CANICCOR

AN INTERFAITH COUNCIL ON CORPORATE ACCOUNTABILITY

P.O. Box 426829, San Francisco, California 94142
Offices at 4407 20th Street, San Francisco, CA 94114
Phone: (415) 282-8497 - FAX: (415) 282-8497 - e-mail: johnlind01@yahoo.com

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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Subject: Comments Docket No. R-1411
Credit Risk Retention

Dear Ms. Johnson:

I am writing in regard to this request for comments because I serve as a consultant to a number of institutional investors which have social concerns in addition to investment concerns. Over the past several years we have had multiple meetings with eight major servicers of single family residential housing loans, which handle about two thirds of all U.S. housing loan servicing. Our concern has been that these servicers provide loan modifications to keep as many as possible of troubled borrowers in their homes and thus prevent price declines and community deterioration while still providing the maximum return to the owners of the loans.

One focus over the last 18 months has been whether loans serviced for others are as adequately serviced, subject to valid pooling and servicing agreements, as loans held in portfolio. There were serious questions concerning the servicing for others by J.P. Morgan Chase after dialogues with them, so CANICCOR filed a request with the OCC for a CRA examination of their servicing in June 2010. Then at the request of an institutional investor, CANICCOR developed a shareholder resolution, which was filed by the Presbyterian Church (USA) and other investors with J.P. Morgan Chase. The resolution asked the Board of Directors to oversee development and enforcement of policies to ensure that loan modification methods for similar loan types are applied to both loans owned by the corporation and those serviced for others, subject to valid constraints of pooling and servicing requirements and to report back to shareholders by 30 October 2011. This resolution was just voted upon on 17 May 2011, gaining 6.4% of the vote. The resolution is very important because it is technically on ordinary business, which is normally excluded from shareholder resolutions by the SEC. However, we were able to argue that while it was normally ordinary business, the significant risk involved made it a matter of investor concern. Fortunately, the SEC had just changed its policy in 2009 to cover such ordinary business. This resolution was one of the first such cases where the SEC refused to issue a no action letter to the corporation, and thereby the resolution remained on the proxy.

As a result of these discussions, I have developed a reasonable background on RMBS from which I will attempt to answer some of the questions raised in the request for comments on credit risk retention. **As a result, my analysis only deals with residential mortgage securities, since my research has dealt almost entirely with residential housing.**

The opinions expressed in this comment letter are solely those of this writer.

My Starting Point

CANICCOR argues that the losses before the current decline in housing prices should be the basis of determining the levels of credit risk for residential mortgage backed securities (RMBS).

In order to understand the recommendations that I have given below, it is crucial to understand how I see the goals of risk retention. For effective risk retention and adequate servicing, the sponsor must be "in the money", i.e. having assets at risk, under most circumstances. Once the sponsor is out of the money, the result is the recent crisis. **The question then becomes how to assure the sponsor is essentially always in the money.**

Assuming that risk retention is able to prevent such a crisis, what is the level of risk retention that is necessary? To estimate that level the maximum level of risk retention, the maximum level of credit losses just before the crash in housing prices would be a reasonable estimate as discussed below, but with down payments of at least 10% to provide a cushion for a modest down turn in prices. While the data in Appendix A on serious delinquencies is useful, I prefer data on losses as the test for risk retention.

First of all if housing prices are rising, borrowers who face special crises, such as job loss, medical problems, divorce, etc., can sell their homes to pay off the mortgage with little loss to the RMBS. Housing prices increase primarily because of general inflation and population increase, or the equivalent of the latter, less restrictive underwriting providing more permissible borrowers. Before the present crisis and since at least 1970 there has been nearly a constantly increasing overall rise in housing prices in the U.S. The exception was the rolling recession of 1988 through 1991, with the peak in 1988-89 in the Northeast and in 1990-91 in California. Housing prices had a downturn in 1990 through 1992 with the downturn in the New England and the Pacific regions extending to 1995, and only picking up in the latter half of the 1990s. Except for New England, the decline in regional housing prices in this period was generally less than 10% and so not comparable to the present crisis. For non-Agency MBS, Standard and Poor's shows an increase of projected losses for the life for 1,130 pools issued between 1986 and 1995 of 1.22% in 1986 and rising to 2.79% in 1990. The losses then rapidly declined to 0.75% in 1991 and continued dropping through these series to 1995.[1]

The present situation started with the increase in the securitization of subprime loans and securitization of high LTV loans in the latter part of the 1990s. For the very high LTV loans, the defaulting loans could not be paid off by selling the property except with another high LTV loan unless prices were rising very rapidly. For subprime loans securitized between 2000 and 2005, the 24 month foreclosure rate varied between 4% and 8%, reaching a maximum of about 12% at 4 years before declining. However, since foreclosures do not result in total losses for the

[1] Gillis T., "The Default and Loss Experience of Nonagency MBS", Handbook of Nonagency Mortgage-Backed Securities, Ed. Fabozzi FJ, Ramsey C, and Marz M, 2nd Ed., Chapter 12, J. Fabozzi Associates, 2000.

owner of the loan, the cumulative losses of 2001 securitizations, the worst performing before 2006, and 2002 securitizations were just under 4% at 7 years after issue, after which losses should be significantly declining. The 2006 losses on both subprime[2] and option ARMs were projected in late 2007 as much higher; however, by this date the crisis was already in effect. By 2010 cumulative losses of subprime securitizations of 2005 were projected to reach 19% and for 2006 securitizations 38%, with similar order of magnitude percentages for Alt-A loans. But by now unemployment was much higher and housing prices had declined by a third; so the sale price would not cover the loan amount. Thus taking the level of losses before the decline in housing prices as a reasonable risk retention level for the future, perhaps 4% would have been adequate for subprime to keep the sponsor in the money and a somewhat higher value would have been required for option ARMs.

As a result of this review, a risk retention of 5% would just keep the sponsor in the money, i.e. losses of less than 5% for subprime loans from the early part of the first decade of 2000 but not in a crisis as we now have. The purpose or risk retention is to prevent such a housing price bubble, so the 5% retention should be sufficient if a housing crisis can be averted. Perhaps a slightly higher level would have been required for Option ARMs, the bulk of which were originated near the beginning of the crisis and helped precipitate it.

With the assumption that a risk retention of about 5% could in general prevent the development of a housing crisis, I believe that the horizontal risk retention would keep the sponsor just in the money. If however, there is a possibility of the sponsor going out of the money as with Option ARMs, then an L-shaped retention or a higher percentage horizontal retention should be required.

II. General Definitions and Scope

The technical aspects of these definitions are not generally within my expertise. However, a general comment can be made on question:

1.Do the proposed rules appropriately implement the terms "Securitizer" and "Originator" of Sec. 15G?

> I believe they do. My one concern was whether a lender with correspondent lines would be considered the originator of the loans from the correspondent lines, but Sec 15G (a)(4) seems not to affirm this interpretation, so see questions under C. Allocations to originator, comment 88.

3(a) Is it appropriate to impose risk retention on the sponsor rather than the depositor for the transaction?

> For simple large bank securitizations of the loans that they originate, the sponsor and the originator are usually the same. However, with CDOs where a selection of various more straightforward securitizations are re-securitized, it is obvious that the sponsor makes the selection of securities for the securitization and determines the risk level of the security. Thus the risk retention requirement must be imposed on the sponsor.

[2] Parisi F and Giudici AJ, "Standard & Poor's Revised Default and loss Curves for U.S. Subprime RMBS", Ratings Direct, 19 October 2007.

For an RMBS issue of loans by several originators, see the discussion under III. General Risk Retention Requirement section C "Allocation to the Originator".

5. through 9. These questions are beyond my expertise.

III. General Risk Retention Requirement

10. is the 5% risk retention requirement for non-exempt ABS transaction appropriate?

The percentage required for risk retention is directly related to the detailed form of the risk retention covered in questions 13 ff and its total burden on the sponsor. First, let me address the total burden on the sponsor.

I realize that the following discussion on shortening the period for holding risk retention is in violation of section 15G. However, see my reply to comment 102 below.

In my comments of 19 February 2010 on ANPR RIN #3064-AD55 of the Federal Deposit Insurance Corporation, I calculated the total burden on the depository of a retention requirement of 5% by two oversimplified models to obtain a general burden level for a sponsor. The models assume that the volume of loans securitized in a given year declines linearly over either 10 or 20 years and that the volume of loans securitized yearly remains constant from year to year.

If the sponsor must hold 5% of each year's securitizations and if the refinancing rate and/or payoff of the loans is so that all loans are repaid within:

1. 10 years, then at steady state the sponsor will hold a total equivalent of **27.5%** of the annual production of securitized loans over the long term.
2. 20 years, then at steady state the sponsor will hold a total equivalent of **52.5%** of the annual production of securitized loans over the long term.

If interest rates are declining over a long period then the first estimate may be more close to the actual while for increasing interest rates the second estimate may be more accurate. However, the equivalent overall burden is unlikely to be more than about 50% of the average annual production being held long-term by the sponsor.

Since the probability of high delinquencies is greatest in the years just after origination, we might assume these delinquencies and defaults occur within the first five years. Then only the equivalent of about a quarter of the average annual production held by the sponsor would be subject to significant delinquencies and defaults. Is this amount then a sufficient deterrent to prevent poor quality lending practices since not all of the 25% subject to high delinquencies will indeed be delinquent?

As a result of the above calculations, I would suggest that the risk retention of a securitization need only be held for 5 to 10 years after its securitization. This shorter period of retention would permit a higher rate of retention on each securitization without undue burden to the sponsor. These numbers then raise question 11 of whether a higher minimum should be required for some loan types.

11. If a higher minimum risk retention should be established, what minimum should be established and what factors should be taken into account in determining this minimum?

The minimum level of risk retention should depend upon the characteristics of the loan. The current crisis was precipitated by subprime loans and continued by loans with negative amortization and loans with little documentation often with adjustable rates and teaser initial rates. A risk retention of 10% could be required for some of these loan types, especially if they need to be held for only 10 years. Generally jumbo loans are less of a problem, except in terms of strategic defaults in times of declining housing prices, so a risk retention of 5% may be adequate for them as well as various fixed rate loans.

Should the above approach be based upon expected losses or on an interest rate spread relative to a benchmark index?

While high interest rates are a significant factor in expected losses, other factors also contribute such as CLTVs and backend debt to income ratios (DTIs), especially when several factors are simultaneously excessive. **Thus an adequate valuation of expected losses should be the ultimate basis.**

I have examined interest rate spreads in my reports on major originators using HMDA data up through 2006 and used the product of the loan-to-income (LTI) ratio times the interest rate spread as a simple index of risk. These calculations included all piggyback loans at their total amounts and effective rates. Loans with rate spreads 3% or more above comparable treasuries were reported, and were of great concern, particularly those with spreads of 5% or more. These interest rate risk measurements were discussed with the major originators and were indicative of the problems some of them faced when the crisis came.

With the revision of Truth in Lending (12 CFR 226) in 2008, "higher priced mortgage loans" were defined as having an ARP that exceeds the average prime offer rate by 1.5% or more for first liens and 3.5% or more for subordinate liens. This definition is better than but roughly comparable to the 3% and 5% limits based upon corresponding treasury rates. On this basis the "Board believes that that these thresholds . . . would cover all or virtually all of the subprime market and a portion of the alt-A market."[3] Thus rate spread is an important and readily available factor to be taken into account. It could be used for specific loan types to specify a risk retention of 5% for loans with rate spreads of 1.5% to 3.5% and a higher risk retention of say 10% for loans with rate spreads to 3.5% or more. I apply here an interest rate range to the lower risk retention similar to what I used in my reports on HMDA data up through 2006. Further research should be done on the resulting losses of these loans as a function of rate spread.

12(a). Would the 5% retention requirement have a significant adverse effect on liquidity or pricing?

(b). What markets would be adversely affected and how?

Obviously, there would be some effect on pricing and liquidity, because risk retention

[3] "B. Threshold for Rate Spread Reporting", Proposed Rules: Home mortgage Disclosure, Federal Resister. 73, No. 147, p. 44192 (30 July 2008).

would mean that the sponsors would be holding larger volumes of securities containing higher risk loans, rather than higher quality lower risk tranches, as has often been the case. However, the reduction of the volume of loans with very high risk associated with them is in itself is a desirable effect of this risk retention.

It is important to remember that when GSE insured securitized loans are included in the totals of ABS for 2002 through 2009, the RMBS account for 70% of all the ABS securities. Of these RMBS, the non-GSE portion accounts for only 27%, thus the real question will be the definition of QRM and how much of the GSEs volume will be included under QRM, rather than any constraints on this smaller portion of non-GES RMBS. See questions 106ff.

RMBS of jumbo loans could be singled out because of less risk and a different distribution of risk, and they will be discussed below. However, many jumbos will qualify as QRMs.

B. Permissible Forms of Risk Retention

13. Is the proposed menu of options which lets a sponsor choose the form of risk retention appropriate?

No, see comment 14.

14 (a) Should the Agencies mandate a particular form of risk retention?

Yes, but depending upon the type of loans securitized.

(b) Which forms should be required and for which asset classes?

The present crisis was instigated by the housing price bubble particularly because of poorly underwritten subprime loans, option ARMs, low doc Alt-A loans, etc. The end result has been unemployment and rapidly declining housing prices affecting a broad credit quality spectrum of borrowers. However, such steep declines in housing prices are the result of earlier poor underwriting conditions. These housing price declines might have been prevented, if the subprime loans had been avoided or better underwritten, and the progression to option ARMs, etc. prevented. Thus I take the credit losses before the housing price decline as my reference point for risk retention in this case, as discussed in the section on CANICCOR's Goals above.

My knowledge is primarily on RMBS and CDOs of RMBS, for which I would generally urge the requirement of holding an horizontal risk retention:

- **For a senior-subordinate structured RMBS** with the retention being of the first loss exposure, i.e. the most exposed tranches, such as the equity tranches and the most subordinate tranches. Since the first loss position usually has the highest return if losses are minimized, this choice incentivizes the sponsor to include only well underwritten loans in the securitization. Horizontal risk retention also promotes modifications of troubled loans, especially if the sponsor is also

- **For pass-through securities**, a representative sample of the first loss loans should be held by the sponsor since there is no such thing as a first loss tranche.

The exceptions to this approach might be:

- **Option loans especially Option ARMs** and **Interest Only ARMs** were widely used for borrowers across the income distribution, so an L-shaped risk retention could be used. In case of the present crisis of rapidly declining housing prices, the higher income borrowers and investor borrowers were more likely to use a strategic default whereas the lower income borrowers suffered inadequate income to meet the mortgage payments.

- **Jumbo Loans** are usually loans to higher income borrowers and thus an L-shaped risk retention may be more appropriate.

If a general housing crisis affecting the majority of the country were instigated by other forces causing general unemployment, such as occurred locally in the rust belt by the movement of manufacturing overseas, then an L-shaped risk retention could be better for keeping the sponsor in the money in most loan types.

15. Does the proposed menu approach achieve incentives to monitor and control the underwriting and align incentives among originators, sponsors and investors?

If the sponsor can choose the form of risk retention, the approach does not necessarily achieve these goals. As stated above, the form of risk retention must be mandated for the particular type of loan. For unusual types, the Agencies should mandate the risk retention type after consulting with the sponsor. Obviously an L-shaped retention could serve as a fall back position but not necessarily the best.

As noted above in a senior-subordinated structure, all the investor tranches will not have the same goals, since very senior tranches may prefer quick foreclosures, being unaffected by the loss, while subordinate tranches will usually prefer modification of loans. I believe that RMBS should be structured similar to that of CMBS, in which case the most exposed but still in the money tranche should control the loss mitigation of the delinquent loans. Such a structure would give preference to loan modifications as would the sponsor holding the first loss position in the current RMBS structure.

16 through 18 are covered above.
19 Are there other forms of risk retention that should be permitted.

Not to my knowledge, but I have little expertise on assets other than RMBS.

20. Should the proposed rules require disclosure as to why the sponsor chose a particular risk retention option?

If the form of the risk retention is not mandated by the Agencies, then it is crucial to have

the sponsor outline how the particular form of risk retention that it decided to use achieves the goals given in 15 in the best manner. The Agencies should have power to deny the use of self-serving risk retentions.

21 through 23. I do not have sufficient expertise to answer these questions.

1B. Vertical Risk Retention

24 and 25 Are the disclosures for vertical risk retention sufficient? Should additional factors be required and what are they?

As noted above, I do not generally support vertical risk retention. However, if it were to be used for senior-subordinate structured RMBS, the disclosures appear to be generally adequate. However the sponsor should show that within each tranche, the holdings are representative, for example across geographies of the loans, LTVs, etc.

For pass-through RMBS, the distribution is less clearly defined. Thus any assumptions and the methods used should be clearly stated and should be reviewed by an Agency.

2B. Horizontal Risk Retention
First-loss exposure to the credit risk of the pool

27. Do the conditions and limitations limit the ability of the sponsor to structure away its risk exposure?

If the sponsor is the originator, I am concerned that there may be other methods to structure away the sponsor's risk exposure such as through buy-downs of the interest rate, where the sponsor holds the buy-down and should be treated similar to the premium capture cash reserve.

Obviously, if the loans in the securitization are of very poor quality, the sponsor might find itself out of the money from first losses, and so the risk retention should be greater than 5% or a L-shaped retention would be required.

28 (a) and (b). Is the restriction on certain payments to the sponsor with respect to eligible residual interest appropriate and sufficient? Why or why not?

Yes, if other payments such as prepaid interest rate buy downs are also included for sponsors that are also originators. These are payments received by the sponsor prior to or in the securitization process which could be considered to compensate for the first-loss exposure of the sponsor. The only question is whether these should be included in the 5% retention or in additional to the retention. I would prefer them to be in addition since they are not a part of the unpaid principal balance.

29 (a) and (b). Is the measurement of horizontal risk based on ABS par value appropriate or would a different approach be better?

For RMBS, I believe that the unpaid principal balance of the security is appropriate. As a result there is the need to have in addition a cash reserve account consisting of the

payments to the sponsor of eligible residual interest, i.e. premium capture cash reserve account, and any interest rate buy downs, if the sponsor is also the originator. These cash reserve accounts are discussed below.

30. Are the disclosures sufficient to tell whether the sponsor has complied with the rule?

No. see question 31.

31 (a) and (b). Should additional disclosures be required; what are they and why?

If the sponsor is also the servicer, the servicing fees paid to the sponsor must be described and the fees must be standardized and approved by the Agency. See question 33.

32 Are there additional factors?

Especially in the case of the sponsor as servicer, the pooling and servicing agreement (PSA) must not be restrictive on loan modifications subject to a positive estimate of net present value (NPV), and the method of estimating the NPV must be provided.

33. Should a sponsor utilizing the horizontal risk retention be prohibited from acting as the servicer for the securitized assets.

No, I believe that if the sponsor is also the servicer and has the first risk, the servicer will make use of modifications whenever possible to reduce foreclosures and maintain the overall value of the securitization. If the risk retention is consumed and further delinquencies occur, the sponsor servicer is no longer 'in the money" and thus has no further interest in the securitization, then its position as the servicer is more questionable. However, the hope is that the sponsor/servicer's first loss position will prevent this situation from occurring or that an L-shaped risk retention is required to keep the sponsor/servicer in the money.

Obviously, the requirement for using independent companies for ancillary services during the foreclosure process would reduce the risk of overpricing of these services by companies related to the servicer.

34. and 35. Are the terms and conditions of the horizontal cash reserve account appropriate and will have the same incentive effects as an eligible horizontal residual interest?

I believe that any other cash reserve account should be treated in the same way as the premium capture cash reserve account.

36. Should the eligible residual interest be required to be structured as a Z bond.

I have no expertise in this area, although a Z bond does not seem unreasonable and is a clearly defined holding.

3B. L-Shaped Risk Retention
50% of total retention vertical and 50% horizontal

37, 38 and 39. Are additional disclosures required for L-shaped risk retention beyond those required for both horizontal and vertical retentions?

If the disclosures under vertical and horizontal are all provided for a 50%-50% L-shaped retention, they presumably are sufficient. If the balance is other than 50-50, then additional requirements are required as to why the ratio has been changed and should require Agency approval.

40. Should agencies permit or require that a higher component be held by either the vertical or horizontal segment of the retention.

I believe that, unless there are compelling reasons for a different combination, the 50-50 rule should apply in general for simplicity.

4B. Revolving Master Trusts

41. through 46. Comments on Revolving Master Trusts.

I have no particular expertise on these revolving master trusts since they are not used for RMBS.

5B. Representative Sample.

47. Should a representative sample be included as a possible risk retention?

For RMBS, the only case for a representative sample being a possible risk retention would be for horizontal risk retention on pass through certificates, unless some sort of Z bond could be used. Discussing a random sample on non-RMBS ABS is beyond my expertise.

48. Are the mechanisms proposed adequate to insure monitoring?

As a back up to this monitoring the representative sample must be held until all ABS interests are paid in full.

49. Is the requirement that the pool contain at least 1000 appropriate assets appropriate?

While 1000 such assets is appropriate for auto loans, it would amount to much more than 5% for RMBS, so the number might need to reduced to between 100 and 200 for pass through RMBS.

50. through 58.

Since the use of a representative sample should only apply to pass through securitizations of RMBS, I don't think it is possible for me to answer these questions.

6B. Asset-Backed Commercial Paper Conduits

59. through 67. I can only comment on RMBS.

7B. Commercial Mortgage-Backed Securities

68. through 78.

I am interested in commercial CMBS because this is an area that has not been as badly hit as RMBS and will be required to help the country move out of the current crisis. Also loans in CMBS affect Community Reinvestment Act performances, which are a concern of the invertors for whom I consult. Finally CMBS are structured so that the most exposed investors of the CMBS, which are still in the money, can pick the trustee to supervise the handling of the exposed debt. This approach is much more useful than the present arrangements for RMBS.

Unfortunately I have little background to understand how well the risk retention by a B-piece buyer has worked and therefore cannot respond responsibly to the questions.

8B. Treatment of GSEs

79, 80 and 81. Is the proposal regarding the GSEs appropriate?

While the GSEs are required to hold 100% of the credit risk on the MBS they issue, they can hedge against this risk. However, I believe that for loans they guarantee that require risk retention, the retention level should be outside of their permitted hedging so that the GSEs too have skin in the game.

9B. Premium Capture Cash Reserve Account

82. Will the premium capture cash account be an effective mechanism?

I do believe that some form of capture of the monetization of the excess spread is necessary to prevent the originator from subverting the risk retention rule.

C. Allocation to the Originator

86. Should the proposed rules permit allocation to the originators if L-shaped risk retention is selected or required?

I presume the assumption is that each originator of at least 20% of the loans would retain a securities risk retention of a representative distribution of all loans in the securitization so that each originator has concern for the overall risk of the securitization. For RMBS of option ARMs and perhaps jumbo loans, L-shape risk retention may be helpful. My concern is that all the significant originators hold representative amounts of securities that are in the money at all times but have significant first loss.

87. Should the rule permit allocation to originators if the sponsor selects the horizontal cash reserve account?

Again I believe that the agencies should mandate the form of risk retention. A horizontal first loss retention should be adequate if the level of retention is determined by the type of loans in the securitization so that the sponsor/originators are always in the money.

88. Should rules permit allocation of risk to originators that have originated less than 20% of the pool?

Twenty percent is a reasonable practical tradeoff, since each originator must survey the whole securitization and since each holds a representative sample of the whole in risk retention. A question might be will the sponsor permit originators of less than 20% to participate since the sponsor must hold that portion of the risk retention. How would such a prohibition hurt smaller originators? I don't have an answer.

Regarding the allocation of risk to the originators of loans sold to the sponsor, which is a major originator itself, through the sponsor's correspondent line, these lines are normally well defined with regular suppliers. Thus contracts could be set up with each of the originators, so that any regular seller of loans through the correspondent channel would be required to hold risk retention based upon the sponsors standard securitization procedures.

89. Should the risk retention of an originator only be on its originations?

The securitization is a joint operation. The investor cannot request investment in only one originator's loans, and so the originators must share in the overall risk.

90, 91 and 92. Should sponsors be permitted to allocate risk to a third party?

I do not know of cases where allocating risk to a third party would be useful.

93 and 94. The retaining sponsor is responsible for compliance. What are the practical implications if and originator fails to comply? Should the sponsor obtain a contractual commitment from the originator to retain interest in accordance the rule.

Since the ultimate responsibility falls on the sponsor, the sponsor needs contractual agreements with the originators that they will comply with the requirements for risk retention. If an originator fails to comply or goes bankrupt, then it would seem that the sponsor must take over that originator's responsibilities. That requirement means that the sponsor must carefully evaluate each originator financially as well as the loans the originator is providing.

D.Hedging: Transfer and Financing Restrictions

96. Is the permitted transfer of risk retention to consolidated affiliates appropriate?

Yes, it is particularly useful that it be transferred to an affiliated depository institution which can be monitored through the call reports of the depository.

97 through 101. Is the proposed hedging prohibition appropriately structured?

I do not have sufficient background to make meaningful comments in this area.

102. Should a sponsor be permitted to freely transfer or hedge its retained exposure after a specified period of time?

See my reply to comment 10 above. Since the primary period of risk of an RMBS is in the first years or so after origination of the loans, perhaps the risk of an untroubled securitization could be hedged after 7 to 10 years.

103 and 104. No Comment.

105. Should all credit protection and hedging by the issuing entity be prohibited?

Yes, such credit protection should not be permitted because it might limit incentive of investors to conduct due diligence.

IV. Qualified Residential Mortgages

A. Overall Approach to Defining QRM

106. Is the overall approach in defining QRM appropriate?

I generally agree with the overall approach to defining QRM, because I agree with the that analysis of Parsons that housing prices are now coming back into line with the long-term trend, while rents have remained at about the long term level.[4] This lack of balance between housing prices and rental prices has needed correction either by income inflation or the decline of housing prices. I do not see income inflation across all income levels occurring, so housing prices should remain somewhere near the present deflated level nationally. The result of this approach is that single family housing will not help to move the economy forward in the near future, so other stimuli will be needed. Since a significant portion of REOs and other foreclosed properties are being purchased for cash[5], a portion of the investment community is banking on rising housing prices soon or in at the least the medium term. These properties may have to be converted to rentals.

With this analysis as background, I believe that this conservative QRM has the capacity to stabilize the market by biasing investors to seek its greater safety.

107. What impact will the proposed rules have on the market for securitizations by QRM and non-QRM loans.

Many smaller banks and institutions like pension funds have been holding large amounts of securitized loans issued by the GSEs and the FHA. Those investors will also be

[4] http://housingbuble.jparsons.net

[5] 30% of home purchase transactions in April 2011 were cash sales. See. "Home Purchase Mortgage Activity Remains Weak As Distressed Properties and Cash Sales Color Market", *Inside Mortgage Finance*, p. 6ff, 27 May 2011.

seeking QRMs. However, the non-QRMs will need time to prove that the new risk retention requirements have indeed improved the underwriting and solved the problems that caused the present crisis.

108. What impact might the proposed QRM have on pricing, terms and availability of non-QRM mortgages including to LMI borrowers.

Since I am not directly involved with mortgage lending, I cannot estimate the impact other than to say that the cost of non-QRM mortgage will increase relative to QRM and that this is a problem to LMI borrowers, who will need to be shunted to FHA loans. See my discussion under E. Request for comment on Possible Alternative Approach.

109. Comment on use of HUD standards.

I am not qualified to comment on these standards, but they look reasonable.

110. Comments on all aspects of the proposed QRM, including section B, Exemptions for QRM.

As a statistician, I have trouble with Section B requiring that all loans be currently performing upon closing the QRM securitization. This detail of tracking seems difficult for some several thousand loans. Thus there should be some method of replacing such loans as soon as they are found non-conforming to QRM. Obviously a limit of a percent or two should be set so that the depositor does not neglect its supervisory controls.

111. Would mortgage guarantee insurance or other enhancements reduce the risk of default?

On face value mortgage guarantee insurance provides the owners of the securitizations or the owner of the loan with a guarantee against first loss. While the borrower pays for this insurance, it would not significantly lower the probability of default by the borrower, since the borrower only received the benefit of a lower down payment. Thus the only way mortgage guarantee insurance may lower the probability of default is that the second look at the origination by the insurer may weed out some of the more poorly underwritten loans. I know of no data substantiating this assertion.

112. If mortgage guarantee insurance or other credit enhancements should be allowed under QRM, how might the standards be monitored and enforced and what disclosures should be required?

The use of mortgage guarantee insurance provides the owner of the loan or security against the initial risk of default of the borrower. In that sense it is more or less equivalent to the owner of the loan or the sponsor to transfer risk retention to a third party. Assuming that the insurer could provide adequate examination of the underwriting, it could permit slightly higher CLTVs or DTIs, etc. under QRM. Obviously, if such alterations were permitted in the QRM, full disclosure of these details by tranche, geography, etc. must be provided. For loan modifications on delinquent loans, many current PSAs require that the modification does not affect the insurance, and this requirement would limit the modification that could be applied and thus the prevention of a default.

If the increased LTV is to be permitted through the use of a mortgage guarantee, then it could be limited to the safer fixed rate loans especially purchase loans. See comments on Section E, Alternative Approach.

113. Are there additional ways to clarify the standards applicable to QRMs?

No comment.

B.Exemption for QRMs

See Comment 110.

C.Eligibility Criteria

1C. Eligible Loans, First Lien, No Subordinate Liens, Original Maturity and Written Application Requirements.

114. Comments on Each Condition

(a) The requirement that the eligible loan is a first lien with no subordinate liens on the property is necessary, because second liens, especially home equity credit lines (HELOCs), have been a major problem in handling delinquent loans during the present crisis. Many borrowers used HELOCs as a credit card for financing their personal needs or small business needs with the result that significant numbers of borrowers have permitted their first lien to become delinquent while continuing to maintain their second lien current in order to be able to further draw down on the HELOC. The use of a second lien upon a refinancing should be permitted if the total LTV of both liens conforms to the LTV requirement for a QRM. This would permit the borrower to have a flexible credit line of a HELOC so long as the various debt to income levels are in conformity with the QRM requirements.

A maximum term must be specified, because if it were not specified there could be increasing terms to permit less qualified borrowers to meet the DTI requirements. Since the 30 year mortgage has been traditional, it is a reasonable limit.

(b) The question of the creditor having knowledge of a second lien should be solved by a national public database showing all liens on a property.

2C.Borrower Credit History

115. Are the proposed credit history standards appropriate indicators?

The avoidance of reliance on credit scores is commendable, because the lender is shirking the responsibility of judging for itself the creditworthiness of the borrower through the use of credit scores. We have already seen similar problems with the use by investors of the rating agencies ratings of various asset backed securities, including RMBS and CDOs. The question then becomes, how does the individual lender obtain sufficient data to make a judgment and will that judgment be better than the average private institution's credit score?

According to Section 1447 of the Dodd Frank Act, HUD is to establish and maintain a comprehensive database on foreclosures and defaults on mortgages and make it publicly available. This database should assist the individual originator in determining the credit history.

On the other hand, when the data on serious delinquency rates for QRMs in the Appendix to this request for comments is examined, the dominant risk indicators are the FICO score followed by the product type. Thus the lender should cross check its evaluation of credit history with an average of credit scores and be able to explain any significant differences.

116. Are there additional or different standards that should be used?

Admittedly for borrowers on hourly wages, involuntary layoffs can be a problem. Presumably they will appear as late payments and such in the credit history. However, an understanding of the type of job or jobs the borrower has held is important in this credit history evaluation, since it is possible to handle occasional late payments adequately, if the circumstances are understood. However, the proposed regulation *II Borrower Eligibility 1. Effective income* seems to cover these areas quite well.

As an aside, I assume the World Savings option ARMs with a 10 year reset were developed in the 1980s to help hourly wage borrowers with periodic lay-offs as well as salaried workers with large bonuses at yearend. Because they had a 10 year reset, they were not nearly so bad as the more recently developed types with 5 year resets, which were used by all types of borrowers.

117. Should Agencies require a minimum credit score, and if so, how might the rules incorporate them?

I do not think a minimum private credit score should be specified. Right now, FICO is developing a new predictor of defaults. How this will change their rating system remains to be seen. Since these scores are proprietary, the agencies and originators have no clear understanding of what is contained in the score. This lack of understanding is particularly important in unusual circumstances such as the present declining housing prices. Obviously some guidance would be needed to determine an adequate minimum credit history.

I do think the average of at least two scores should be used to help corroborate the rigorousness of lender's evaluation. Any differences should be justified by the lender.

118. Comments on the appropriateness of the Safe Harbor:

I know that lenders like a safe harbor, but I think that using the average of a couple of scores is like the use of Fitch and Moody's ratings of an RMBS by an investor, which did not save investors.

A safe harbor on the credit history in no way implies a safe harbor on the loan. I state this after having written a report on J.P. Morgan Chase where their Washington Mutual

subprime loans and option ARMS in portfolio as of the end of 2010 contained 18% and 44% of the UPB, respectively, with refreshed FICO scores of 660 or greater[6], i.e. prime loans on the basis of the OCC-OTS Metrics measure[7]. Presumably this percentage of "prime" loans was even higher before the crisis, which caused many credit score to decline. These "prime" loans were presumably non-prime because of other risk factors not included in the FICO scores.

If this statement refers to a safe harbor regarding the loan in the securitization, this could only be possible so long at the final LTV, CLTV, front end and backend DTI, interest rates, etc. of the mortgage loan are within the specified QRM limits.

3C.Credit Terms

119. Credit Terms

a. Comment on all aspects of the proposed rule's limits on payment terms.
See below.

b. Additional or different payment terms?

I am less concerned about excluding interest only loans, since they are useful for borrowers who do expect to resell the house in the short to moderate term. Actually the initial payments on any mortgage are primarily paying the interest with principal being paid down in the later years of the mortgage.

c. Would different interest rate caps be more appropriate?

I believe an interest rate cap of no more than 1% in any 12 month period with a total cap of 4% over the life of the mortgage would be better. This assumes that the mortgage is approved using this maximum rate with appropriate DTIs, etc., over the first 5 years. The proposed rule 6% total life time increase with annual increases of 2% would mean that an initial interest rate of 4% could rise to as high as 10% over the first 5 years of the mortgage. Using Freddie Mac historic interest tables, the last time the 1 year adjustable rate hit 10% was mid-1985 and for 30 year fixed rate it was mid 1990. The 1980s were a very unusual time as gold prices soared at the beginning of the decade, resulting in the South African debt crisis. Thus the use of a cap of 1% per year would still permit an increase of 5% over the first 5 years raising a current 4% loan to 9%. Taking a more extreme example of the 30 year fixed rate, the last time we saw a 9% rate on a 30 year fixed was September 1991 and the last time the fixed rate hit 8% was the end of 1992. Thus I think a maximum increase for the life of the loan of 4% is more reasonable.

Thus my priorities are first limit that cap on the annual increase to 1% and then consider limiting the lifetime increase to 4%. The decrease on the annual cap would also help prevent a lender from using the permitted cap for a teaser initial rate. Obviously, the ultimate limit of decreasing these limits is a fixed rate mortgage, so we are seeking some optimum in between.

[6] J.P. Morgan Chase, SEC Form 10-K, p. 235, 31 December 2010.
7 OCC-OTS Mortgage Metrics Report, P. 9, First Quarter 2011.

d. Should agencies permit prepayment penalties? If so, what limitations should apply?

A short prepayment penalty of a year might be advisable especially in times or rising housing prices to prevent speculation in the market for a gain on a quick turnover and to provide some initial stability to the securitization. A year is short enough if a borrower becomes distressed because of unexpected medical bills, etc. that it is not a long encumbrance.

4C Loan-to-Value Ratio

120. Comment on the appropriateness of the proposed LTV ratios for different types of mortgages:

Since the LTV is also the cumulative LTV (CLTV) for a QRM and assuming that the data for the graph in this section of the request for comments also represent the CLTV, then the proposal limiting the default rates to about 4% yields CLTVs of 70%, 75% and 80% for cash-out, rate-term and purchase, respectively. The levels of these should be conditioned by at least two factors.

1. First, there must be skin in the game, when housing prices start to decline. The previous decline at the start of the 1990s suggests that a 90% LTV would more or less handle a decline of that size.

2. The household savings rate must be adequate. At the start of this housing bubble in 2000 the personal savings rate was about 3% having declined from around 5% in 1995. It then declined to 0.8% in 2005 and is now has risen to 5.0% in the first quarter of this year.[8] After a return of savings rates to a more normal value, time is required to build up the necessary down payment.

These levels seem reasonable for refinancings, but in order to provide some stimulus to the economic recovery, I could suggest a CLTV of 90% for at least the next 5 years. While CLTV is a significant cause of default among borrowers with high CLTV loans[9], the data in the Appendix of the request for comments on purchase loans as well as refinancing shows that low FICO scores are more predictive of serious delinquencies than LTVs. Thus additional restrictions on first-time home buyer's credit quality could compensate for this slightly higher risk associated with a CLTV of 90%.

5C Down Payment

121. Comment on proposed amount and acceptable sources of funds for a down payment.

My concern about down payments centers on gifts. Depending upon the conditions of the gift, it may or may not put the borrower's "skin in the game". It also makes housing

[8] Monthly seasonably adjusted annual personal saving rate, PSAVERT, Dept. of Commerce, Bureau of Economic Analysis

[9] Qi M and Yang X, "Loss Given Default of High Loans-to-Value Residential Mortgages", Economic and policy Analysis Working Paper 2007-4, Office of the Comptroller of the Currency. August 2007.

more available based upon family background and family wealth. Gifts are less likely to be a possibility for LMI borrowers. Thus I believe gifts should only account for a portion of any purchase, possibly with a maximum of no more than half the down payment.

6C. Qualifying Appraisal

122. Should other valuation approaches be considered?

I concur with the proposal but have little expertise on appraisals.

7C. Ability to Pay

123. Comment on the appropriateness of the proposed front-end ratio limit of 28% and the proposed backend ratio limit of 36%:

Based upon the table in Appendix A, the loans with high PTI/DTI values have serious delinquencies roughly comparable to those loans with high LTVs but significantly under those with high FICO and product type exceptions.

In the present crisis, the need for modifications to reduce the front end DTI to the order of 28% is generally caused by the extensive use of second liens which resulted in unusually high cumulative LTVs (CLTVs). In a more stable situation, where the purchase loan QRM is not permitted to have a second lien, then a higher front end ratio should be permitted, perhaps up to the traditional 33% for fixed rate loans. For refinancings, this limit should be for the CLTV of the first and second liens. A higher front end DTI is particularly important for first-time home buyers and especially low-moderate income first time home buyers.

Since the down payment cannot include credit card debt, the back end ratio can be placed reasonably low at 36% to 38%. Obviously placing limits on the back end DTI after the loan is closed is difficult, if not impossible, so the limit upon closing should be maintained low.

8C. Points and Fees

124. Comments on all aspects of points and fees for QRM purposes.

Bona fide discount points should be excluded from points and fees since they relate to payments on interest.

9C. Assumability Prohibition (no questions)

10C. Default Mitigation

125. Should the definition of QRM include servicing requirements?

Yes, servicing requirements should be more robust and require rapid application of loss mitigation processes, because the loan has no risk retention and will remain in the securitization if modified successfully. An attempt must be made to preserve it as a

QRM, or at least return it to performing as a loan not qualified as a QRM loan on the basis of the QRM criteria. According to the proposal, it would allow individual QRM loans to be modified after securitization without the loan ceasing to be QRM in order to avoid disincentive to engage in appropriate loan modifications. Thus presumably a modified loan that exceeded various LTV limits etc. would still remain in the QRM security.

126. Should the servicing regulations be more robust than proposed and how should the requirement be changed?

The servicing of QRMs should include requirements to include details on the various loss mitigation techniques, in particular modification methods and what happens if a modification returns as a performing loan to the QRM securitization even if it does not meet QRM requirements. See questions128 ff. A water fall must be set up governing the loss mitigation methods as is the case with HAMP modifications

127a, b, and c. Should servicers be required as proposed to have policies and procedures for loss mitigation if the borrower is 90 days delinquent but not in default?

Yes, the servicers should be required to have policies and procedures, including modification, that provide for loss mitigation when default is reasonably foreseeable.

128 a, b and c. Should the servicers be required to have policies and procedures that provide for loss mitigation when the net present value (NPR) of the action exceeds the NPR through foreclosure.

Yes, those policies should include actions such as (i) restructuring the loan, (ii) reducing the borrower's payments through interest rate reductions, extension of the loan maturity, etc. (iii) making principal reductions or taking other mitigation actions if the NPR of that action would exceed the NPR of foreclosure.

The implications of this approach are that the loan upon modification may no longer be qualified as a QRM. Such as the debt to income ratio may be too high if there is job loss in the household, the term may be extended beyond 30 years, or better the principal be reduced, etc. However, such a modification is in the interest of the borrower and the community in which the borrower lives and is in the interest of the owners of the lower tranches of the securitized loans. Only the servicer, which is often the sponsor and originator, has additional costs that must be adequately compensated. That compensation needs to be explicitly worked out. See question 136.

I would advocate that a specialty servicer with proper policies and procedures be required to handle any loan that is 60 days or more delinquent to insure proper servicing as is the case with CMBS.

129. Should other servicing standards be included, subject to the statute's authority?

The present standards seem quite inclusive of the means of modification. Presumably the more normal methods of merely capitalizing lost payments, and if the loan cannot be saved from default, short sales, etc. would be included. Servicer compensation must be included.

130 a, b and c. What are the practical implications of the proposed QRM servicing standards and what are operational issues involved?

Compensation for the servicer for additional costs of the full servicing outlined in the previous questions must be worked out in detail and set up.

d and e. Are the standards sufficiently clear? I believe the standards are clear but not the implementation.

131. Would the proposed QRM servicing conditions restrict or impede the ability or willingness of certain originators to originate QRMs.

Since I am not involved directly with originations, I cannot speak with authority.

However, if the servicing is adequately compensated for these loss modification methods I do not see a problem from the servicing side. One instance of less willingness to originate QRMs would be originators that hold servicing but do not want to develop and maintain adequate servicing of these varied loss mitigation processes. They would then need to sell or be required to sell the servicing or subservicing to specialty servicers.

Obviously, there will be overall increases in the cost of originations because of monitoring and reporting requirements and water fall constraints, but they are presumably compensated by the fact that risk retention is not required.

132 a. and b. Is the scope of the QRM servicing standards appropriate?

I believe that the scope of the servicing standards is appropriate, if the policies of question 128 are included, and I don't know of any other more appropriate standards.

133 a and b. Should the servicing requirement be part of the pooling and servicing agreement?

Since the PSA usually specifies whether and under what conditions a loan may be modified, placing these requirements under the PSA is logical. If it is a part of the QRM specification only but separate from the PSA, the requirements of the QRM must supersede any PSA.

134 a and b. If a creditor or an affiliate has an ownership interest in a subordinate lien mortgage and the creditor services the first lien, should the creditor be required to implement processes to address potential conflicts of interest when the first lien becomes 90 days past due, and what should be required?

If the creditor services the first lien and it or an affiliate holds a second lien on the same property, the second lien must be modified in a manner similar to that of the first lien, otherwise the first lien may not be salvageable from foreclosure. This should be held true whether the second lien was originated at the time of the first lien or at a later date, since it affects the back end DTI. In fact a database needs to be set up linking liens on the same property so that the when a first lien is modified the second is correspondingly modified or extinguished.

c. Would specification of a particular process unduly limit the ability of the creditor to address different circumstances?

The loss mitigation process of a first lien with a second on the same property must treat the loss mitigation of the total amount of the two liens as if they are a single loan or extinguished the second lien in order to permit a modification of the first lien. This process is sufficiently complicated that specification of a particular process is required.

135 a and b. Should the imposed standard be that a particular risk mitigation activity maximize the NPV to avoid potential conflicts of interest between different classes of investors and how would that be determined?

Yes, maximizing the NPV should be the basis for loss mitigation of a loan. To implement the NPV calculation, the Agencies must specify the method of determining the NPV, and a waterfall process must be set up to clearly specify the process, as is the case with HAMP modifications.

c and d. Would this approach improve the ability of servicers to serve the best interest of all investors and what are the practical implications?

This approach would best serve the interests of the most exposed junior tranches of the securitization as well as the interest of the borrower. Since the junior tranches have the most to lose from defaults, they should be protected as much as possible as is the case with CMBS.

136 a, b and c. Are the proposed compensation requirements appropriate? Should the compensation structure be more specific and if so how?

The compensation structure must be more specific. The present problems with modifications of loans serviced for others arise partly out of the lack of proper compensation for the loss mitigation process, especially loan modifications. See question 137 for further discussion.

137 a and b. Servicers are generally to advance scheduled payments of principal and interest to investors for some period of time after a delinquency begins. Do these delinquency payments to investors create liquidity constraints that incent servicers to take action that may not be in the investors' best interest? If so, should the Agencies put limits on servicing advances?

I and some of the investors for whom CANICCOR consults are concerned that servicers are incented to proceed quickly with foreclosure and seek additional fees from the borrower rather than proceeding as quickly as possible with a modification. This concern has been illustrated by the CANICCOR request to the OCC of a CRA examination of servicing and the shareholder resolution referred to earlier in these comments.

A logical limit for scheduled payments of principal and interest to the trust by the servicer is after 60 or not later than 90 days delinquent. The 90 day time interval is the point at which, for bank owned loans, the lender can be put the loan on non-accrual. I would suggest that at some point such as when the loans exceeds 60 days delinquent, the

standard servicing fee to the servicer should stop and a fee be provided to the servicer for the resulting loss mitigation dependent upon the maximization of the NPV of the loan. A structure similar to the CMBS, where a specialty servicer is required to serve as the servicer or subservicer would provide a good solution. We will soon see this arrangement being tested out by the agreement with Bank of America to seek adequate subservicers for about $200 billion of Countrywide loans, but unfortunately finding such adequate subservicers will be difficult.

Some structure of the type just described based upon the maximization of the NPV is necessary to align the interests of the servicer with those of the investor and also with the borrower, if a modification is possible[10]. Such a new payment system for the servicer should be sufficiently well defined to adequately compensate the servicer but preclude excessive ancillary fees, etc. Obviously, this payment system would take considerable effort to develop.

c and d. Would such a limitation harm investors' interests and what are the practical implications of such an approach?

My understanding is that most of advances by the servicer are repaid by the trust upon foreclosure of the property. The cost of the further loss mitigation must be paid to the servicer by the trust, as discussed above.

At present a successful modification remains in the securitization. If that rule were not included in the proposal and the modification then produces a non-QRM, some arrangement needs to be worked out so that the sponsor or originator would purchase the loan at a discounted price to compensate for the additional servicing costs. Again some waterfall process is needed with timelines to prevent the servicer from overcompensating itself.

138 a and b. Should the Agencies require servicing standards for a broader class of securitized residential mortgages? If so, how?

I presume this question can only be answered if the current interagency effort on national servicing standards develops standards that are not adequate for non-QRM loans.

139. For commenters responding to the above questions, are these approaches consistent with statutory factors regarding QRM?

I believe the statutes do not state much about servicing of QRMs.

140. Since the Agencies are developing national servicing standards, would it be better to use these standards for the servicing of all loans?

The use of national standards depends upon the quality of the standards that are developed. They must align the interests of the servicer with those of the investor and of

[10] See for example the discussionin Levin AJ and Twomey T, "Mortgage Servicing", Georgetown Public Law and Legal Theory Research Paper 11-09 (http://scholarship.law.georgetown.edu/facpub/498) , Yale J on Reg. (forthcoming, 2011)

the borrower.

D. Repurchase of Loans Subsequently Determined to be Non-Qualified after Closing

141. Should the sponsor be required to repurchase the whole pool if the amount of loans required reaches a certain threshold?

The repurchase of the pool should be required if the percentage of loans to be repurchased exceeds a level of perhaps 3% to 5% in order to insure that the sponsor has proper procedures in place, but that occasional random errors can be corrected.

142. Should the sponsor be permitted to replace a loan determined to be non-QRM within 4 weeks in lieu of purchasing it for cash.

I do not have a clear idea of what the time limit would be, but the replacement in a short time of securitization is reasonable.

E. Request for Comment on Possible Alternative Approach

143. What are the potential benefits and costs of the broader QRM?

I believe a broader definition with a 90% CLTV and slightly higher DTIs would permit more first-time home purchase buyers, especially low-moderate income borrowers to qualify, subject to adequate underwriting. The 90% CLTV provides a reasonable amount of skin in the game, so both flipping of loans for economic gain is less likely as well as providing some insurance against default upon a moderate decline in housing prices.

However higher levels of CLTVs constitute a significant problem:

As argued above, CLTV limit is primarily to provide skin in the game and to show some ability of the borrower to save. The main problems for subprime loans were not so much LTV levels but rather CLTVs, rate spreads and other factors.

From a large LoanPerformance database, Chomsisengphet and Penning-Cross[11] showed that the average fixed rate subprime loan between 2000 and 2004 had LTVs of below 80% rising only to about 82% by 2005. For ARMs the LTV peaked in 2000 at 87% and declined to about 79% in 2005. Thus significant proportions of subprime borrowers had LTVs of well below 90%. However these analyses do not attempt to take account of second liens, which were prevalent.

My own attempt to estimate this second lien problem, I used HMDA data for 2004 through 2006 and matched second liens with first liens to yield the total number and amount of piggyback loans. For purchase loans, the percentage by number of loans increased from 10% through 18% to 20%, respectively, over the three

[11] Chomsisengphet S. and Penning-Cross A, "The Evolution of the Subprime Mortgage Market", *Review*, p. 46, February 2006, Federal Reserve Bank of St. Louis

years. Refinance piggybacks were only 3.5% and 4.9% for the last two years. Only closed-end second were required to be reported under HMDA so these percentage do not include home equity lines (HELOCs).

An FDIC study did show that 2002 through 2004 were years with high increases in HELOCs, with a relative decline in 2005[12]. This decline is probably the cause of the increase of piggybacks with closed-end second liens from 10% to 18% between 2004 and 2005 from the HMDA data. In discussing HELOCs owned by a major lender, investors asked about modifications of first liens on which they held HELOCs. They replied that less than half of their HELOCs were on first liens they had originated. The greater number of HELOCs was probably more like takeout refinance loans for consumer purposes, but still they count as part of the CLTV rather than consumer loans.

All this being said, the result is that the closed-end piggyback loans in this period accounted for about 20% of purchase loans, with the possibility of total piggybacks including those with HELOCs being twice that percentage. Thus high CLTVs were a significant problem.

The inclusion of rate and term refinancing may be fine. However, **I am concerned by point (1) that there would be no restriction on the existence of a subordinate lien at the closing of a purchase transaction.** The point speaks of a combined LTV of 90%, so presumably this means that, if the LTV of the first lien is less than 90%, the difference can be made up by the second lien. However, the statement is unclear since it speaks of no restriction on the existence of a second lien, which could imply a much higher CLTV.

144 a, b and c. If such an alternative were adopted, what stricter risk retention requirements would be necessary in order to originate more loans within the new definition of QRM?

We know from the above discussion that, while CLTV and DTIs are important in determining the quality of the loan, the credit quality (i.e. FICO score) of the borrower and the type of loan and its interest rate are more crucial in determining as to whether the borrower will default. I do not see a need for greater risk retention of non-QRM loans to steer lenders to QRMs, but I do think certain types of loans need greater risk retention. See question 11.

145. How would this approach to a QRM help to insure high quality underwriting and align interests of investors?

With the loosening of CLTV and DTIs, the underwriting must be more carefully controlled, which means that minimum FICO scores, or other indices of the borrower's credit worthiness more carefully reassessed.

[12] Montgomery L, "Substituting Mortgage Debt for Consumer Debt", FDIC Outlook, Summer 2006.

146 a, b and c. Would this approach in effect exempt most residential loans from risk retention?

The main problems causing the present crisis have included low teaser rate loans, loans with very high CLTVs, negative amortization, high interest rares and poor underwriting (no doc loans), such as subprime, option loans, and Alt-As. These are the types of loans that should have high risk retention to exclude them as much as possible from the market. This alternative would still exclude most of those high risk factors.

Once the housing market reaches a more stable market, the result would be that most residential loans might be securitized risk free. The primary danger would be that of a severe downturn in housing prices resulting from forces external to the housing market would cause default because the loans become underwater. However, excluding the present crisis, the problems of declining housing prices in the early 1990s, even in the hardest hit Pacific region did not exceed 10%. Thus a 10% down payment would both provide skin in the game and some safety regarding a housing price decline.

147. What impact might a broader QRM definition have on pricing, liquidity, and availability of loans that fall outside the QRM boundary?

With this broader alternative definition of QRM, fewer loans would fallout side the QRM boundary. Thus the liquidity of these non-QRM loans would probably be decreased, but I have no ability to gauge the significance of that decrease or pricing.

148. Would lower QRM standards under the alternative be consistent with QRMs being fully exempt from risk retention.

I believe the alternative standards are still sufficiently safe as discussed in 145 and 146 would be consisted with QRMs being fully exempt from risk retention.

149. How could this type of alternative be redesigned to limit the likelihood that loans with significant credit risk be included in the pool?

There will always be regional bubbles caused by shifting job opportunities, resulting in shifting populations and resulting in declining housing prices as population moves away. This problem can be partly solved by each securitization covering a wide geography or regions, but obviously the overpriced regions will have the highest volume of loans. While good underwriting will help out, if employment declines some foreclosures will result independently of all the above criteria.

V. Reduced Risk Retention Requirements for ABS Backed by Qualifying Commercial Real Estate, Commercial or Automobile Loans

A. Asset Classes

150 a. Should underwriting standards be developed for RMBS under which a sponsor would be required to maintain more than zero but less than 5% credit risk?

There needs to be some way to bridge the abrupt gap of credit risk retention between zero and 5% for loans that lie slightly outside of the QRM, where there are compensating factors between the various criteria.

150 b. What should these underwriting standards be?

I believe that a minimum CLTV of 90% should be held to insure skin in the game. FHA can be used for those seeking CLTVs above 90%. Thus the altered underwriting would necessarily deal with compensating effects between for example DTIs and the borrower's credit history. However, these compensating effects would need to be clearly reported by the originator.

150 c. Should a CLTV of 90% be permitted if mortgage insurance is provided?

If the LTV of 90% is not directly permitted by the QRM, mortgage insurance is a solution to increasing the CLTV from 80% to 90% on first liens and would give some additional verification of the credit of the borrower.

150 d. If additional underwriting standards were established, what amount of risk retention should be required?

I believe the simple answer is to split the difference and set the risk retention at 2.5%. To provide gradations depending upon changes of underwriting would probably not be worth the additional effort of crafting rules.

I have not a sufficient background to comment further on these remaining questions especially those on other ABS.

VI General Exemptions

I have not a sufficient background to comment meaningfully on these exemptions.

I greatly appreciate this opportunity to comment on these regulations and hope that these views from a person who consults for institutional investors concerned about RMBS may be of assistance.

Sincerely yours,

John E. Lind, Ph.D.
Executive Director

cc:

William Somplatsky-Jarman, Mission Responsibility through Investment Committee, Presbyterian Church (USA)

Stephanie Leighton, CFA, Chief Investment Officer, Trillium Asset Management

Dennis W. Fredo, Director, Lutheran Office for World Community, Evangelical Lutheran Church in America

Vidette Bullock Mixon, Director, Corporate Relations, General Board of Pension and Health Benefits, The United Methodist Church

Heidi Soumerai, S.V.P., Director of ESG Research,
Walden Asset Management, Boston Trust & Investment Management Co.

Valerie Heinonen, Mercy Investment Services

Susan Vickers, RSM, VP Community Health,
Catholic Healthcare West