hemert. "Understanding the Subprime Mortgage Crisis." December 5, 2008. Available at SSRN: http://ssrn.com/abstract=1020396

[24] See for example July 11, 1995 Freddie Mac Industry Letter on "the Predictive Power of Selected Credit Scores."

[25] Roberto G. Quercia and Michael A. Stegman. "Residential Mortgage Default: A Review of the Literature." *Journal of Housing Research*, 3:2, 1992.

Problem 4: ***Successful models of low-income, high LTV lending are ignored by the QRM.***
There is ample evidence that high LTV lending can be done with minimal credit risk. We provide just three of them here.

Self-Help's Community Advantage Program
Launched in 1998, by Self-Help in partnership with Fannie Mae and the Ford Foundation, this program has funded nearly 50,000 mortgages nationwide. The UNC Center for Community Capital has been studying this portfolio for nearly a decade.[26] The median borrower earned about $30,000 at origination; about 40% of the mortgages are to single female-headed households, and about 40% are to minority borrowers. The risk profile of these mortgages looks daunting, especially by today's standards: 39% had a credit score at origination of 660 or less and 80% of the borrowers put down less than 10%, including 69% who put down *less than* 5 percent. Yet ever to date, just 5.5% of the loans have ended in foreclosure for Self-Help, who retained recourse on the mortgages. Meanwhile, the median CAP owner has accumulated more than $16,800 in equity from origination through the first quarter of 2011.

The CAP borrowers overwhelmingly received retail-originated, fixed-rate, thirty-year, amortizing mortgages at prime-market pricing to purchase homes, fully underwritten by the originating lenders following guidelines approved by Self-Help. As an additional underwriting control, lenders had to agree to repurchase early term defaults. For its part, Self-Help was required by Fannie Mae to meet capital and other financial standards, including regular counter-party risk reviews.

Mortgage Insurance
Private primary mortgage insurance (PMI) has been part of the modern mortgage finance industry since the 1950s. Although typically paid by the borrower as part of their monthly mortgage payment, the owner of the mortgage, not the homeowner, is the beneficiary. The insurance covers the amount of the loan above some threshold percentage of the value of the property, putting the mortgage insurer in a first loss position. That financial protection allows lenders and investors to reduce and manage the risks of high LTV lending. Fannie and Freddie are required to use certain approved credit enhancements for loans with less than a 20% down payment, and mortgage insurance is a standard mechanism. During the current crisis, the mortgage insurance industry has paid substantial claims that have reduced the taxpayer costs associated with Fannie Mae and Freddie Mac. At the same time, the industry has been able to attract new capital.

Private mortgage insurance rates must be filed with and approved by state insurance regulators. Thus their rates have, at least until recently, been transparent and relatively static throughout cycles in the real estate market. State regulators' high capital and reserving requirements that are effectively countercyclical: in addition to having a statutory limit of 25:1 risk to capital, they are required to hold 50% of premiums in reserve for ten years. In contrast, during the buildup of the mortgage bubble, alternative sources of credit enhancement, particularly purchase money second liens or "piggyback" mortgages, became increasingly cheap relative to the institutional mono-line sources (primary mortgage insurance and FHA insurance), which lost market share. As a result, the amount of capital backing high LTV lending system-wide declined.

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[26] See Community Advantage Panel Study Policy Brief at http://www.ccc.unc.edu/documents/CAP_Policy_Brief_July09.pdf.

Research presented by the mortgage insurance industry and Promontory Financial Group provides clear evidence that loans made during the period leading to the mortgage crisis that had mortgage insurance had a lower rate of default than low down-payment loans with purchase money seconds. Using data on 4.9 million conventional and private label securitized loans, and controlling for origination year, geography, level of documentation, loan purpose, FICO score and CLTV, Genworth Mortgage Insurance company found that loans with mortgage insurance were both significantly less likely to become seriously delinquent than loans with piggy back seconds, and when they did do so, there were significantly more likely to cure.[27] Similarly, Promontory Financial Group's analysis of more than 5 million loans originated from 2003 to 2007 controlled for a host of risk factors (including documentation level, loan purpose, owner-occupied status, CLTV and FICO score, and local economic conditions) confirmed that loans with piggyback second liens were nearly 21% more likely to default than comparable mortgages with mortgage insurance.[28]

Interestingly, these purchase money seconds are effectively risk retention in the form of a relatively large (10% to 20%) horizontal exposure for the originator who keeps the second lien on their own books. But they do not appear to have prevented defaults as much as the third party alternative, mortgage insurance. Further, piggyback second liens have also proven to be an obstacle to loan modification and other workout solutions to keep borrowers in their home, particularly when the second lien is held by the mortgage servicer. Second lien holders have an incentive to hold refinancing or modification plans hostage unless they receive some benefit, demonstrating the fact that poorly structured risk retention can actually create conflicts of interest. In fact, the NPR anticipates such conflicts when it asks, "Should a sponsor be prohibited from utilizing the horizontal risk retention option if the sponsor (or an affiliate) acts as servicer for the securitized assets?" Using mortgage insurance, incentives are better aligned. Consequently, mortgage insurers have had an important role in developing not only underwriting standards on high loan-to-value mortgages, but also loss mitigation techniques.

Massachusetts Housing Partnership's SoftSecond Program

Massachusetts Housing Partnership has operated the SoftSecond® Loan Program since 1990, financing over 15,000 home purchases. The program finances up to 97% of the purchase using a second mortgage for 20% of the purchase price. Notably, however, the program differs substantially from reckless piggyback second liens. For example, while lenders retain credit risk on the first mortgage, they can utilize a cash-funded loan loss reserve operated by Massachusetts Housing Partnership for any losses faced on the second mortgage. Further, the second mortgage is interest-only, and occasionally even subsidized, for the first ten years before payments gradually increase. Consequently, the SoftSecond is more similar to down payment assistance used to overcome wealth barriers to homeownership, albeit assistance that is gradually repaid by the borrower.

The SoftSecond program targets households earning less than 60% of area median income. No loan-level price adjustments based on risk-based pricing models are used, although a minimum FICO score of 660 is required. Debt-to-income ratios can be as high as 36% on the front-end and 43% on the back-end, well above the standards proposed for QRM. Yet, as delinquencies peaked in the summer of 2010, the

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[27] Genworth Financial. Genworth Mortgage Insurance Company Public Comment on Credit Risk Retention Rule; July 28, 2011 viewed at http://www.regulations.gov/#!documentDetail;D=OCC-2011-0002-0216.

[28] "Assessing the Delinquency and Default Risk of Insured and Non-Insured High LTV Mortgages." Promontory Financial Group. July 12, 2011.

SoftSecond program had a foreclosure rate of just 1.01%. For comparison, the foreclosure rate for prime loans in Massachusetts was 2.14% and for subprime loans was 13.6%.

Examples of successful low-income, high LTV lending show alternative forms of risk retention are viable and should be included into the definition of QRM or that the definition of QRM itself should be expanded. Otherwise, many creditworthy borrowers may be lost in the non-qualified wilderness. The three examples discussed above suggest that some forms of credit enhancement are desirable and even preferable to risk retention. Some common features include real, institutional capital at risk, conforming to strong counterparty risk management standards, held by players that have a role in setting underwriting standards *in advance* of taking on the risk, and whose financial interests are realized only if borrowers pay off their loans.

Allowing soft second liens and other forms of *bone fide* down payment assistance, mortgage insurance, and alternative methods of risk retention to meet the definition of QRM is important for facilitating their sale on the secondary market. For example, Massachusetts Housing Partnership states that "SoftSecond's most significant shortcoming is the inability of lenders to sell mortgages on a flow basis to the secondary market. If this were possible, lenders would be able to originate SoftSecond loans with fewer, if any, internal volume restrictions. This would also allow a greater number of small, local lender to participate, particularly those who do not have the capacity to hold or service their own loans." Because non-qualified mortgages cannot be mingled with QRM loans for the security pool to be exempt from risk retention, ensuring that models already utilizing alternative forms of risk retention meet the definition of QRM is important to their liquidity and continued viability in the market.

The proposed QRM puts the viability of down payment assistance programs funded by non-profits and state and local housing finance agencies at risk. These flexible loans can ensure successful homeownership experiences by preserving the liquidity of household financial assets, which is especially important for lower-income households in covering unexpected expenses that sometimes arise. A recent survey by the Center for Community Capital of 117 housing counselors nationwide found that over half (54%) were currently seeing frequent use of soft second mortgages or down payment assistance programs, indicating that these programs are important in today's fragile market. We encourage regulators to consider certain subordinated lien programs as substitutes for risk retention.

Overall, at issue is the balance of credit risk and access to homeownership. These examples show that the borrower-related criteria of QRM can be expanded with minimal increase in defaults. As noted, Genworth estimates the predominantly product-related QM regulations would already reduce the overall default rate from to 3.19%, using broad market data. Genworth also estimates that the QRM rule, as proposed, would further reduce the default rate for mortgages originated between 2001 and 2008 to just 0.81%. For illustrative purposes, they compare the proposed rule (in parentheses) to an alternative QRM filter, defined as a 45% DTI ratio (vs. 36%), a 660 credit score (vs. 690), and a 97% LTV using historic loans with MI if LTV is over 80% (vs. 80%). ***This example alternative QRM results in a historic default rate over the period of only 1.55%, a full 70% lower than the overall default rate for the time period. In exchange, the expanded QRM definition increases the number of eligible mortgages nearly 59% over the NPR version of the QRM.*** Mortgages that would not have qualified under the expanded QRM definition have a 6.74% default rate (4.35 times higher than the alternative QRM group).[29] As noted, this

[29] These are results of internal analyses prepared by Genworth Mortgage Insurance Company using data from First

alternative QRM is only illustrative, used to demonstrate that by loosening any of these criteria at the margin, the market *can be* expanded with only slight and manageable increase in the predicted QRM default rate.

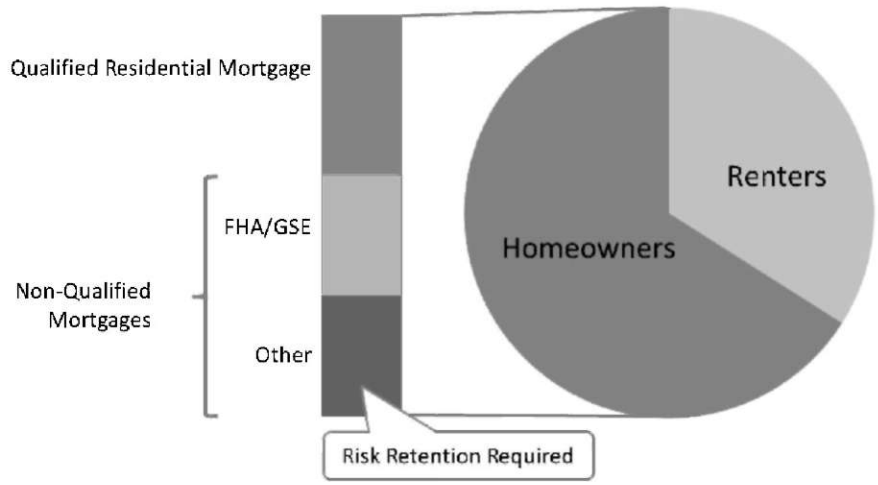
Falling outside the definition of QRM would not mean mortgages could not be obtained, of course; however, risk layering and nontraditional loan products would only be restricted by the effectiveness of risk retention, which history shows has not been perfect (see below). For example, given that many Americans do not have the assets to put 20% down, and are therefore excluded from a potential QRM designation as proposed, there is little to encourage lenders to provide the safest product features to these households. Such borrowers, once outside the QRM zone, might be more likely to be offered adjustable-rate mortgages, prepayment penalties or other features which compound risk for those least able to weather financial shocks, because lenders and investors might be able to profit on such loans despite high defaults. In 2007, Federal Reserve Board Governor Ned Gramlich asked, "Why are the most risky loan products sold the least sophisticated borrowers?" More recently, Mark Zandi commented that the proposed QRM definition "has the odd effect of regulating the best quality borrower, those least likely to require intervention, more heavily than the rest of the market."[30] The goal of mortgage market reform should not be to partition the market, but to ensure its sustainability in its entirety, and that requires ensuring that sustainable loan products are the preferred option for creditworthy but less well-resourced borrrowers.

The Ultimate Impact of the QRM will be Determined by the Other Moving Parts

The impact of the QRM will be determined less by the definition itself than by other factors. First, its importance will be affected by the strength of the risk retention rules for non-qualified mortgages. The full implications for the housing and mortgage market are also contingent on the degree and nature of the government role in the mortgage market, either through a secondary market agency with Enterprise-like functions, or through the Federal Housing Administration. How all of these decisions interact will determine which borrowers access which channels and at what cost, and therefore, ultimately, who has access to homeownership.

American CoreLogic.

[30] Mark Zandi and Christian deRitis. "Reworking Risk Retention." Moody's Analytics. June 20, 2011.



Absent strong risk retention, QRM is a distinction without a difference.

The growth of the originate-to-distribute model of mortgage lending led to misalignment in the incentives of originators and investors. Risk retention should reduce the attendant principal-agent problems that arose. However, as many have noted, the conventional wisdom that lenders and security issuers lacked "skin in the game" is not entirely accurate.[31]

One possible reason for the ineffectiveness of risk retention in preventing the housing bust is that risk retention at the individual loan or security level did not effectively block the buildup of systemic risk. As defaults became correlated, the ability to shift risk to the equity tranche was exhausted and the senior tranches were no longer safe. Consequently, holding a horizontal mezzanine tranche or a vertical tranche might be more effective than a horizontal slice, but may also require thicker risk retention.[32]

In addition, during the housing bubble, financial institutions were able to sell or hedge their risk exposure from retained equity tranches.[33] The proposed rule on risk retention rightly prohibits some forms of hedging if based on the particular risks of the mortgage security. However, the rule allows hedging based on the general market, which is beneficial for safety and soundness. Recognizing the challenges in distinguishing the two underscores our point that risk retention is an imperfect tool.

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[31] The "representations and warranties" of originators often included promises to repurchase loans in default, effectively a form of risk retention. In addition, Moody's Analytics notes, "Before the financial crisis, many investment banks held significant amount of the credit risk is their securitizations… Thus, despite having lots of skin in the game, the securitizers still made huge errors." Moody's estimates that Alt-A and subprime securitizations had between 5% and 15% subordination levels below Aaa. Mark Zandi and Christian deRitis. "The Skinny on Skin in the Game." Moody's Analytics. March 11, 2011. The shortcomoings of purchase money second liens has been discussed earlier in this commentary.

[32] Ingo Fender and Janet Mitchell. "Incentives and Tranche Retention in Securisation: A Screening Model." Bank for International Settlements, Working Paper No. 289, September 2009.

[33] For example, the Senate Permanent Subcommittee on Investigations released a report, which profiles the collateralized debt obligation (CDO) known as Hudson Mezzanine Funding 2006-1 issued by Goldman Sachs. Goldman had a $6 million equity stake in the CDO, a fact used in the Hudson 1 marketing materials to show that Goldman's interests were aligned. However, Goldman was at the same time also shorting all $2 billion of the CDO. See, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse." Majority and Minority Staff Report, Permanent Subcommittee on Investigations, U.S. Senate. April 13, 2011.

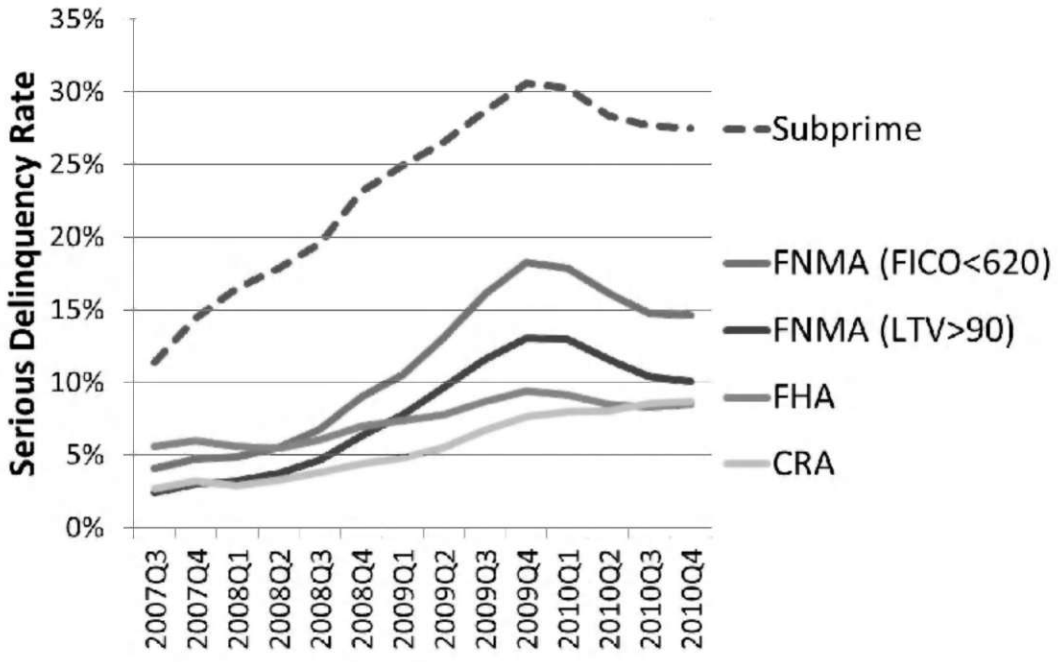
Getting the rules on risk retention and hedging right are vitally important to the future of the mortgage finance system, but it is also very difficult to do with precision and without unintended consequences. If risk retention is not a sufficient deterrent to originating non-exempt mortgages, the designation of a QRM becomes meaningless in this context, though it may inadvertently be applied in others.

The ultimate impact of the definition of QRM lies in the overall structure of the future mortgage finance system, which remains unknown.

Currently, government-backed agencies dominate the mortgage market. Per Dodd-Frank, by virtue of holding *all* credit risk with government support, these agencies are deemed to meet the risk retention requirement. Consequently, rulemaking on QRM will have little immediate impact.

However, the Enterprises appear to be slated for retirement. The future size and role of the federal government in the mortgage market is uncertain, which makes the optimal shape of QRM and risk retention difficult to assess.

Under one scenario, a narrow QRM definition would secure investor confidence without requiring a government guarantee, leading to a limited but robust private secondary market. A strong risk retention requirement for private institutions should discourage another "race to the bottom" in underwriting standards. Meanwhile, a federal agency (FHA or GSE) could also operate in the non-QRM segment to ensure broad access to homeownership. Experience shows that supposedly higher risk mortgages originated under the auspices of government programs (FHA, GSE affordable housing goals, Community Reinvestment Act) have performed substantially better through the housing downturn than market subprime mortgages.



Note: CRA delinquency rate taken from a portfolio of CRA loans managed by Self-Help Credit Union.
Sources: Mortgage Bankers Association; Fannie Mae; Center for Community Capital

On the other hand, in the event of a reduced role for federally sponsored agencies, a very broad QRM, ensuring greater access to homeownership for all Americans without compromising safety and soundness, is more desirable. The regulations should take the possible scenarios into account.

Ultimately, these decisions will dictate not only the degree of government presence in the mortgage market but the overall balance between risk and access. It is worth noting that after dramatic growth in subprime and Alt-A lending over the past decade, from $200 billion to over $1 trillion, the homeownership rate among families earning less than median income peaked at 53.1%, just one-tenth of one percentage point higher than its level in 2001. The perception that high risk lending was driven by a desire to promote homeownership is belied by the fact that homeownership did not grow in proportion to the increase in such lending. Instead, the reckless lending of the housing bubble was not needed to raise the low-income homeownership rate; in fact, the unsustainable nature of those loan products has led to widespread and devastating foreclosures. Similarly, historically high levels of low-income homeownership did not precipitate the housing crisis, as the homeownership rate rose continuously through the 1990s while housing prices remained tethered to economic fundamentals.

In summary, high and sustainable levels of homeownership can be achieved without abandoned credit quality; indeed, it requires attention to good underwriting and servicing. Risk retention is one mechanism for encouraging sound practices by agents, but it is imperfect. In the past, risk retention has sometimes failed or led to unintended consequences. Moreover, factors yet to be decided will determine the ultimate impact of the QRM definition. In certain scenarios, a too narrow QRM would lead to seriously constrained credit, further weakening housing values. Given the fragility of the current market, a broad QRM has the potential to restore access to credit more equitably, support broader homeownership and help the market recover, without compromising systemic safety and soundness.

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