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August 1, 2011

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Re: Credit Risk Retention Proposed Rule
Transmitted electronically to

- OCC: regs.comments@occ.treas.gov (Docket No. OCC-2011-0002)
- Federal Reserve: regs.comments@federalreserve.gov (Docket No. R-1411)
- FDIC: comments@FDIC.gov (RIN 3064-AD74)
- SEC: Rule-comments@sec.gov (File Number S7-14-11)
- FHFA: RegComments@FHFA.gov (RIN 2590-AA43)
- HUD: www.regulations.gov (Docket No. FR-5504-P-01)

Ladies and Gentlemen:

I am writing on behalf of the 1.1 million members of the National Association of REALTORS® (NAR), the CCIM Institute, the Institute of Real Estate Management (IREM®), and the Society of Industrial and Office REALTORS® (SIOR) to express our opposition to the definition of Qualified Residential Mortgage (QRM) in the Credit Risk Retention proposed rule.[1] NAR believes that the proposed QRM definition is unduly narrow and is not necessary to assure safe and sound mortgage lending. Traditional residential mortgages, without risky features such as teaser rates and balloon payments, coupled with sound underwriting and documentation of income and assets, perform well with relatively low default rates. REALTORS® believe that imposing a minimum 20% downpayment, stringent debt-to-income ratio requirements, and rigid credit standards will deny millions of creditworthy Americans access to the lowest cost and safest mortgages.

EQUAL HOUSING OPPORTUNITY

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

[1] 76 Fed. Reg. 24090 (April 29, 2011).

The National Association of REALTORS® is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

NAR believes that the proposed rule should be withdrawn and republished for public comment because the rule:

- Is inconsistent with the standards set forth for risk retention in title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and violates Congressional intent.
- Unnecessarily defines the QRM exemption from the risk retention requirements to include only a narrow slice of the mortgage market.
- Makes homeownership more expensive or unattainable for millions of creditworthy consumers.
- Jeopardizes the fragile housing market and general economic recovery.
- Raises other concerns related to residential mortgages.
- Reduces liquidity for commercial real estate.

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I. STATUTE AND LEGISLATIVE HISTORY
(Addressing Preamble Question 106)

Section 941 of the Dodd-Frank Act adds a new section 15G to the Securities Exchange Act of 1934 that requires securitizers to retain 5% of the credit risk of a residential mortgage asset that it sells to a third party. Section 15G(e)(4) requires the regulators to define and exempt QRMs "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default, such as—"

i. documentation and verification of borrower's financial resources;

ii. standards related to residual income and debt-to-income ratios;
iii. features that mitigate payment shock;
iv. mortgage guarantee insurance or other insurance or credit enhancement, "to the extent such insurance or credit enhancement reduces the risk of default;" and
v. prohibiting or restricting high risk features, including balloon payments, negative amortization, prepayment penalties, and interest-only mortgages.

The proposed regulation published on April 29, 2011, would define QRM narrowly by including among the criteria a minimum 20% downpayment requirement (without allowing a lower downpayment coupled with mortgage insurance), low debt-to-income ratios, tight credit history standards, a 3% limit on total points and fees, and mandatory appraisals (including for refinancings).

The Act provides additional authority for the regulators to adopt other exemptions:

- Section 15G(c)(1)(G) requires the risk retention regulations to provide "(i) a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors."
- Section 15G(e)(2) requires the regulators in establishing exemptions to:

  "(A) help ensure high quality underwriting standards for the securitizers and originators of assets . . . ; and

  "(B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors."

NAR believes that the proposed rule is not consistent with the terms of the statute or its legislative history. The Congressional objective of reducing excess risk-taking can be achieved by adopting a much broader definition of QRM. As described below, a much broader definition is consistent with ensuring safe and sound lending affordable by creditworthy borrowers. Accordingly, the narrow definition is inconsistent with the statutory standard that the exemption should be both "in the public interest and for the protection of investors."[2] The public interest is not served by denying millions of creditworthy potential borrowers access to the safest and most affordable mortgages. The law also requires the regulators to establish exemptions consistent with improving "access of consumers . . . to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors."[3] The statutory standards demonstrate Congressional focus on the need to balance risk retention with the need to provide mortgage credit for consumers.

The legislative history of QRM makes clear that the Senate sponsors of the QRM amendment intended a broad exemption. In the Senate debate, Senators Corker and Isakson expressed concern that risk retention would "shut down the securitization process and make less credit available."[4] Even an amendment setting a 5% downpayment requirement, offered by Senator Corker, failed because, in the words of Senate Banking Committee Chairman Dodd: "[t]he amendment puts in government-dictated, hard-wired underwriting standards that would have very serious consequences

[2] Section 15G(c)(1)(G) of the Securities Exchange Act of 1934.

[3] Section 15G(e)(2) of the Securities Exchange Act of 1934.

[4] 156 Cong. Rec. S3514 (May 11, 2010).

. . . for first-time homebuyers, minority home buyers, and others who are seeking to attain the American dream of home ownership . . . ."[5] During the debate, Senator Dodd also alluded to the many mortgage programs that require less than a 5% downpayment and noted "[t]hey are performing well, and have done so in the past. And we want low- and moderate-income families to go to banks and get loans, qualified low- and moderate-income people . . . . We do not want to simply shut them off to nonprofits. We want to get them into the financial mainstream."[6] The Senate rejected the Corker amendment by a vote of 42-57.[7]

The debate on the QRM amendment offered by Senators Landrieu, Isakson, Hagan, and others makes Congressional intent even clearer. Senator Isakson explained that the 5% risk retention would not work and that a QRM exemption was needed or there "would be no mortgage loans."[8] No one can know for sure whether Senator Isakson is right that there will be no non-QRM loans, but what is clear is that he wanted to encourage lenders to make safe and sound loans that qualify for the QRM exemption. The Senator's view was that "the only risk retention that will be required is when someone is making a bad loan, which means people will stop making bad loans."[9] Senator Isakson wanted to return to the days of sound underwriting, but he recognized that "the way things used to work"[10] included mortgage insurance where downpayments were less than 20%. No Senators spoke against the Landrieu-Isakson-Hagan amendment, which was enacted as part of the Dodd-Frank Act, without any amendment affecting this analysis.

This statutory language, bolstered by the legislative history, makes clear that the QRM definition was not intended to be a narrow slice of extremely high-quality mortgages, but a broad slice of mortgages—the more the better—to maximize the availability of safe mortgages at a reasonable cost for creditworthy borrowers.

II. BASE THE DEFINITION OF QRM ON A STRONG DEFINITION OF QM

The regulation of the mortgage lending industry is becoming so complex that it threatens to weaken the system, instead of curing abuses. To minimize what many believe is becoming a chaotic situation, NAR recommends that the regulators seriously consider defining a QRM as any mortgage that meets the Qualified Mortgage (QM) ability-to-repay standard of Title XIV of the Dodd-Frank Act. A creditor is presumed to have met the ability-to-repay requirement if the loan is a QM. While the law requires that the definition of QRM not be broader than the definition of QM, there is no reason why it should not be the same. The QM standard will assure a safe and sound mortgage loan that does not include questionable loan features but does require verification and documentation of borrower income and assets and compliance with other sound underwriting rules. A QRM/QM mortgage should be a mortgage for which risk retention is not needed for investor security.

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[5] 156 Cong. Rec. S3518 (May 11, 2010).

[6] 156 Cong. Rec. S3520 (May 11, 2010).

[7] 156 Cong. Rec. S3574 (May 12, 2010).

[8] 156 Cong. Rec. S3576 (May 12, 2010).

[9] Id.

[10] Id.

III. PROPOSED NARROW DEFINITION OF QRM IS NOT NECESSARY TO ENSURE SAFE AND SOUND MORTGAGES

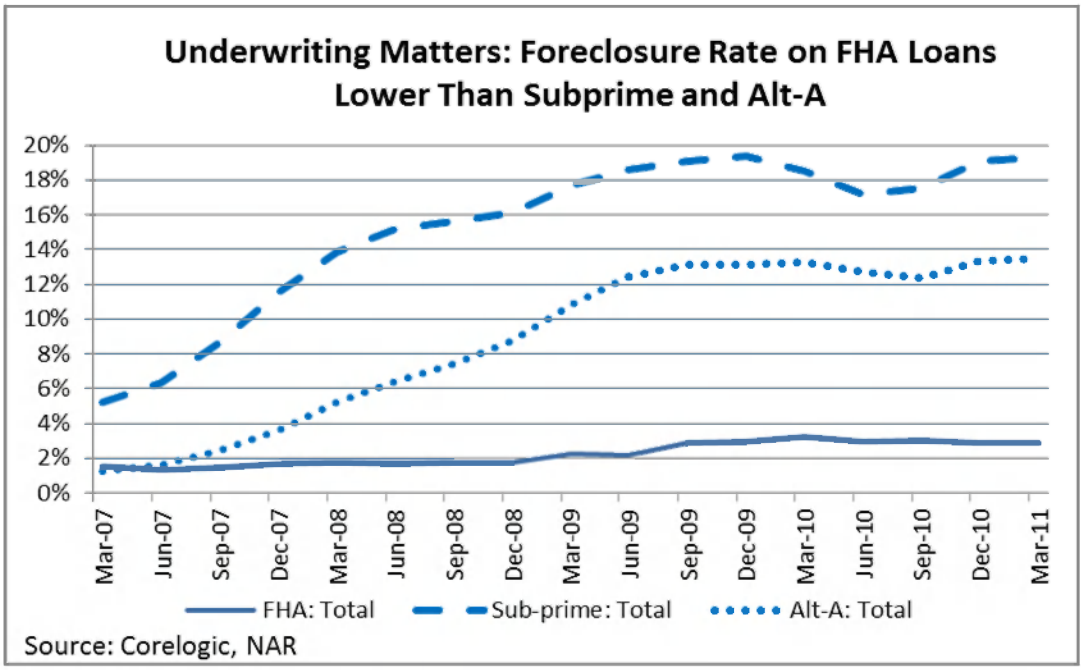
The proposed definition of QRM is unduly narrow and is not necessary to assure safe and sound mortgage lending. Traditional mortgages, without risky features such as teaser rates and balloon payments, coupled with sound underwriting and documentation of income and assets, perform well with relatively low default rates. REALTORS® believe that imposing a minimum 20% downpayment, stringent debt-to-income ratio requirements, and rigid credit standards will deny millions of Americans access to the lowest cost and safest mortgages.

20% Downpayment Requirement (Question 121)

The regulators proposed a 20% minimum downpayment requirement based on what NAR believes is a mistaken opinion that the QRM definition should be extremely narrow and allow only extremely safe mortgages to be exempt from risk retention. As discussed above, this was not the intent of Congress and the proposed policy has no factual basis.

Two things happened during the housing boom: underwriting was weakened and risky mortgage products ended up in the hands of people who could not afford them. Comparing the foreclosure rate on FHA products with that of the Alt-A and subprime sectors contrasts the different impact that underwriting and product type had on the same pool of relatively higher risk borrowers. FHA allowed low downpayments but because it required strong underwriting, including documentation, its portfolio has performed far better than subprime and Alt-A loans without the same sound underwriting and loan characteristics, as illustrated in Exhibit 1.

Exhibit 1



As proposed, the narrow QRM definition ignores this compelling data that demonstrate that sound underwriting and product features, like documentation of income and mortgage type, have a larger impact on reducing default rates than high downpayments.

An analysis of loan performance data from CoreLogic's servicing database[11] on loans originated between 2002 and 2008 shows that reducing downpayments from 20% to 5% has only a negligible impact on default rates, but it significantly reduces the pool of borrowers that would be eligible for the QRM standard. Exhibit 2 shows the default performance of a sample of high quality mortgages (sample QRM) based on the following attributes of loans:

- fully documented income and assets;
- fixed-rate or 7 year or greater ARMs;
- no negative amortization;
- no interest only loans;
- no balloon payments;
- 41% total debt-to-income ratio;
- mortgage insurance on loans with 80% or greater loan-to-value ratios; and
- maturities no greater than 30 years.

These criteria were applied to more than 20 million loans originated between 2002 and 2008. Default performance is measured by origination year through the end of 2009.

Exhibit 2
Sample QRM Analysis: Impact of Reducing Downpayment Requirements on Default Rates and Borrower Eligibility

Origination Year	2002	2003	2004	2005	2006	2007	2008
Increase in default rate* by reducing downpayment from 20% to 5%	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%
Proportion of borrowers made eligible for sample QRM if downpayment reduced from 20% to 5%	16.9%	14.5%	19.4%	19.2%	19.1%	20.1%	18.0%

*Default = 90 or more days delinquent, plus in process of foreclosure, plus loans foreclosed.

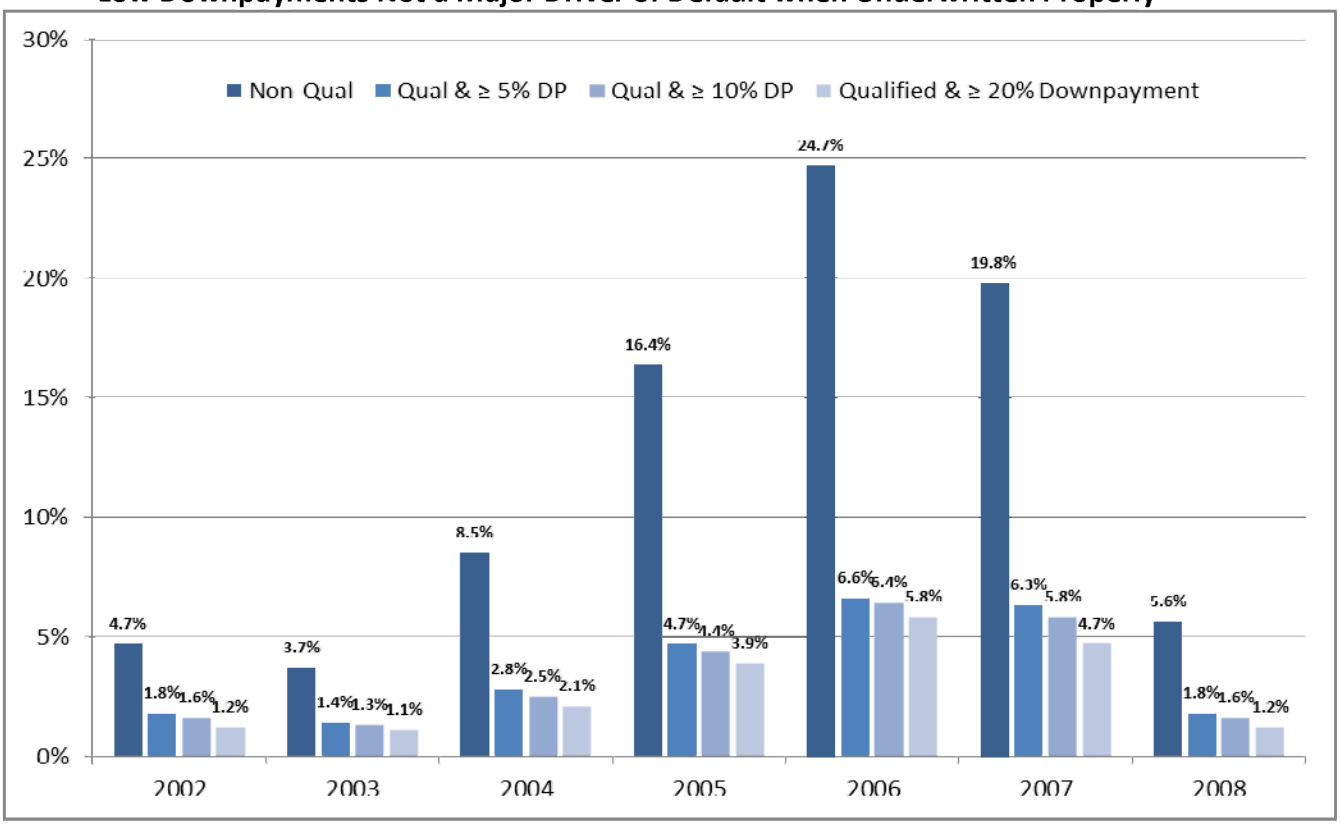
Source: Data from CoreLogic, Inc. Analysis by Vertical Capital Solutions for Genworth Financial and the Community Mortgage Banking Project.

While loans with 5% downpayments are certainly riskier than loans with a 20% downpayment, the data in Exhibits 2 and 3 show that low downpayment loans that follow the strong underwriting and product standards outlined above can be exempted from risk retention without exposing investors, or the broader housing market, to undue risk (less than 1% in years other than the high default year of 2007). Once you apply the strong underwriting standards in the sample QRM definition, reducing the downpayment from 20% to 5% would allow 14.5% to 20.1% additional borrowers to qualify for a lower rate QRM loan

[11] Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm, conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008.

Importantly, this analysis shows the broad market impact of a sample QRM with a 5% or greater downpayment requirement compared to a QRM with a 20% or greater downpayment requirement, rather than simply comparing default risk on 5% down loans to 20% down loans. Clearly, moving to higher downpayments has a minor impact on default rates for the broader market, but a major adverse impact on mortgage volume and access by creditworthy borrowers to the lower rates and safe product features of the QRM. This lopsided result compromises the intent of the QRM provision in the Dodd-Frank Act, which is to assure clear alignment of interests among consumers, creditors, and investors without imposing unreasonable barriers to financing of sustainable mortgages. In addition, NAR believes this is an unnecessary trade-off and would undermine efforts to create a sustainable housing recovery.

Exhibit 3
Impact of Increasing Minimum Downpayment on Default Rates for Loans that Meet Sample QRM Standard: Low Downpayments Not a Major Driver of Default when Underwritten Properly

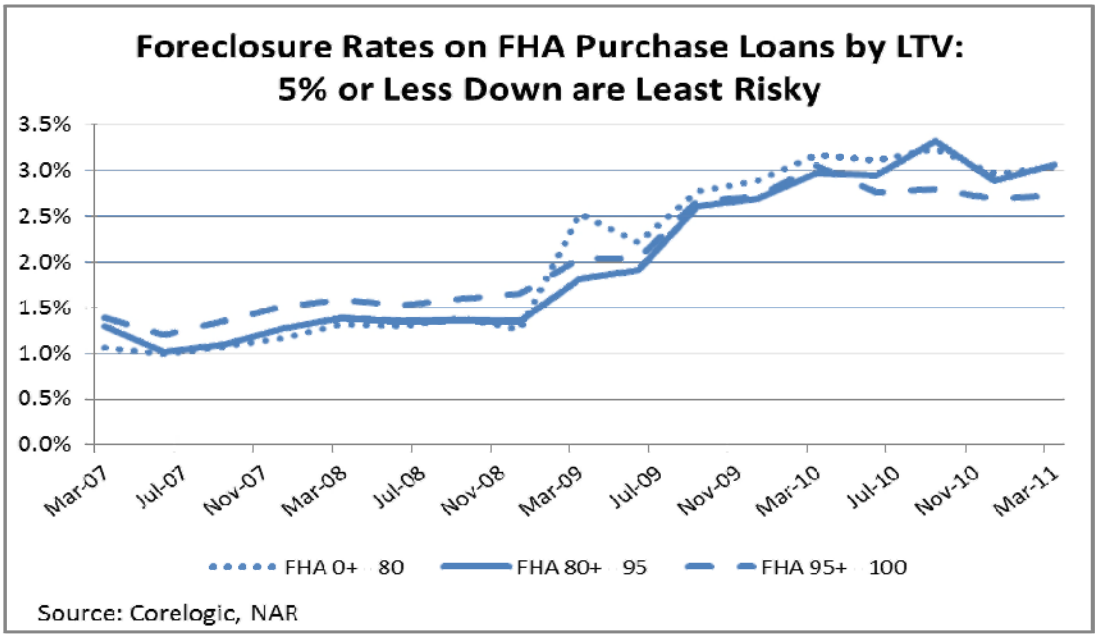


Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008. Note: Default rates are by origination year, through the end of 2010. The sample QRM in this analysis is based on fully documented income and assets; fixed-rate or 7-year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41% total debt-to-income ratio; mortgage insurance on loans with 80% or greater loan-to-value ratios; and maturities no greater than 30 years.

The darkest bar shows the performance of mortgages originated from 2002 – 2008 that do not meet all of the standards and features outlined above in the note. The other bars show the performance of mortgages that meet all of the sample QRM product and underwriting features. Within this second group of sample QRM bars, the bar shows how loans performed that met all these standards, plus had a 5%, 10%, or 20% downpayment or more. As expected, loans with strong standards and at least 20% down performed best. However, the chart also shows clearly that lower downpayment loans can be included in a strong QRM framework can result in strong performance, and will not expose investors or the broader market to excessive risk.

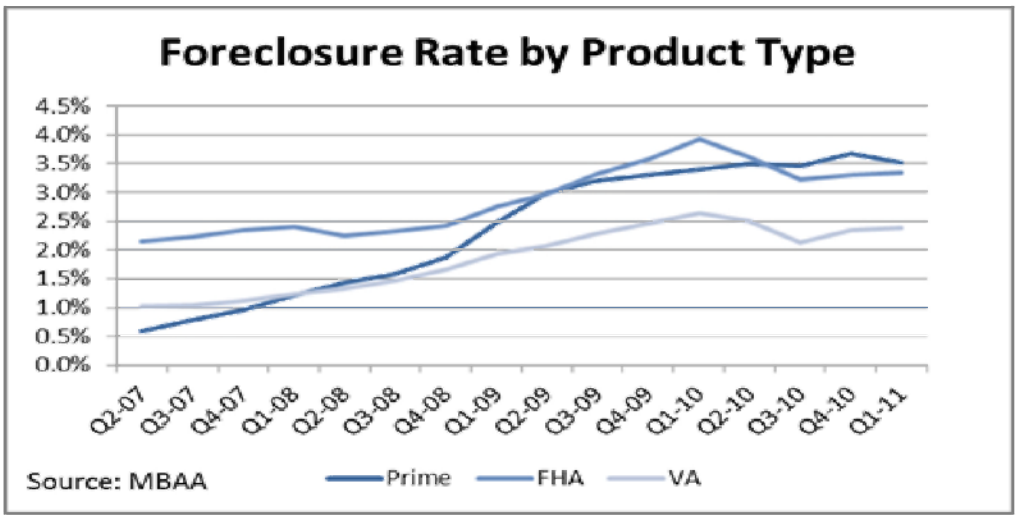
The FHA foreclosure rate experience is further evidence that the key to safe lending is sound underwriting and documentation, not high downpayments. Exhibit 4 shows that the foreclosure rate for FHA insured mortgages remains in a narrow band, regardless of the amount of downpayment. The foreclosure rate has recently increased, reflecting the housing market crisis, but the performance remains remarkably similar regardless of the amount of downpayment.

Exhibit 4



The VA foreclosure rate has been significantly lower than the rate for prime and FHA mortgages since 2008, according to Mortgage Bankers Association data through the first quarter of 2011 (Exhibit 5). VA loans have no downpayment requirement. Exhibit 5 also shows the good FHA loan performance, based on sound underwriting and documentation, which puts it on a par with prime mortgages during the crisis.

Exhibit 5



Mortgage Insurance Enhances Performance (Questions 111(a), 111(b))

While eliminating risky product features and requiring traditional, documented underwriting are the keys, no one disagrees that there is a somewhat higher default rate as the amount of the downpayment is reduced. To the extent borrowers make a downpayment lower than 20%, mortgage insurance (MI) should be recognized as an appropriate requirement to mitigate risk through additional underwriting requirements and the private capital that is available to cover some or all of the loss.

Even though the Act refers to the use of MI as a possible feature of a QRM "to the extent such insurance or credit enhancement reduces the risk of default" the proposed rule does not allow a loan with less than 20% down, with mortgage insurance, to qualify. Historically, MI has been used to mitigate the risk of default. In fact, MI was recommended for use in the same NAR document cited in the QRM preamble to the proposed regulation as a basis for the low DTI proposal.[12] MI helps to ameliorate the concern that securitizers should have "skin in the game." The MI's "skin in the game" continues for the life of the insurance even when the securitizer sells the securitized mortgage.

Recent work done by Elul *et al.*[13] suggests that the risk of default is lower for a loan with MI than a loan with a second mortgage. The authors find that while a second lien (piggyback mortgage) added 0.224 pp/q (percentage points per quarter) to the risk of default, the presence of MI only added 0.164 pp/q. The difference suggests that there is a mitigating benefit due to MI since the default risk was 36% less with MI than with its most common substitute, a piggy-back loan.

A study completed by for Genworth Financial illustrates the differences in delinquency rates of loans that carry mortgage insurance versus loans that have co-originated second loans (e.g. piggy-back loans).[14] The study shows that not only do loans with mortgage insurance have lower

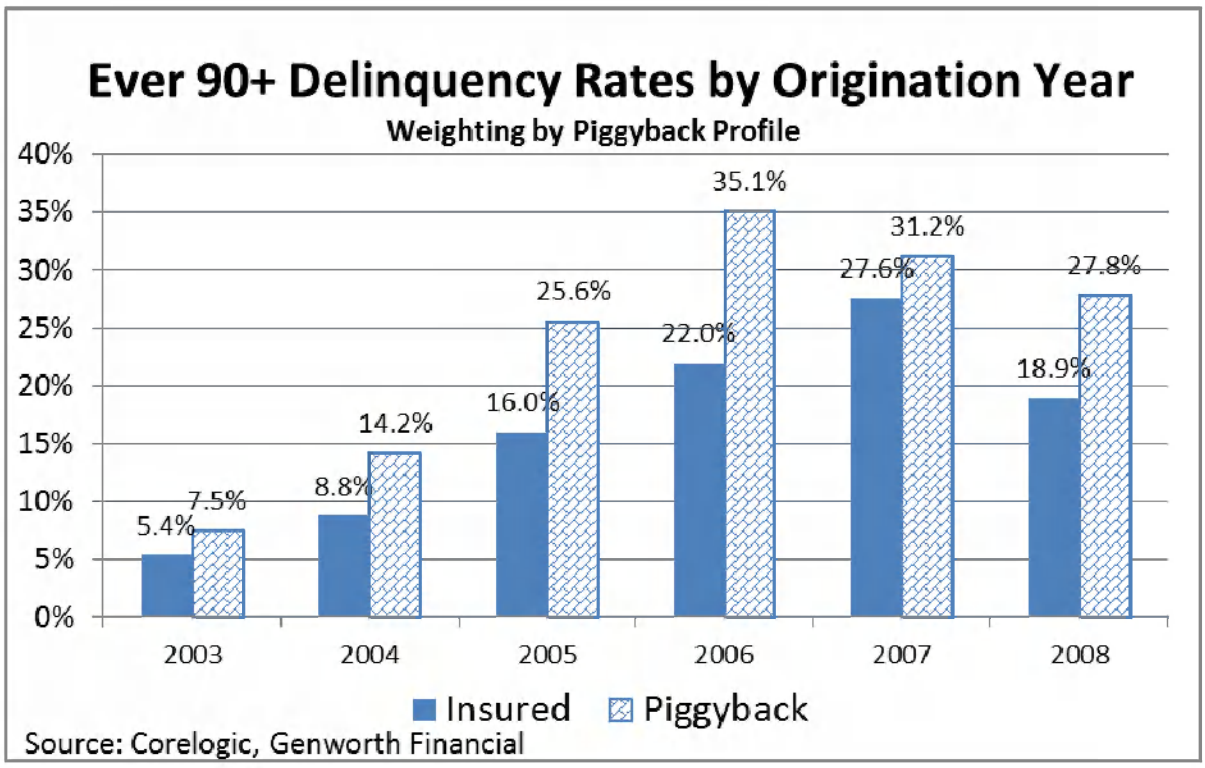
[12] National Association of REALTORS®, "Financing the Home Purchase: The Real Estate Professional's Guide," Chicago: National Association of REALTORS® (1993), at 20.

[13] Elul et al, "What 'Triggers' Mortgage Default?". Working Paper No. 10-13. Federal Reserve Bank of Philadelphia. April 2010.

[14] Genworth Financial. "Performance of Insured vs. Piggyback Mortgage Loans," Genworth Financial (August, 2010).

delinquency rates across origination years and across the FICO spectrum (see Exhibits 6 and 7), but loans with mortgage insurance have higher cure rates across both spectrums as well (see Exhibit 8).[15] These results suggests that the incentives of mortgage insurers are aligned with market stability. At origination, mortgage insurers vet loans that they suspect may result in a claim and they are either better able to identify borrowers who can cure or they act to facilitate the cure process. Mortgage insurers must pay when a borrower defaults. On the contrary, banks can recoup most and sometimes all of their costs by foreclosure.

Exhibit 6



[15] Note that while the delinquency rates in these three exhibits are extremely high, this is because the mortgages analyzed include the "low doc/no doc" and no downpayment loans that would not be allowed under QRM or under the Ability-to-Repay/QM requirements of Title XIV of the Dodd-Frank Act.

Exhibit 7

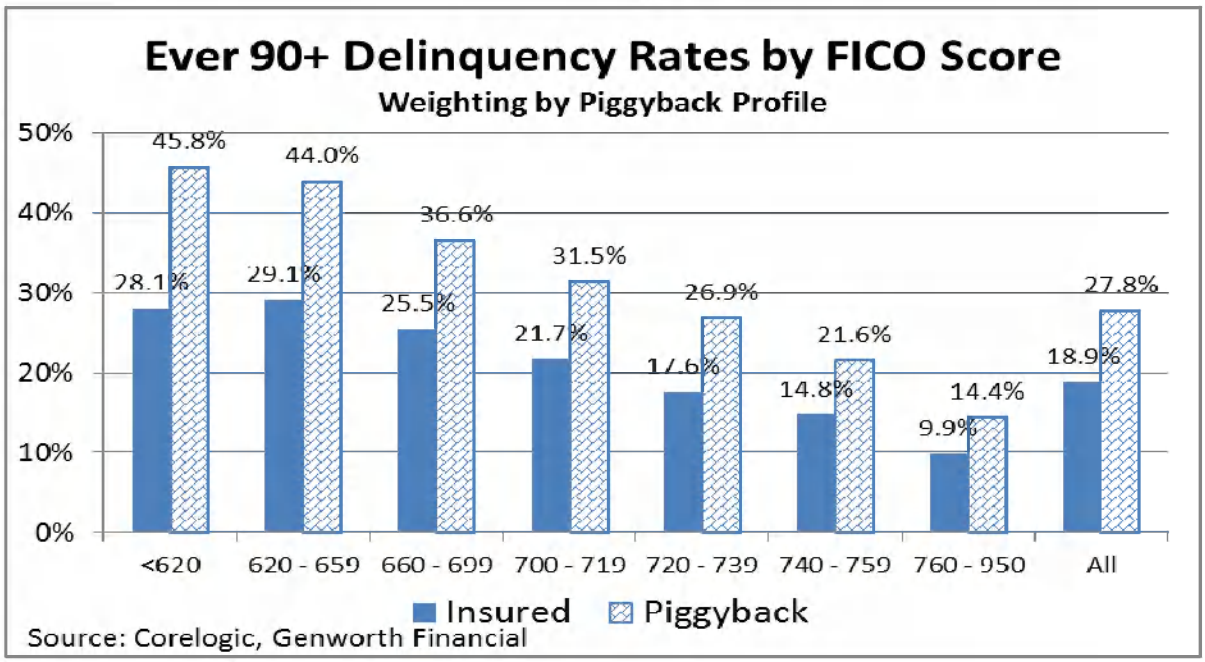
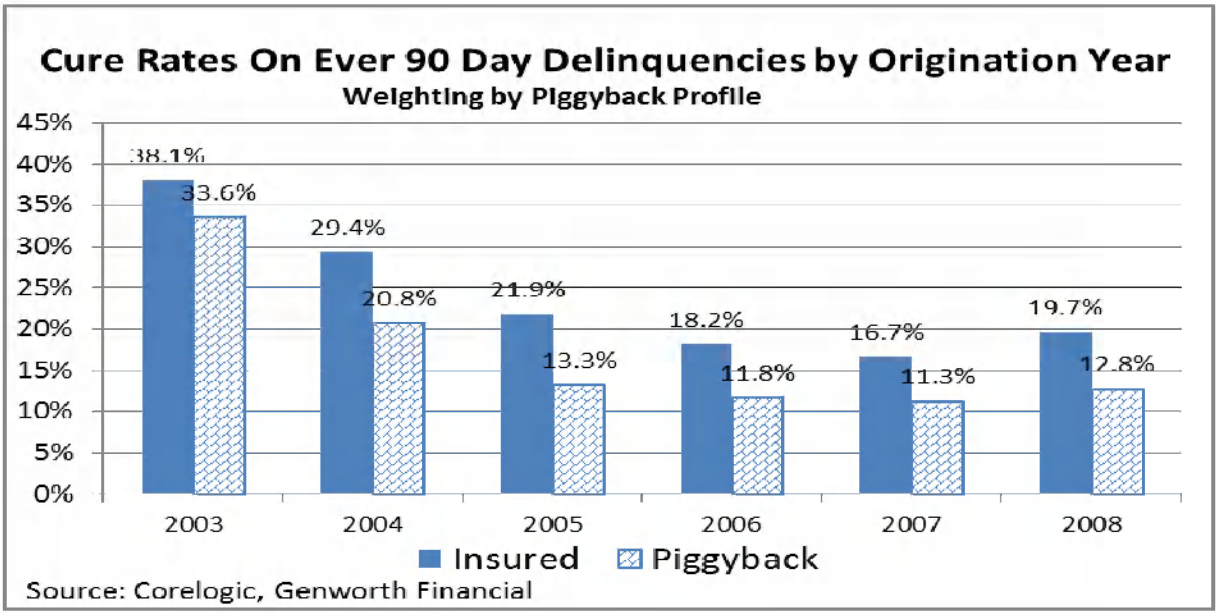


Exhibit 8



The incorporation of MI allows lenders and investors to recognize low-risk borrowers who merit a loan, but who may not meet the QRM standard as proposed due to changes in a borrower's life-style or because the borrower may be at a high cost point in their life cycle. It also acts as an important check on the process of origination and should be allowed in the final QRM rule.

Stringent Debt-to-Income (DTI) Requirements (Question 123)

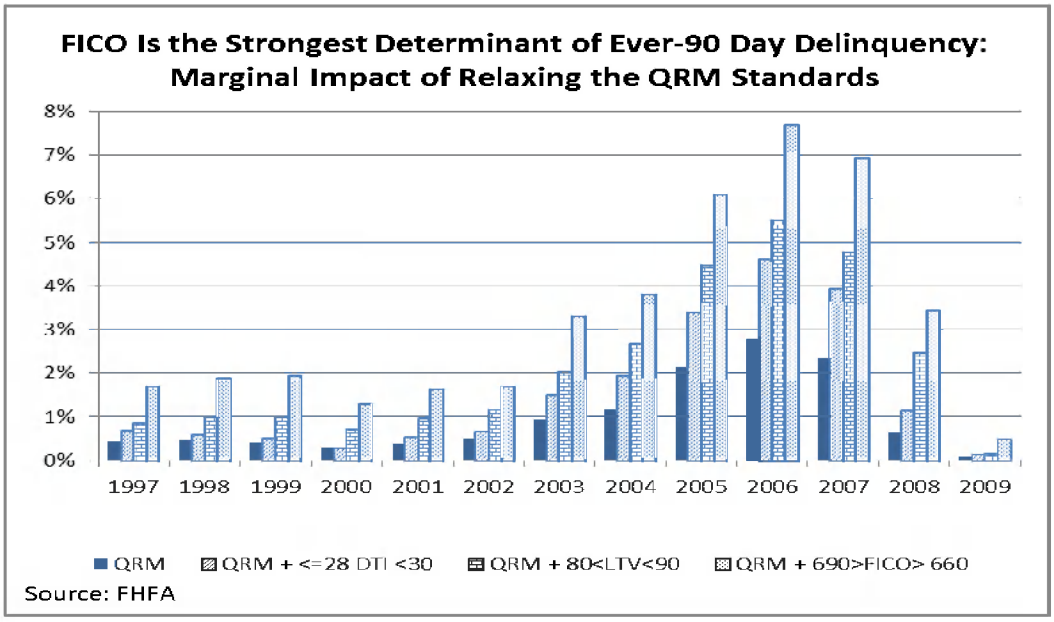
The proposed rule requires a QRM mortgage to have a ratio of (1) monthly housing debt to the borrower's monthly gross income of 28% or less (up-front DTI), and (2) total monthly debt to the

borrower's monthly gross income of 36% or less (back-end DTI). The 28/36 ratios were last in routine use in the late 1980s and are simply too restrictive to be practical, particularly for low- and moderate-income families, first-time homebuyers, and homebuyers in high-cost areas.

In the preamble to the Federal Reserve Board's proposed rule implementing the Ability-to-Repay/Qualified Mortgage (QM) provisions of Title XIV of the Dodd-Frank Act, in the context of discussing the two QM options, the Board questions whether DTI criteria should be a criterion for a QM.[16] It questions whether a DTI ratio has a "significant predictive power of loan performance" after considering credit history, loan type, and loan-to-value ratios. In conducting "outreach" to creditors, the Board was informed that creditors often question whether the front-end DTI is a strong predictor of whether the borrower has an ability to repay. The Board states that a DTI test "might" ensure the consumer's ability to repay. The Board also expressed concern that setting a specific DTI level or residual income level could limit credit without "providing adequate off-setting benefits." One thing is clear: the Board has doubts about whether DTI is an accurate predictor of default risk. NAR does too.

NAR believes that the marginal reduction, if any, in default rate that results from a low DTI is not worth the impact on consumers and that the DTI requirement should be dropped from the QRM definition. The Federal Housing Finance Agency's analysis of the proposed QRM definition shows that relaxing the DTI has a smaller impact on delinquency compared to the manageable impact of relaxing the LTV (see Exhibit 9). Analysis of LPS' loan-level data set shows that the delinquency rate on loans that meet the QRM standard except for a front-end DTI between 30% and 34% was only slightly higher than that for borrowers with a front end DTI between 28% and 30% (see Exhibit 10).[17]

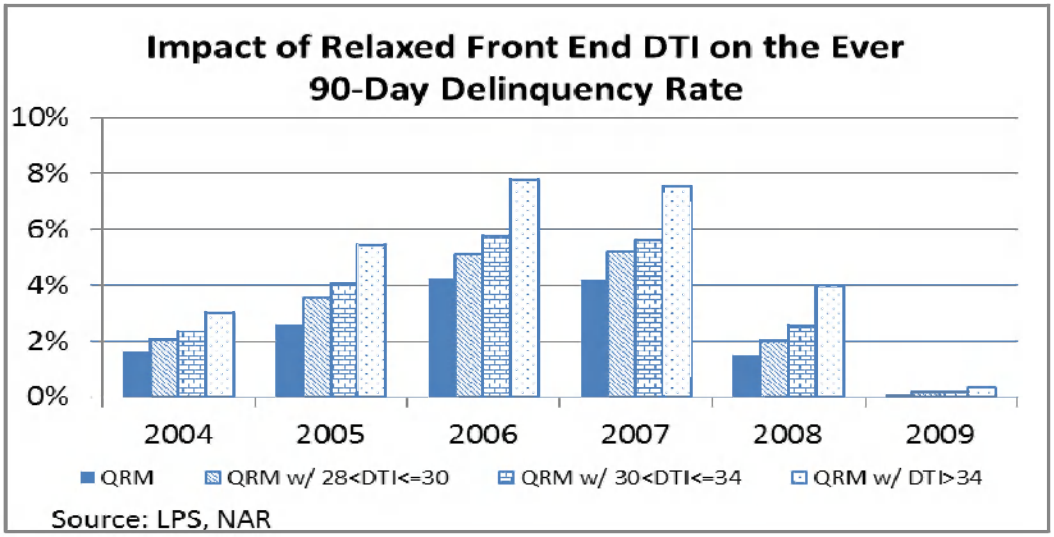
Exhibit 9



[16] 76 Fed. Reg. 27454 and 27460-1 (May 11, 2011).

[17] QRM and relaxed QRM estimates were generated using the LPS dataset excluding FHA loans and where QRM reflects fully documented, fully amortized, first-lien loans, fixed rate or ARM with initial adjustment period of 7 or more years, no Balloon, no IO, no option ARMs, with front-end DTI ≤28, LTV ≤80, and FICO ≤690.

Exhibit 10



Intuitively, it seems likely that the initial DTI should reflect one's ability to meet the monthly obligation and should be correlated with default. However, academic research suggests that the link is not clean.

In a 2009 study, researchers at the U.S. Federal Reserve and the University of Geneva (Foote, Gerardi, Goette, and Willen)[18] found that the initial DTI had a strong impact on default among subprime mortgages, but less so for prime borrowers. In addition, subprime borrowers with high FICO scores "are better able to tolerate high DTIs [which] suggests that these borrowers may have been able to make good predictions of their future income and of the likely variation in these incomes." Finally, the authors found that prime borrowers with high initial DTIs were more likely to prepay.

Additional recent research finds that the DTI is less relevant for prime borrowers. "The DTI for prime loans is not significantly correlated with defaults, except for loans originated in 2007, but it matters consistently for subprime borrowers". [19]

An excessively stringent DTI will inhibit many otherwise creditworthy borrowers from attaining a reasonably priced mortgage. As the academic literature suggests, a young couple with good credit who have student loans and a new car loan may have a high DTI ratio, but they are more likely to prepay, likely refinancing into a more affordable position as these debts are paid off. The definition of QRM should not impose limits on DTI ratios, in light of these studies and the relatively small impact DTI ratios have on default rates.

[18] Foote, Gerardi, Goette, and Willen. "Reducing Foreclosures: No Easy Answers." Federal Reserve of Atlanta. Working Paper 2009-15. May 2009.

[19] Amromin and Paulson. "Comparing Patterns of Default in Prime and Subprime Borrowers." Federal Reserve Bank of Chicago. 2Q 2009.

IV. RIGID CREDIT STANDARDS
(Questions 115, 117(a))

The proposed QRM definition would require the creditor to verify and document that within 90 days before closing:

- The borrower is not 30 days or more currently past due on any debt.
- Within the previous 24 months, the borrower has not been 60 days or more past due on any debt.
- Within the previous 36 months, the borrower has not been in bankruptcy, had any personal property repossessed, or had a 1- to 4-unit property subject to foreclosure, deed-in-lieu of foreclosure, or short sale.

The problem with the proposal is that it fails to allow for compensating factors. What if a consumer had missed several payments 22 months ago but had otherwise stellar credit and an excellent credit score? What if the consumer had struggled successfully almost three years ago to avoid a foreclosure by electing a short sale, without ever being delinquent, and had rebuilt his or her credit history?

NAR understands why the regulators chose not to adopt a credit score approach, since that raises concerns about favoring one commercial enterprise over others. An equally serious problem is that it makes no sense to lock-in a particular a credit score because credit score values need to be adjusted, up or down, to maintain the same risk exposure over time. A 740 minimum score, for example, could mean a 1% propensity to default today, but, when consumer debt management behavior improves, perhaps when jobs become more plentiful, the overall amount of systemic risk also improves. Therefore, the minimum score for QRM would also need to be lowered to maintain the same 1% propensity to default. The regulators should assess the feasibility of QRM qualification based on a propensity to default, a measurement that will remain static, providing a consistent level of risk over time.

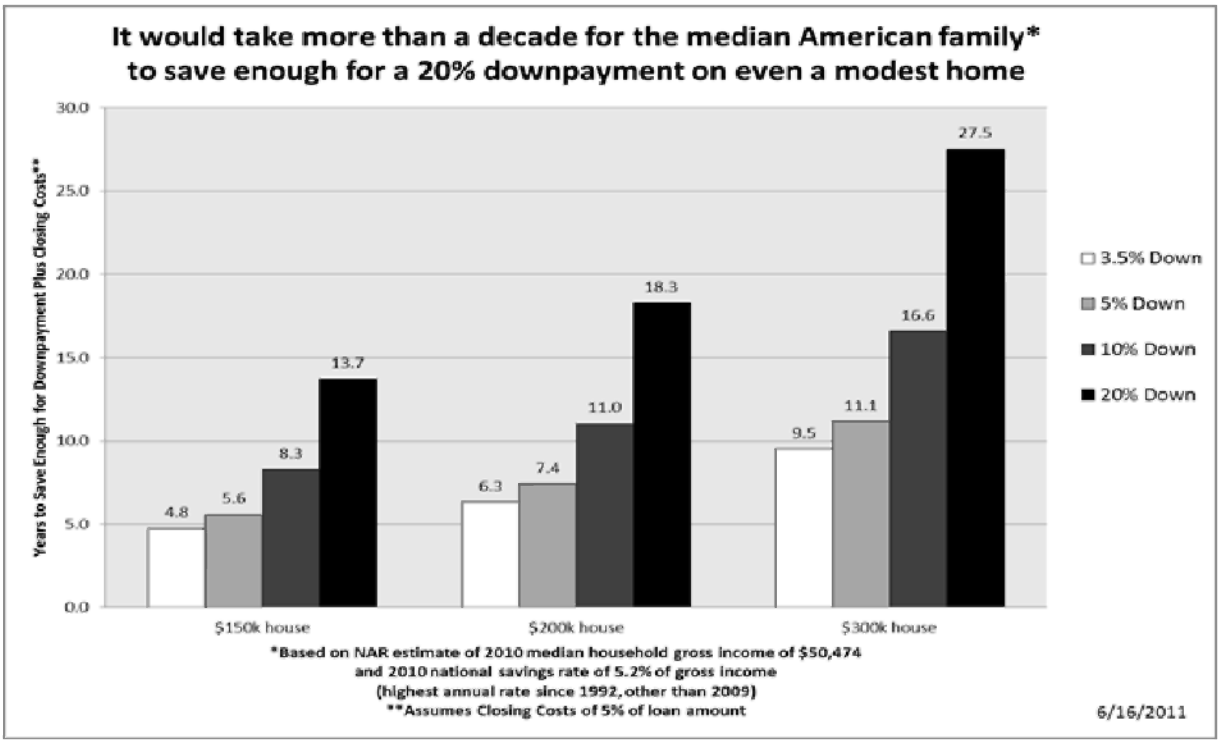
V. NARROW QRM DEFINITION DENIES CREDITWORTHY CONSUMERS ACCESS TO AFFORDABLE MORTGAGES

The impact of the proposed narrow definition of QRM would be to curtail the ability of creditworthy households from obtaining mortgages to purchase a home. Focusing the QRM exemption on underwriting factors that do not significantly improve loan performance means millions of families will fail to qualify for a QRM mortgage and will have to pay higher rates and fees for a non-QRM mortgage, if they are even able to qualify. As an example illustrated in Exhibit 2, a review of loans originated in 2008 reveals that reducing the downpayment from 20% to 5% increases the default rate by only 0.6%, but makes 18% more borrowers eligible for a QRM loan. As a practical matter, a narrow QRM exemption creates a permanent bar to homeownership for creditworthy families unless they are able to obtain an FHA or, while Fannie Mae and Freddie Mac are in conservatorship, a GSE loan.

Impact on the Ability of Median Income Households to Achieve a 20% Downpayment (Question 121)

Based on NAR estimates, assuming that 100% of family savings are dedicated towards a downpayment and closing costs, it would take more than a decade for a family with a median household income to save enough for a 20% downpayment for a $150,000 home (lower than the current median). Even a 10% downpayment would take a family more than eight years to save. Exhibit 11 shows at a glance how difficult it will be for families to save for large downpayments, and the discussion below of the high cost of a non-QRM mortgage explains why this is so important.

Exhibit 11

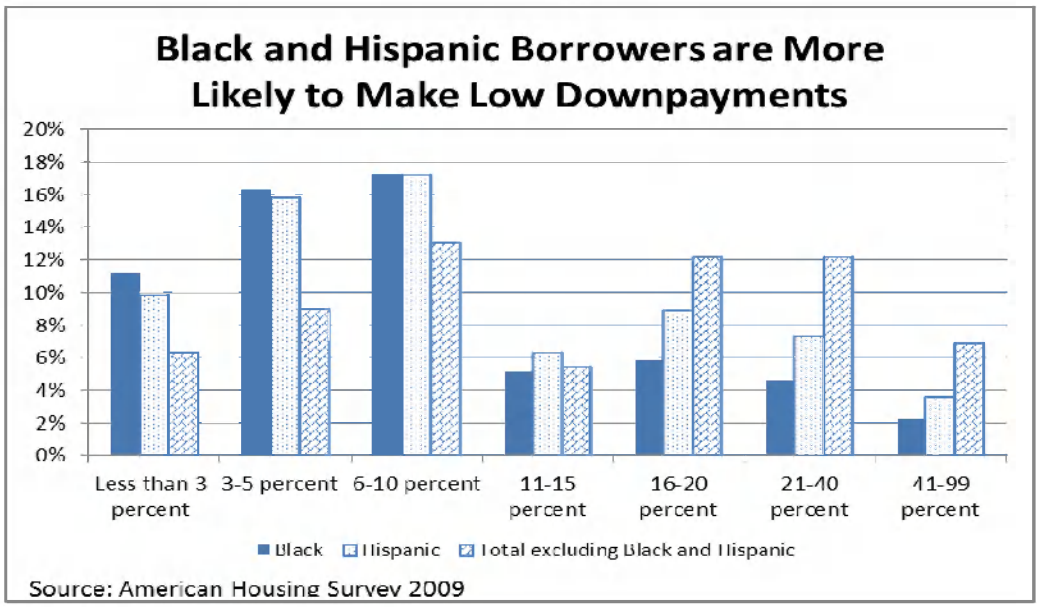


Impact on Homebuyers, Including Minority and First-Time Homebuyers (Question 108)

As bad as the effect of the proposed QRM definition on the median income household would be, the impact on minority and first-time homebuyers would be even worse. As evidenced by data in Exhibit 12 from the 2009 American Housing Survey, Black and Hispanic borrowers are more likely to make smaller downpayments than all other minority groups. Roughly 50% of Black and Hispanic borrowers put down 15% or less for their downpayment.[20] Excluding these groups, the average is 34%—a significant drop.

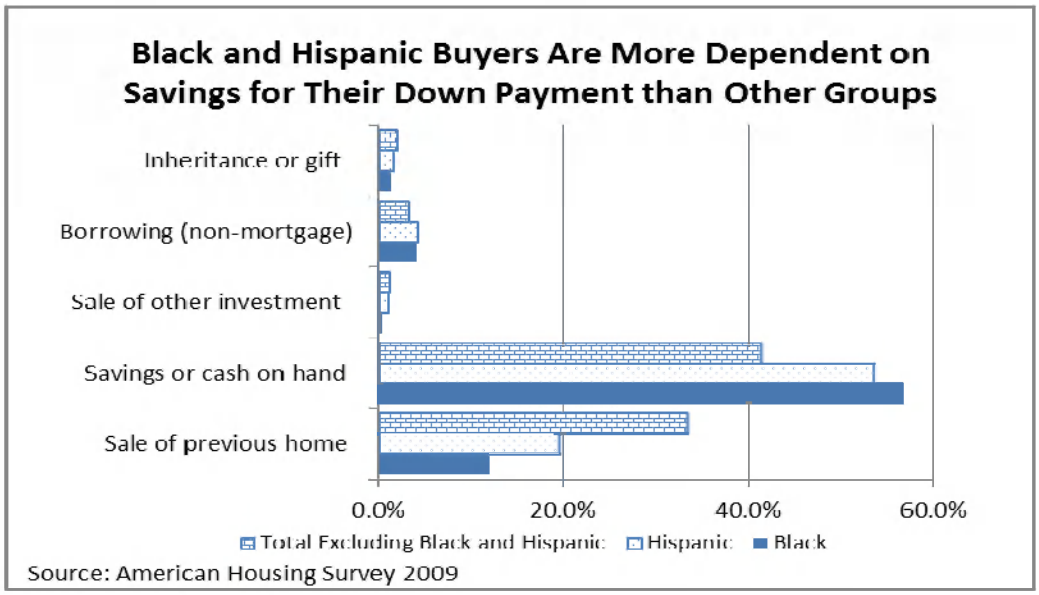
[20] The 16% to 20% category was excluded because many borrowers put down exactly 20% to get better mortgage rates. These loans would meet the QRM requirement for downpayment.

Exhibit 12



Furthermore, as shown in Exhibit 13, Black and Hispanic home buyers are more likely to rely on savings to finance their home purchase and less likely to use inheritance, gifts, investments, or proceeds from previous home sales than other groups. The current downpayment requirement of the QRM would narrow the field of affordable financing options for most Black and Hispanic borrowers to FHA and VA loans.

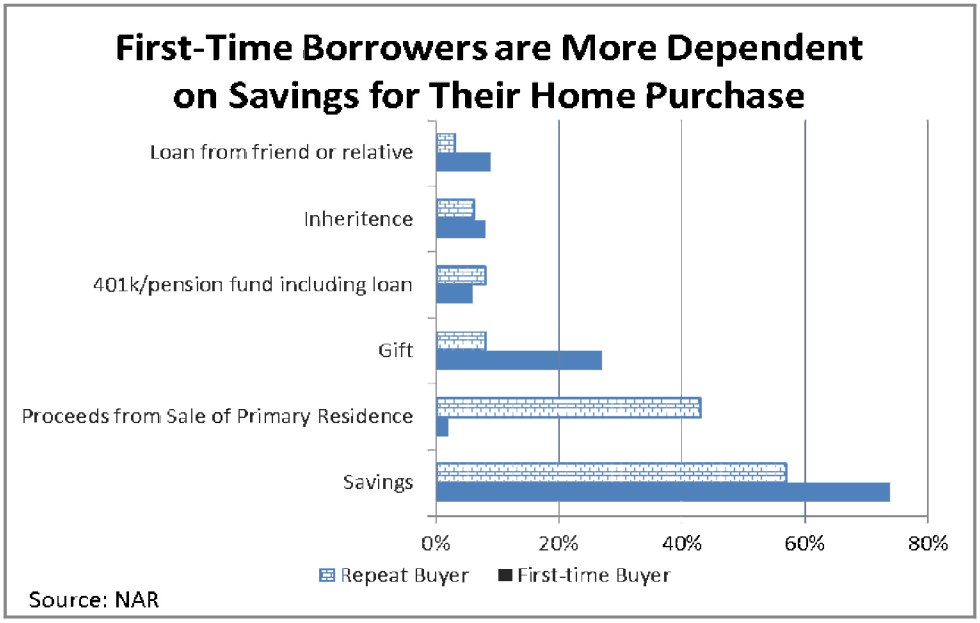
Exhibit 13



The proposed QRM definition would also have an unsettling impact on the ability of first-time buyers to enter the market. Like Black and Hispanic borrowers, first-time borrowers rely heavily on their savings to finance their initial home purchase (see Exhibit 14). From 2006 through 2010, an average of 86.8% of first-time homebuyers who used a mortgage put less than 20% down. Not surprisingly, repeat buyers are less reliant on savings and are able to use the proceeds from previous

home sales in their subsequent purchase. Fewer eligible first-time buyers, however, would lower demand and undermine the ability of current homeowners to sell and trade-up to a larger home for a growing family. Moreover, with the impending surge of baby boomers seeking to downsize, the impact of the proposed QRM definition could also hamstring the plans of this large segment of the population.

Exhibit 14



The reach of the QRM is likely to be more broadly felt than just first-time buyers and minority groups. Research conducted by economists at Economy.com[21] found that an increase in mortgage rates of one percentage point would reduce home sales by roughly 425,000 per year and depress the median existing home price by 8.5%. An increase of rates by 1.5 percentage points would have an even stronger impact, reducing home sales by nearly 690,000 units annually and causing prices to fall 13.8%. Furthermore, the economists at Economy.com point out that the estimates are not linear and that "the estimates . . . are based on raising the fixed mortgage rate from 6% to 7%. The housing market impacts would be measurably greater if fixed rates were to rise from say 7% to 8%." While the average 30-year fixed rate mortgage is below 5% today, it is likely to rise over the next 5 to 10 years with inflation and economic growth. A simple forecast of long-term mortgage rates, using the Congressional Budget Office's January forecast of the 10-year Treasury and the historical spread between the 30-year fixed rate mortgage published by Freddie Mac and the 10-year Treasury, places the average 30-year fixed rate mortgage at 6.5% for 2013 through 2016 and roughly 7.2% for 2017 through 2020.

Higher Costs for Non-QRM Mortgages and the Impact (Question 107, 108)

The regulators have informally suggested that risk retention will result in "only" a 10 to 15 basis point increase in rates for non-QRMs compared to exempt QRMs (although no methodology for

[21] http://www.economy.com/mark-zandi/documents/Reworking-Risk-Retention-062011.pdf?src=DS.

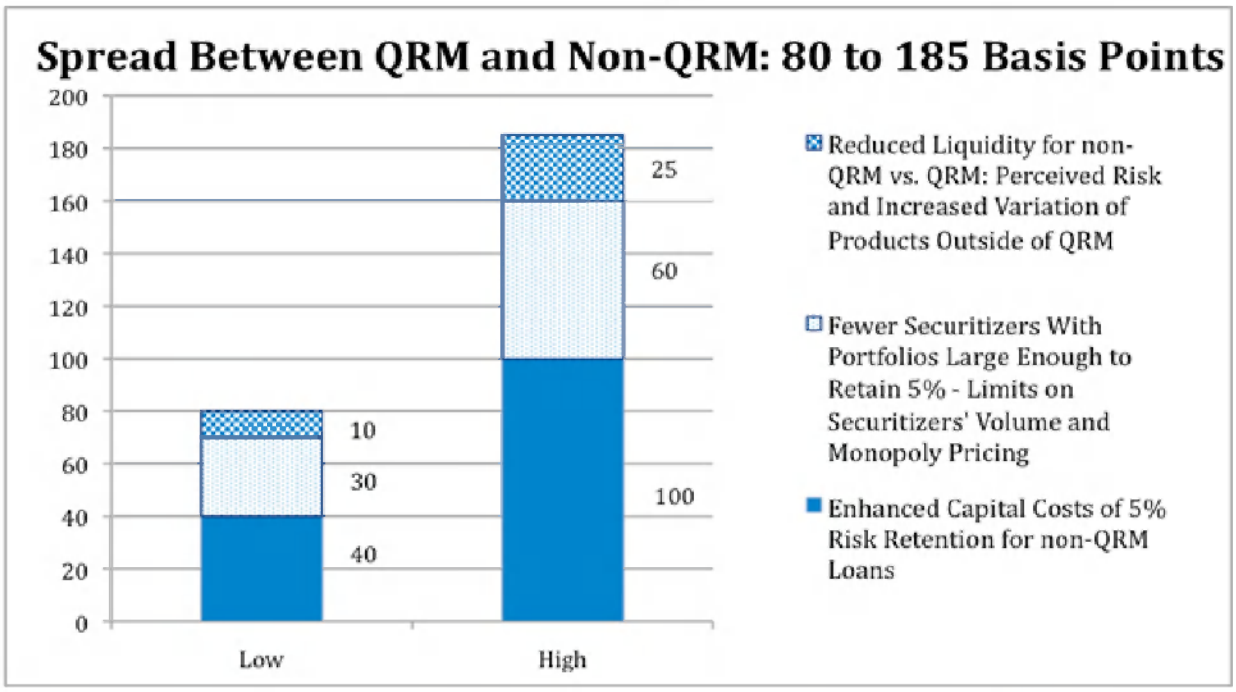
this estimate is provided).[22] However, most private estimates of the cost of risk retention on non-QRMs are significantly higher.

NAR estimates higher cost for a non-QRM mortgage would range from 80 to 185 basis points (see Exhibit 15). Since banks must hold back 5% of each non-QRM MBS issuance, they will not be able to re-use that capital for further MBS issuance or other more productive ventures. The sidelined capital will need to be managed, incurring costs. Furthermore, since each issuance will begin to lock-up the capital of an issuing entity for an extended period of time, only those with large portfolios will be able to compete in this space. Loans that qualify as QRM will likely be perceived as less risky than non-QRM loans. Finally, with fewer regulations, the larger variety of mortgages in the non-QRM space might make it more difficult for securitizers to create standardized securities. These costs will be passed on to the consumer.

- Discussions with economists and analysts familiar with the securitization process put the impact on mortgage rates of 5% retention at an increase of 40 to 100 basis points. At this time there are several unknowns regarding the mechanics of the QRM rule. Issuers do not like to hold loans with long terms, like the 30-year fixed, because rising rates can eat away profits. Consequently they are asking for a sunset provision that would allow them to sell off their retention after the loans have successfully performed for a number of years. In addition, the proposed regulation would create a "premium capture" rule, which would make it difficult for issuers to reap profits in the short-term, reducing their incentive to issue MBS, or to offer loan features like interest rate locks. This estimate of basis points could rise or fall as these uncertainties are resolved.
- The banking industry experienced consolidation since the housing boom that has placed upward pressure on the rate spread between the primary and secondary mortgage markets. Similarly, only a few entities have portfolios large enough to securitize mortgages with a 5% retention requirement. Consequently, securitizers of non-QRM loans are likely to exercise their market power in light of limited competition, driving rates upward. Likewise, it remains unclear whether the private securitizers will have the ability to handle the volume of securitization under the current system. During periods of financial distress, both investors and securitizers will likely choose to pull back. Together these facets will add an additional 30 to 60 basis points to the full impact of a system under QRM, or more.
- MBS investors underpriced the risk of borrowers with non-QRM characteristics in the past and are likely to command a higher risk premium going forward. Furthermore, portions of the non-QRM market will become idiosyncratic and have trouble pooling into sellable MBS. The void in lending that would result suggests an additional spread of 10 basis points and possibly more due to liquidity issues.

[22] *"FDIC's Bair Would Rather Eliminate QRM From Risk Retention Rule,"* American Banker, June 10, 2011.

Exhibit 15



Source: NAR estimates. See http://economistsoutlook.blogs.realtor.org/2011/06/17/qrm-higher-mortgage-rates-on-the-horizon/ for additional details.

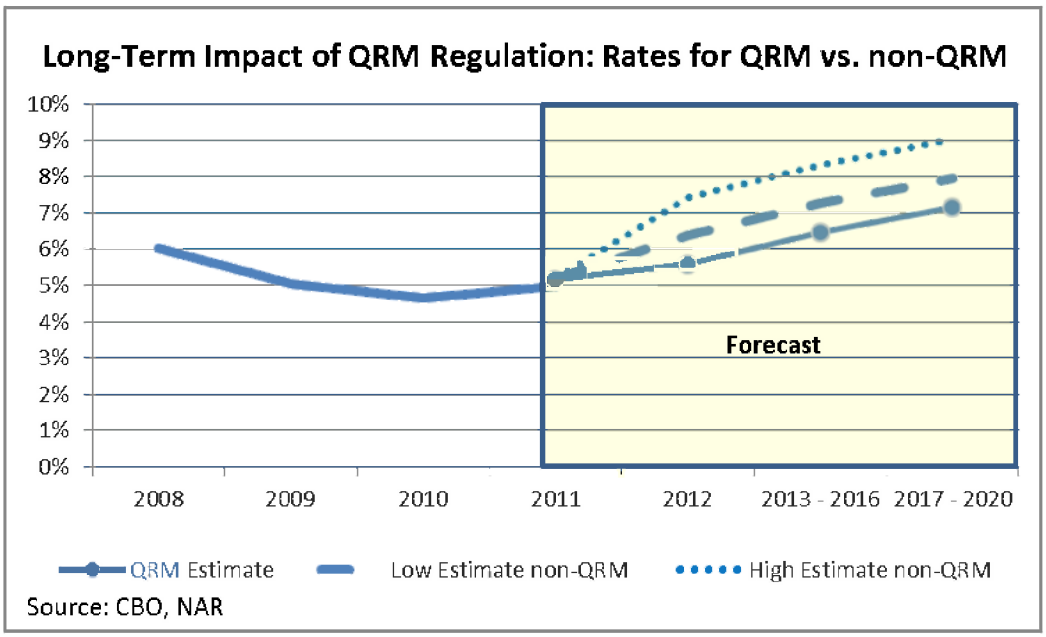
Similarly, a June 20, 2011 analysis by Mark Zandi of Moody's Analytics estimates "conservatively" that borrowers of non-QRM mortgages would be saddled with interest rates 75-100 basis points higher than QRM-eligible borrowers.[23] Based on the range of estimates in the NAR and Zandi estimates, today's 4.5% contract rate for a 30-year fixed-rate loan that did not meet the QRM requirements would become a 5.25% rate, at best, and could go as high as 6.35%.

The American Securitization Forum comment letter, submitted to the agencies on June 10, 2011, estimates that interest rates would be two percentage points higher due solely to the proposed premium capture rule, exceeding both the NAR and Zandi estimates. If the ASF is right, the total impact on interest rates for a non-QRM loan would be catastrophic in terms of eligibility for virtually all borrowers who are not eligible for a QRM loan.

A simple forecast of long-term mortgage rates was created and displayed below using the Congressional Budget Office's January forecast of the 10-year Treasury and the historical spread between the 30-year fixed rate mortgage published by Freddie Mac and the 10-year Treasury. For simplification, the rate for QRM loans assumes the forecast baseline, while spreads are added to reflect the low and high estimates of the non-QRM rates. The impact of the spread on the non-QRM market is significant and heightened by the rising baseline mortgage rates. See Exhibit 16.

[23] Mark Zandi and Cristian deRitis, Moody's Analytics Special Report, "Reworking Risk Retention," June 20, 2011.

Exhibit 16

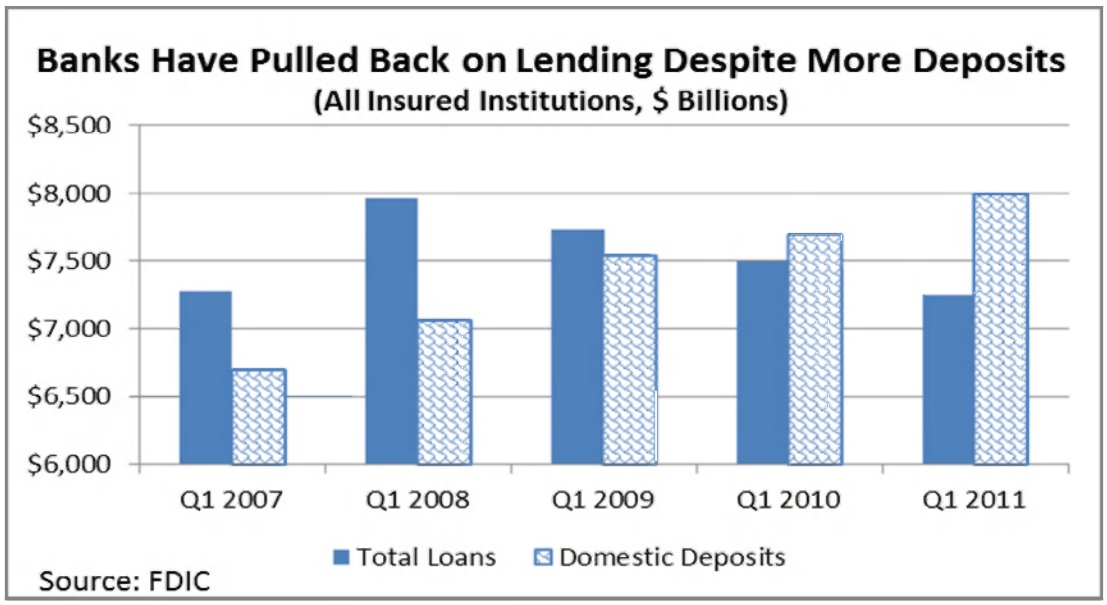


The impact of the proposed QRM definition, in the short term, would not be as severe as outlined here, since many borrowers would obtain exempt FHA loans or, until the GSE loan exemption is removed, GSE loans. However, these substitutions run contrary to the objectives of policy makers seeking to restore private capital and reduce dependence on federal guarantees in the mortgage market (as noted in more detail in the next section). As a result, when policies designed to shrink the FHA and GSE footprint are implemented, the full adverse effects outlined here of the narrow QRM will be felt.

Beyond the increase in costs to borrowers, the new QRM regulation will introduce volatility into the system, particularly as the government's role in the securitization market declines.

- The impact of duration risk and a sunset provision are uncertain. Furthermore, flaws in the rule are likely to emerge that will cause securitization to ebb and flow in the years to come. This process will affect the flow of funds to the origination market.
- During periods of economic instability or falling/flat home prices, securitizers will reduce the volume of loans that are securitized. This mechanism tends to over-correct as evidenced by the sharp reduction in loans made by banks over the past 3 years despite the large increase in deposits and improved credit quality of loans made since 2009 (see Exhibit 17).

Exhibit 17



As discussed earlier, analysts with Economy.com estimate that a one percentage point increase in rates for a non-QRM mortgage would cause a decline in sales of 425,000 per year and an 8.5% price decline.

Considering the significant higher cost for non-QRM loans, the regulators should be careful to define QRM to include a broad range of safe and sound mortgages and require risk retention only for those mortgages with risky product features or weaker underwriting.

VI. PROPOSED NARROW QRM DEFINITION JEOPARDIZES THE FRAGILE HOUSING MARKET AND THE ECONOMY (Questions 107, 108)

REALTORS® believe that the proposed narrow QRM rule discourages development of a renewed, robust and diversified private lending market. Under the restrictive QRM rule, a very large majority of loans will be non-QRMs subject to the higher costs of risk retention, yet it is not clear whether investors will view risk retention as providing sufficient protection that would encourage them to invest significantly in non-QRM mortgage securities.

The rule does little to establish the certainty needed for the development of a strong private secondary mortgage market based on sound underwriting principles and product standards. In fact, mortgage securitization pioneer Lew Ranieri has said:

> The proposed very narrow QRM definition will allow very few potential homeowners to qualify. As a result, it will complicate the withdrawal of the Government's guarantee of the mortgage market. I fear it will also delay the establishment of broad investor confidence necessary for the re-establishment of the Residential Mortgage-Backed Securities market.[24]

[24] RISMedia, April 8, 2011, "Diverse Groups Respond to Proposed Rule for Qualified Residential Mortgages."

It is not clear that the private sector has the ability to absorb the share of the securitization market as the GSE role is reduced over coming years. If it does not, and the role of FHA is reduced as well, the gap that remains would likely leave those least able to save or those with weaker credit with limited access to mortgage credit. This process would be exacerbated during periods of weakness for the economy or housing market as lenders restrict credit to borrowers perceived as safer because they meet the QRM definition or are close to it.

NAR is also worried that the proposed risk retention rule is likely to increase systemic risk rather than relieve it. By creating such a narrow QRM market, the capital required to make loans outside of the QRM (which would be most loans made today) will simply not be available to most community-based lenders. The result will be even further concentration of mortgage lending in a small number of the largest institutions, reducing competition and increasing systemic risk.

The Joint Center for Housing Studies of Harvard University recently released its 2011 report on the State of the Nation's Housing. The report cites tight lending standards as one of the factors hindering homebuyer demand. It expresses concern that "overly rigid guidelines may unnecessarily restrict access of low- and moderate-income households to the benefits of homeownership."[25] Future homeownership for minorities and first-time buyers is identified as a key factor to the housing market's recovery. Minorities are expected to constitute one-third of all U.S. households by 2020, and thus continued low ownership rates among minorities will depress the national homeownership rate.[26] Homeownership rates among minorities in 2010 stood at 48.9%, compared to 74.4% among whites.[27] The study concludes that for the housing market to recover, "a more normal rate of household growth is needed to hasten the absorption of excess supply," and that "[t]he farther the homeownership rate falls, the longer it will take to work through the excess inventory."[28] The Joint Center report supports NAR's view that creating an unnecessarily narrow definition of QRM will only make a fragile housing market situation worse.

VII. TREATMENT OF GOVERNMENT-SPONSORED ENTERPRISES

Background

Fannie Mae and Freddie Mac (the government sponsored enterprises or GSEs) fully guarantee the timely payment of principal and interest on the mortgage-backed securities they issue, and are exposed to the entire credit risk of the mortgages that collateralize those securities. Since September 2008, both GSEs have been operating under the conservatorship of FHFA. As conservator, FHFA has assumed all powers formerly held by each GSE's officers, directors, and shareholders. As proposed, the risk retention proposed rule exempts any securitization transaction that is collateralized solely (excluding cash and cash equivalents) by residential, multifamily, or health care facility mortgage loan assets if the assets are insured or guaranteed as to the payment of principal and interest by the United States or an agency of the United States. Under the proposed rule, the guaranty provided by a GSE while in conservatorship will satisfy the risk retention requirements of the GSEs. Similarly, an equivalent guaranty provided by a limited-life regulated entity that has

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[25] "State of the Nation's Housing," The Joint Center for Housing Studies at Harvard University, 2011 (page 2), http://www.jchs.harvard.edu/publications/markets/son2011/son2011.pdf.

[26] *Id.*, at 4.

[27] *Id.*, at 36.

[28] *Id.*, at 1.

succeeded to a GSE charter and that is operating under the direction and control of FHFA, will satisfy the risk retention requirements, if the entity is operating with capital support from the United States.

Support for Treatment of Enterprises

NAR supports the proposed rule's treatment of GSE securities. NAR believes that the agencies should remain cautious implementing any regulations, including risk retention, that would impede a recovery in housing or the overall economy. The GSEs continue to play a crucial role in providing readily available financing for consumers during the current economic downturn and are critical to maintaining a liquid residential mortgage market, throughout the nation, that serves a wide range of borrowers, including qualified low- and moderate-income families, while private capital remains on the sidelines. Imposing risk retention requirements on the GSEs would result in unnecessarily higher mortgage interest rates for millions of consumers and further delay the housing recovery as it regains its footing after the worst economic downturn since the Great Depression.

Private Capital Participation

The agencies may receive comments asking that the GSEs be made subject to the same risk retention standards as their private market counterparts. NAR recognizes the need for private capital participation to reduce the federal government's financial support of the housing sector if the housing finance system is to right itself. However, in today's unstable economic conditions, private capital has retreated from the market, requiring the increased and continued participation of entities that provide financing in the marketplace regardless of economic conditions. Robust real estate and mortgage markets are essential ingredients to the nation's recovery from economic downturns. Without the GSEs staying true to their mission of providing affordable mortgage capital during all market conditions during the housing crisis, there would have been a much more serious disruption to the market. Until the statutory and regulatory framework for the GSEs becomes clear, we believe that for the benefit of homeowners, homebuyers, renters, and the entire economy, the agencies should not impose risk retention standards that would put potential creditworthy homeowners in the position of being unable to find fair and affordable mortgages. Any concern about the proposed rule giving the GSEs an unfair competitive advantage rule would be fully addressed if the agencies adopt NAR's recommendation for defining a QRM. Our approach would exempt a wide range of safe and sound mortgages from risk retention, leveling the playing field in the process.

VIII. QUALIFYING APPRAISALS
(Question 122)

After considering a variety of valuation information sources, the agencies are proposing that a QRM be supported by a written appraisal that conforms to generally accepted appraisal standards, as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP), the appraisal requirements of the federal banking agencies, and applicable laws.

The agencies believe these requirements will help ensure that the appraisal is prepared by an independent third party with the experience, competence, and knowledge necessary to provide an accurate and objective valuation based on the property's actual physical condition. These requirements are intended to ensure the integrity of the appraisal process and the accuracy of the estimate of the market value of the residential property.

In question 122, the regulators have asked: Should other valuation approaches be considered in determining the value of the real property pledged on the mortgage transaction?

NAR believes that other valuation approaches should be considered in determining the value of real property for purposes of determining whether the mortgage is a QRM. NAR supports the independence of appraisers and the integrity of the appraisal process. However, an appraisal is not required or necessary in all circumstances that may be covered by a QRM. The agencies should establish separate valuation rules for purchase and refinance mortgages that are defined as a QRM.

NAR supports the requirement of an appraisal for purchase transactions that qualify as a QRM. In fact, for purchase transactions involving a mortgage, an appraisal is already the industry standard. The Dodd-Frank Act establishes valuation requirements by prohibiting the use of broker price opinions as a primary method of valuation in conjunction with the purchase of a consumer's principal dwelling unit. While an appraisal is only required on federal transactions above the *de minimis* threshold of $250,000, in practice very few homes purchased with a mortgage are done without a USPAP-compliant appraisal. An appraisal is required for all purchase transactions by Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA). Together, these entities account for almost all purchase transactions in the current market.

There are some transactions where an appraisal is more burdensome than useful for determining value, and NAR encourages the agencies to consider valuation methods as dictated by the circumstance of the mortgage transaction. For example, often homeowners work with their existing lender to refinance their mortgage. Consumers refinance for a variety of reasons, including, but not limited to, taking advantage of lower interest rates or reducing the term of the existing mortgage. In this situation the lender often has a wealth of data available about both the consumer and the principal dwelling unit. The lender should have the option of utilizing an automated valuation model (AVM), a broker price opinion (BPO), an appraisal, or some combination of these valuation products without forfeiting QRM eligibility.

IX. POINTS AND FEES: DISCRIMINATION AGAINST AFFILIATES

The provision relating to the definition of "points and fees" in the proposed Risk Retention rule is identical to that found in the Qualified Mortgage provisions in Title XIV of the Dodd-Frank Act. The proposed definition of a QRM limits total points and fees payable by the borrower to 3% of the total loan amount.[29] The proposal also defines "points and fees."[30] The definition of fees and points discriminates against lenders with affiliates for no obvious reason, and NAR recommends that the final rule be amended to correct this problem.

The Federal Reserve Board notes in the QM proposed regulation that there was concern regarding the definition of fees and points in the legislation.[31] A legislative technical correction was included in House versions of these provisions dating back to 2007. The provision would have treated mortgage lenders with affiliates involved in the transaction almost the same as unaffiliated lenders as long as the affiliated relationship was in compliance with the Real Estate Settlement Procedures Act

[29] Proposed Rule §__.15(c)(7).

[30] Proposed rule §__.15(a).

[31] 76 Fed. Reg. 27404 (May 11, 2011),

(RESPA). The Board also noted that Congress ultimately did not include a legislative technical correction for the definition that would have treated affiliated and unaffiliated providers equally. While it is true that the legislative fix was removed in the final conference version of the legislation, the circumstances of its removal was largely the result of haste and not deliberate reflection as the Board implies. In fact, NAR has subsequently met with key Members of Congress who inserted the provision and those in a position to remove it and none gave any indication or reason for its removal other than possibly a staff error.

The RESPA affiliate exception should be reinstated because it maximizes consumer access and choice in mortgage providers. RESPA prohibits kickbacks and unearned fees among settlement service providers making the differential treatment of affiliates unnecessary. The affiliated business exception allows affiliates to profit for services rendered and for a parent owner or partner to receive a return on their ownership interest commensurate with their investment in the affiliated firm. It still prohibits unearned fees or returns and requires significant disclosure of affiliated relationships. For this reason alone, the fears that may have inspired the inclusion of affiliate charges such as title insurance and escrow is unwarranted.

What is most pernicious about the disparate treatment of affiliates is that the particular affiliate or other charges ascribed to lenders with affiliates in the transaction are not likely to differ whether there is an affiliate involved or not.

The item most likely to cause a lender to violate the points and fees cap is title charges. The title industry is heavily regulated in the vast majority of states, and the likelihood that consumers would pay a non-market rate to an affiliate title company, as opposed to an unaffiliated firm, is slim. In fact, in a December 2010 Harris Survey of recent and prospective buyers, respondents said that using affiliates saves them money (78%), makes the home buying process more manageable and efficient (75%), prevents things from "falling through the cracks" (73%), and is more convenient (73%) than using separate services. This response is consistent with data from similar surveys in 2008 and 2002.

Title and certain escrow charges (including homeowner's insurance) can be significant depending on location and would certainly contribute to either a firm exceeding the 3% cap or making a lender's interest rate uncompetitive if they must build in the true lender costs into the interest rate.[32] Of course, the other listed charges would also contribute to an affiliated firm exceeding the 3% cap while an unaffiliated lender would be free to charge the entire 3% for its own benefit. Therefore discrimination against affiliates could in fact increase costs since the consumer would still have to pay the other charges such as title and amounts in escrow (for example, insurance) to third parties.

Since discrimination against affiliates will reduce competition and perhaps even increase cost and given the repeated survey data showing consumer's desire, NAR strongly urges the agencies to either reinstate the RESPA affiliated business exemption or remove title and escrow charges from the calculation of fees and points.

[32] Building cost into the rate, an option discussed in the preamble, could be a risky option since the lender could face charges of discrimination and redlining.

X. COMMERCIAL AND MULTIFAMILY REAL ESTATE

Background

We are also pleased to offer our views from the commercial and multifamily real estate perspective in response to the proposed rule as it affects new commercial and multifamily mortgage financing. The following commercial NAR affiliates are joining in this comment:

- CCIM Institute[33]
- Institute of Real Estate Management (IREM®)[34]
- Society of Industrial and Office REALTORS® (SIOR)[35]

The Dodd-Frank Act adds a new section 15G(c) to the Securities Exchange Act of 1934 to "require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party." Section 15G(c) generally requires a 5% risk retention for most asset classes, however, Section 15G(c)(1)(E) gives the agencies broad authority to identify the acceptable types, forms, and amounts of risk retention for "low risk" commercial and multifamily mortgages.

The proposed rule outlines "low credit risk" underwriting standards that would permit asset-backed securities backed exclusively by commercial and multifamily loans[36] to qualify for a less than 5% risk retention. Specifically, the agencies have proposed 0 percent risk retention for commercial mortgage-backed securities (CMBS) issuances that meet a series of underwriting standards.[37]

Preliminary Thoughts

NAR is committed to facilitating the establishment of a well-functioning and transparent securitization market for commercial and multifamily real estate mortgages. While we applaud the agencies for providing flexibility in certain areas, we have serious concerns with the proposed rule.

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[33] The CCIM Institute confers the Certified Commercial Investment Member (CCIM) designation through an extensive curriculum of 200 classroom hours, as well as experiential requirements. The designation was established in 1969 and is recognized as the mark of professionalism and knowledge in the commercial real estate industry. More than 9,000 professionals currently hold the CCIM designation, with another 6,000 practitioners pursuing it. The mean value of commercial real estate transactions completed by a CCIM member in a 12-month period is $44.6 million.

[34] The Institute of Real Estate Management (IREM®) – has been the source for education, resources, information, and membership for real estate management professionals for more than 77 years. Membership in this international organization includes more than 18,000 individual members and over 525 corporate members. IREM® promotes ethical real estate management practices through its credentialed membership programs, including the CERTIFIED PROPERTY MANAGER® (CPM®) designation, the ACCREDITED RESIDENTIAL MANAGER® (ARM®) certification, the ACCREDITED COMMERCIAL MANAGER (ACOM) certification, and the ACCREDITED MANAGEMENT ORGANIZATION® (AMO®) accreditation. Collectively, IREM® Members in the United States manage over $1.5 trillion in real estate assets, including 9.37 million residential units and 8.4 billion net square feet of commercial space.

[35] The Society of Industrial and Office REALTORS® provides the prestigious SIOR designation to industrial and office real estate brokers who meet SIOR's stringent pre-requisites for experience, education, and annual transactional volume. In addition, SIOR has members engaged in developing and investing in industrial and office properties. SIOR's 3,000 members are located in 580 cities in 28 countries. They conclude more than 78,000 transactions each year.

[36] Also referred to as "qualifying CRE loans."

[37] 76 Fed. Reg. 24132-24134 (Apr. 29, 2011).

Given the current fragile state of the CMBS market, NAR is concerned that certain underwriting elements of the agencies' risk retention proposal would further reduce access to credit for the commercial and multifamily real estate industry, curtailing our nation's economic recovery. Therefore, NAR wishes to comment on the agencies' proposed risk retention guidance on commercial and multifamily real estate mortgages in the following sections of our comment letter:

1. Overview of Commercial and Multifamily Real Estate
2. Exemption for Qualified CRE Loan: Underwriting Standard Recommendations
3. Conclusion

1. Overview of Commercial and Multifamily Real Estate

Commercial & Multifamily Real Estate Finance. Commercial and multifamily real estate are income-producing assets, generating rental or other income and having a potential for capital appreciation. Unlike residential property, the value of commercial property depends largely on the amount of income that can be expected from the property. This $7 trillion sector houses virtually all of the nation's businesses within retail shopping centers and strip malls, hotel and tourist buildings, office buildings, and industrial properties. The commercial real estate industry also houses over 14 percent, or one-in-seven, of American households living in multifamily housing units.[38]

The commercial and residential real estate industries share many similarities in basic structure and terminology. For example, location of a property is a significant factor impacting the value of both property types. However, these sectors have many inherent differences. Unlike most residential borrowers, commercial borrowers are required to pay debt service from property income rather than from personal income. As a result, many of the loan structures, such as low introductory interest rates or 30 year fixed-rate mortgages, used in the residential real estate market are not available in the commercial and multifamily market.

There are two categories of commercial real estate mortgages: (1) construction and development financing and (2) permanent financing. Construction and development loans are often called "acquisition, development, and construction" (ADC) or "construction and development" (CD) mortgages. These loans are typically short-term with an adjustable interest rate and allow the developer to obtain funds to build a commercial property.[39] Construction loans often include an interest reserve which holds back enough of the loan proceeds to cover the interest payments due during the term of the construction loan, since the property under construction does not generate income to cover the debt service.

Once property construction is finished and the building is leased to tenants, the developer takes out a commercial loan as "permanent financing" and uses the proceeds to repay the construction loan. The terms of the permanent financing depend, again, on the income the property is expected to generate, based on its initial leasing rate, overall economic conditions, and demand for the property type. This projected value sets the loan-to-value (LTV) ratio, which is the principal loan balance divided by the property's value. Permanent financing mortgages are also generally short-term, between 3 to 10 years, and require refinancing of the unpaid balance at the end of the loan term.

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[38] U.S. Census Bureau, 2007 American Housing Survey.

[39] Brueggeman and Fisher, *supra* note 13, 445.

The amortization schedule is often longer than the term of the loans, usually 30 years, with a balloon payment of the remaining outstanding balance due at loan maturity.

When it is time to refinance a permanent financing commercial loan, underwriting focuses on the property's net operating income[40] and its value to determine the new loan amount. The net operating income (NOI) allows the borrower and lender to determine whether the property's cash flow is sufficient to cover operating expenses, capital improvements, and mortgage payments. The NOI is compared to the required debt service to determine the Debt Service Coverage Ratio (DSCR).[41] A DSCR less than one indicates that the property is not earning sufficient income to make debt payments.[42] More importantly, this critical analysis is re-executed generally on a quarterly basis for CMBS.

Commercial Mortgage-backed Securities (CMBS). CMBS are asset-backed bonds based on a pool of commercial and multifamily mortgages, which vary in size, property type, and location. A single CMBS issuance usually represents 100 to 200 commercial loans (some can be as low as 30 to 40 mortgages).[43] A CMBS pool is typically set up to be eligible for tax treatment as a Real Estate Mortgage Investment Conduit (REMIC), in which taxation on income and capital gains occurs only at the investor level.[44] The mortgages in a CMBS pool are structured or "tranched" into different asset classes, which allow investors to choose from varying risks and reward ratios. Interest and principal payments from the underlying mortgages flow through to investors—a process often described as a waterfall. Under this structure, investors in the most senior or secure tranche are paid first. If the CMBS has cash left over, the next tranche is paid. This process continues down to the investors with the least secure or most subordinate tranche.[45] If there is insufficient cash flow to meet payments for all tranches, the most junior or subordinate tranche is not paid.

The different bond classes or tranches associated with a CMBS are assigned credit ratings by at least two nationally-recognized credit rating agencies. Due to their lower risk, senior tranches earn a better credit rating than more subordinate tranches. These are often referred to as "investment grade" tranches and typically have a credit rating of "AAA" to "B-." More risky or subordinate tranches yield a lower credit rating and are classified as "B-piece" investments, which are rated "BB" and below or in some cases have no rating. These are purchased by specialized investors who comprehensively scrutinize the deal and the underlying properties.[46] The B-piece buyer assumes a higher level of risk, but would receive a higher yield than an investment grade buyer.

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[40] Net Operating Income (NOI) is defined as income generated by a CRE property, net of all expenses that have been deducted for federal income tax purposes (except depreciation, debt services, and federal and state income taxes) and any unusual or nonrecurring income items.

[41] The Debt Service Coverage Ratio (DSCR) for a CRE loan equals the CRE property's annual NOI minus the annual replacement reserve of the CRE property at the time of origination divided by the sum of the borrower's annual payments for principal and interest on any debt obligation.

[42] Brueggeman and Fisher, *supra* note 13, 344-45.

[43] Testimony of the CRE Finance Council before the U.S. Senate Subcommittee on Securities, Insurance & Investment hearing on "The State of the Securitization Markets." (May 18, 2011) (hereafter, "CRE Finance Council testimony").

[44] Brueggeman and Fisher, *supra* note 13, at 558-559.

[45] DeMichele and Adams, *supra* note 22, at 329-330 (hereafter, "DeMichele and Adams").

[46] See DeMichele and Adams.

The varying yields and payment priority allow for investors to purchase bonds based on their individual risk and reward requirements and tolerance. Also, CMBS have unique characteristics that set it apart from other securitized assets, which are discussed below.

- **Commercial Borrowers & Loan Terms**

  Unlike most residential borrowers, commercial borrowers tend to be highly sophisticated with cash flows based on the business operations of income-producing properties. Also, commercial real estate loans often differ from other asset types due to their non-recourse nature, which allows the lender to seize the collateral in cases where the borrower defaults, but not seek recovery from other assets.

- **CMBS Structure**

  CMBS are generally backed by fewer and larger-sized assets, which allows for greater review and diligence by all market participants on an ongoing basis. Specifically, this limited number of loans permits market participants to do a comprehensive review and analysis of each mortgage in the CMBS pool. The smaller number of commercial mortgages also allows for an extensive, non-statistical analysis of the CMBS pool in which investors, credit rating agencies, and other market participants can gather detailed information (for example, cash flows, quality of tenants) about the performance and risk of each commercial mortgage in the CMBS pool.

- **Greater Transparency through IRP Reporting**

  The CMBS market has standard reporting documents called the Investor Reporting Package (IRP), which continue to evolve with market changes. This in-depth package provides market participants with a wealth of information from property debt service coverage ratios to delinquency data. The existing IRP creates enhanced transparency by ensuring all CMBS market participants have the necessary information to evaluate risk in a uniform and timely manner.

- **B-piece Investor Review and Analysis**

  As previously mentioned, CMBS issuances are typically structured with a "first loss" or "B-piece" component. Under this structure, real estate investors who purchase the lower-rated bond conduct their own extensive review and analysis of each mortgage in the loan pool. The B-piece bondholders usually have the opportunity to negotiate the removal of any loans they consider to be problematic from a credit perspective.

- **Flexibility of CMBS**

  The CMBS structure usually allows for the modification or workout of a non-performing loan in order to maximize returns for bondholders.

The unique structures of CMBS along with existing credit risk analysis standards have enhanced the safety and transparency of the CMBS market. More notably, these safeguards continue to ensure the alignment of interests among all market participants, creating the cornerstone of a robust secondary commercial and multifamily real estate market.

State of Commercial Real Estate Lending. Having a sound and well-functioning commercial and multifamily real estate sector is critical to our country's economic growth and development, and to millions of U.S. businesses of all sizes that provide local communities with jobs, housing, and services. It is estimated that the commercial real estate sector supports more than 9 million jobs and generates billions of dollars in federal, state and local tax revenue.[47] Nonetheless, the overall economic downturn and crisis in the broader financial markets are directly hurting not only the fundamentals of commercial real estate finance, but also the outlook for recovery. And while the commercial and multifamily real estate markets play a vital role in the economy, these markets are now experiencing the worst liquidity challenge since the Great Depression.

Specifically, slow job growth and high unemployment levels continue to put pressure on the commercial and multifamily real estate industry, resulting in higher vacancy rates and lower property values. In fact, commercial property values are down between 30 and 50% since their peak in 2007.[48] This has created an "equity gap" for many property owners, where the outstanding balance of their loans is more than the present value of the commercial property. Many lenders are requiring property owners, including owners of "performing" properties that continue to support monthly payments, to provide additional equity as a requirement for refinancing. While 49% of the $346 billion of commercial mortgages due this year are underwater, Trepp predicts the underwater share of commercial loans reaching maturity in 2015 will reach a staggering 75%.[49] These circumstances, paired with nearly $1.2 trillion of anticipated commercial mortgage maturities over the next several years, create a challenging commercial and multifamily real estate finance environment.[50]

In the past, the CMBS market has been able to meet the refinancing needs of property owners when the banking sector failed to meet demand from commercial borrowers. The CMBS market currently represents nearly 26% of the outstanding balance of commercial and multifamily mortgages.[51] This is down from nearly 50% in 2007, when the CMBS market provided approximately $240 billion in financing.[52] In contrast, the CMBS market provided less than $13 billion in issuances in 2008 and $2 billion in 2009, despite strong credit performance and huge demand from borrowers. Although the CMBS market is showing some signs of a recovery, with $12.3 billion in new issuances in 2010, prolonged weak economic fundamentals continue to limit the CMBS market's capacity to refinance commercial loans.[53] In fact, the inability to secure refinancing will result in increased loan defaults and foreclosures, and the forced sale of many properties at greatly depressed prices, creating a ripple effect of financial losses and more job layoffs, threatening our nation's economic recovery.

2. Exemption for Qualified CRE Loan: Underwriting Standard Recommendations

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[47] Testimony of The Real Estate Roundtable before the U.S. Senate Committee on Environment and Public Works and Subcommittee on Oversight joint hearing on "General Services Administration: Opportunities to Cut Costs, Improve Energy Performance, and Eliminate Waste." (March 30, 2011).

[48] See CRE Finance Council testimony.

[49] Ulam, Alex. "Commercial Property Remains Strong Despite Dire Predictions," *American Banker* (July 12, 2011).

[50] North America CMBS Strategy, Morgan Stanley Research, April 12, 2011, p.1.

[51] Mortgage Bankers Association Commercial/Multifamily Quarterly Data Book, Q1 2011.

[52] See CRE Finance Council testimony.

[53] See CRE Finance Council testimony.

As mentioned earlier, the proposed rule provides for certain criteria for a commercial and multifamily real estate loans to qualify as low risk, and in turn, be exempt from 5% risk retention. Specifically, a qualifying commercial real estate (CRE) loan must meet over 30 different underwriting conditions in order to forgo the agencies' risk retention requirement. Our review of these underwriting requirements leads us to believe that this proposal is so narrowly focused that virtually no CMBS loans could qualify. Accordingly, in an analysis of these proposed underwriting standards, Morgan Stanley estimates:

> that if just three of these requirements are applied (LTV of 65% or less, DSCR of 1.7x or higher and an amortization period of 20 years or less at securitization), approximately 0.4% ($2.9 billion) of the $671 billion conduit loans that have been securitized since the beginning of the CMBS market would have qualified. If the rules were loosened to 1.5x DSCR, 70% LTV and 25-year amortization, 3% ($17.5 billion) would have qualified.[54]

Consequently, NAR is very concerned that the proposed thresholds for loans to be exempt from risk retention are too restrictive to apply to the majority of commercial and multifamily loans. This would effectively reduce the number of CMBS issuances – severely diminishing the amount of financing available to the commercial and multifamily sector. Furthermore, NAR believes that defining a low risk commercial loan by meeting a set of quantitative performance metrics does not exclusively guarantee the loan will be low risk. Qualitative features that are not readily defined by metrics, such as the location of the property and individual market conditions, can indicate whether a loan is low risk. Thus, we urge the use of a combination of both qualitative and quantitative measures as criteria for determining low risk loans.

NAR's specific underwriting recommendations related to the agencies' risk retention proposal are listed in greater detail below.[55]

Definition of a Commercial Real Estate Loan. REALTORS® work with a wide range of clients in the commercial real estate market, including C corporations, partnerships, limited liability companies, private investment funds, S corporations, and Real Estate Investment Trusts (REITs). Regardless of the way they operate their businesses for tax purposes, each client pursues unique objectives in the market, and secured lenders will judge them solely on the ability to repay a mortgage loan based on the cash flow from the underlying property.

Based on their experience in the market, our members were surprised to find that the proposed rule includes a broad exclusion of "a loan to a real estate investment trust (REIT)" from the definition of a "Commercial real estate (CRE) loan." Due to the construct of the proposed rule, a loan made to a REIT that meets the high underwriting standards the agencies propose for "qualifying CRE loans" would nevertheless be ineligible for inclusion in an asset backed securitization for which reduced risk retention requirements could apply. This would arbitrarily and unnecessarily increase borrowing costs for REITs and would exclude a significant pool of creditworthy mortgages from the CMBS market for no good reason.

Because CRE loans are nonrecourse and the mortgages are secured only by the revenues generated by the property, there is no reason to believe that a loan is inherently more risky simply because the borrower has elected to comply with the tax rules for REITs, just like it would make no sense in

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[54] North America CMBS Study, Morgan Stanley Research, April 12, 2011, p.4 (hereafter, "Morgan Stanley Research").

[55] Response to questions 156(a), 156(b), 157, 158 in proposed rule.

excluding S corporations. Yet, the agencies have proposed this inexplicable and unsupported distinction. In the final rule, the agencies should remove provision (2)(iii) from the proposed definition of "Commercial real estate (CRE) loan" under §__.16, so that no market participants are unnecessarily penalized solely based on how they elect to be taxed.

Amortization and Loan Term.[56] The proposed rule would require a qualified CRE loan to have a minimum term of 10 years with a straight-line amortization schedule not exceeding 20 years. NAR is very concerned with this provision because most commercial mortgages are amortized on a 30-year basis. In fact, a study by Morgan Stanley states that:

> The proportion of conduit loans originated since 1995 that have a 20-year or less amortization schedule at securitization is 2%, the proportion with an amortization of 25 years or less is 7%. The percent of a loan that amortizes in 10 years, on a 20-year schedule is 43%, under a 25-year schedule, 30%. Assuming a 65% LTV and a 20-year amortization schedule on a 10-year loan, property value would have to decline 63% before the debt incurred a loss (equity would be hit at a 29% property value decline). Under the same LTV and term assumptions, but with a 25-year amortization schedule, the property value could decline 55% before the debt incurred a loss (equity would be hit at a 20% property value decline).[57]

Also, the 10-year minimum loan term requirement does not recognize the economics of the industry, as many commercial loans have terms ranging between 3 and 7 years. Since very few commercial real estate loans are amortized straight-line over 20 years, NAR recommends the elimination of this unrealistic requirement. Similarly, we request the agencies to remove the 10-year minimum loan term, as it excludes a large number of commercial mortgages and is not necessary to identify low risk mortgages.

Debt Service Coverage Ratio (DSCR).[58] Under the proposed rule, only properties with a DSCR of at least 1.7 can qualify for the risk retention exemption. However, a 1.5 DSCR would be permitted for properties with a demonstrated history of stable NOI. NAR believes the proposed DSCR of 1.5 to 1.7 is too high, as the majority of commercial mortgages will not be able to qualify and that criterion is not necessary to identify low risk mortgages. Historically, a DSCR of 1.2 to 1.3 has been sufficient. Properties with a DSCR in this range generate between 20 to 30% more cash flow than what is necessary to cover all debt payments and operating expenses. A better test would be the minimum debt yield (NOI divided by the outstanding balance). Unlike the DSCR, debt yield is not dependent upon where interest rates are at the time the loan closes, and does not effectively impose a penalty based on amortization. NAR recommends a minimum debt yield of 12%, which is rather conservative, as market debt yields are currently around 10%.

Loan-to-Value.[59] The agencies have proposed that the combined LTV ratio (CLTV) of a qualified CRE loan cannot be more than 65%. A CLTV of 60% is permitted if the cap rate used in the appraisal is less than the 10-year interest rate swap plus 300 basis points. Restrictions based on cap rates do not warrant a change in LTV. Cap rates reflect the risk premium investors demand to invest

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[56] Proposed rule §__.19(b)(2)(iii), §__.19(b)(6)(i & ii), §__.19(b)(7)(i).

[57] See Morgan Stanley Research.

[58] Proposed rule §__.19(b)(2)(vi & vii).

[59] Proposed rule §__.19(b)(2)(vi & vii).

[59] Proposed rule §__.19(b)(5), §__.19(b)(6).

in commercial properties. As a result, properties with lower risk command lower cap rates and properties with higher risk command higher cap rates. The proposed rule differentiates LTV based on cap rates would result in weaker projects qualifying as low risk loans with lower LTVs, while stronger projects with lower cap rates would be subject to higher LTV restrictions. This appears counter to the intention of the rule. NAR recommends deleting the cap rate test.

NAR also recommends the agencies eliminate the CLTV cap, as it is not directly relevant to the credit backing the first mortgage. Instead, we recommend an LTV ratio for a qualified CRE loan of 65% or less at the time of the loan origination, and no more than 50% at loan maturity with valuation based on appraisal value at the time of loan origination. NAR believes the incorporation of an ending LTV concept eliminates the need to impose specific amortization and loan terms.

Qualified Tenant.[60] The proposed rule would require a qualified CRE loan to be secured by a commercial nonfarm real property that derives at least 80% of its revenue from "qualified tenants." A qualified tenant is defined as a lessee that is or was subject to a triple net lease.[61] Unfortunately, this does not accurately reflect industry practices. For example, the majority of office leases are full service gross (lessor is required to pay all building operating expenses), not triple net. These leases are typically short-term and common within industrial and retail properties. Therefore, NAR recommends the elimination of the qualified tenant requirement from the agencies' proposal.

Borrower Credit and Verification.[62] Under the proposed rule, originators for a qualifying CRE loan are required to verify and document whether the borrower has the resources to service their debt. However, NAR believes that the financial condition of the property sponsor is a more appropriate entity to review, as most CMBS borrowers are special purpose entities.

In addition, the proposed rule requires the originator to look forward 2 years and speculate the borrower's ability to pay its debts for the next several years. Not only is this difficult and burdensome to perform, it is not industry practice. A vast majority of commercial loans are non-recourse. Thus, borrowers effectively purchase the option to default, and it is assumed by industry participants that they will exercise their default option optimally. Here, ability to service the debt reflects only the ability of the property to generate sufficient NOI to service the debt.

NAR urges the agencies to eliminate the 2-year look forward provision in the proposed rule. Conversely, we support a 2-year look back of historical information on the property, with an exception for a shorter time period for newer properties.

Financial Disclosure.[63] The proposed rule for exempt commercial mortgages would require the borrower to provide to the originator and any subsequent holder of the commercial loan, and the servicer, the borrower's financial statements and supporting schedules on an ongoing basis. Instead of requiring the borrower's financial statements, NAR recommends that the agencies focus on the property's financial statements, which is consistent with current industry practice of property performance analysis.

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[60] Proposed rule §__.16(1& 2), §__.19(b)(2)(vi & vii).

[61] Triple net lease means a lease pursuant to which the lessee is required to pay rent as well as taxes, insurance, and maintenance expenses associated with the property.

[62] Proposed rule §__.19(b)(2)(i), §__.19(b)(2)(v & vi).

[63] Proposed rule §__.19(b)(3)(i).

Loan Interest Rate.[64] The proposed rule permits a qualified CRE loan to have an adjustable rate if the borrower obtains, prior to or concurrently with origination of the CRE loan, a derivative that effectively results in a fixed interest rate. However, industry practice allows interest rate caps as well as interest rate swaps. NAR recommends that the agencies focus on limiting the potential increase in debt service to a level not supportable by the property's NOI.

Collateral Restrictions.[65] Under the proposed criteria for a qualified CRE loan, a borrower would generally be prohibited from creating any other security interest with respect to any property that serves as collateral for the loan. However, the subordinate financing market is critical to many borrowers and the CMBS market in general. In addition, numerous real estate finance investors specifically invest in the subordinate financing space and many borrowers rely on that market.

Limiting or eliminating subordinate financing for borrowers in the CMBS market would result in excessive and unnecessary losses since borrowers would not be able to refinance existing CMBS or other debt. This will be very challenging for commercial borrowers, as demand to refinance will continue to rise steeply over the next several years. Therefore, NAR recommends that subordinate financing should be permitted subject to a maximum CLTV.

Buy Back Requirement.[66] Under the proposed rule, a sponsor that has relied on the qualifying CRE loan exemption will not lose it for the entire transaction if the sponsor repurchases the non-compliant loan(s) from the issuing entity at a price at least equal to the remaining principal balance and accrued interest on the loan(s) within 90 days after the determination that the loans do not comply, among other requirements. NAR requests that the agencies remove this provision, since the appropriate place to address the buy-back requirement is in the representations and warrantees.

3. Conclusion

While NAR is devoted to enabling a safe, transparent, and fully-functioning CMBS market, we believe policymakers should institute rules that will help restore confidence in the system, not stifle it. Unfortunately, the agencies' proposed underwriting requirements for a qualifying CRE loan fail to take into account the unique characteristics and economics of the CMBS market, and would significantly reduce access to capital for the commercial and multifamily industry. We believe NAR's underwriting recommendations will improve both transparency and confidence within the CMBS market, while achieving the goals of the Act and the proposed rule.

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[64] Proposed rule §__.19(b)(7)(iii).

[65] Proposed rule §__.19(b)(3)(ii)(A), §__.19(b)(4).

[66] Proposed rule §__.19(c).

XI. CONCLUSION

Some media pundits have grossly misunderstood NAR's underlying concern about both the Ability-to-Repay/QM proposed regulation and this Risk Retention/QRM proposal. The last thing REALTORS® want is to return to the unfair and unsustainable lending policies that created havoc in the housing and mortgage markets and serious problems for the economy. What we seek is a return to safe and sound mortgage lending, which requires moderation of the current over-correction in response to the abuses.

As noted in the NAR comment letter on the Ability-to-Repay/QM proposed rule,[67] REALTORS® are in exceptionally good positions to report on the challenges faced by consumers and creditors and, when necessary, to sound the alarm of problems in the mortgage market. In May 2005, we warned anyone who would listen (not many did) that consumers were being taken advantage of by intemperate, and often predatory, lending. NAR's 2005 policy includes the following statement:

> NAR supports strong underwriting standards that require all mortgage originators to verify the borrower's ability to repay the loan based on all its terms, including taxes and insurance, without having to refinance or sell the home. Lenders should consider all relevant facts, including the borrower's income, credit history, future income potential, and other life circumstances. Lenders should not makes loans to borrowers that make loss of the home through sale or foreclosure likely if the borrower is unable to refinance the mortgage or sell.

Earlier adoption of NAR's recommendations would have minimized the impact of abusive lending that flourished for too long. This May 2005 policy formed the basis for our comments on the 2006 and 2007 Interagency Supervisory Guidance on the risks of nontraditional mortgages and subprime mortgage abuses, as well as for our testimony before Congress.

Now REALTORS® are warning that the lending industry and the regulators have over-corrected in response to abuses in the middle of the previous decade. In November 2010, NAR called on the credit and lending communities and federal regulators to reassess the entire credit structure and look for ways to increase the availability of credit to qualified borrowers who are good credit risks.[68]

Accordingly, NAR urges you to reconsider your approach, in response to our concerns and the concerns of virtually every major entity involved in the housing industry, dozens of consumer groups, and a majority of the members of the Senate and the House of Representatives, and publish once again for public comment. As Exhibit 18[69] illustrates, while removing LTV and DTI from the QRM definition will increase the delinquency rate somewhat, NAR believes this is a reasonable trade-off to avoid denying homeownership to millions of creditworthy Americans and perpetuating economic instability.

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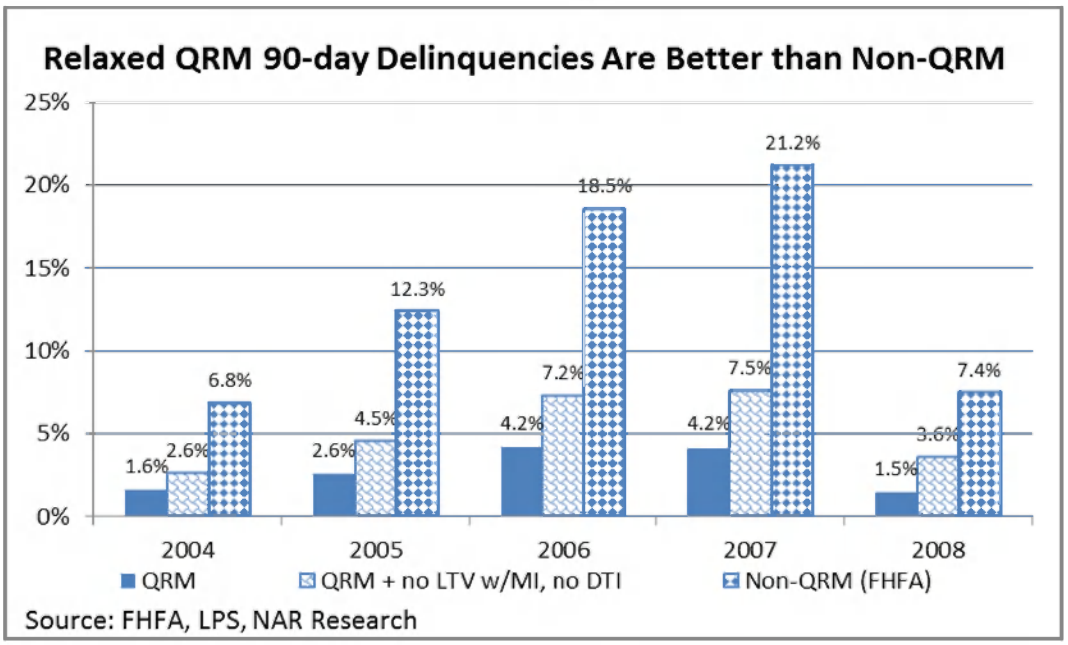
[67] http://www.ksefocus.com/billdatabase/clientfiles/172/3/1287.pdf.

[68] http://www.realtor.org/government_affairs/gapublic/fincredissues.

[69] See footnote 16 for mechanics of the LPS analysis. Due to deficiencies in the LPS dataset, the delinquency rate on non-QRM mortgages calculated by the FHFA in its March 31, 2011, Mortgage Market Note was used. The calculations from the LPS data likely reflect an upward bias relative to those calculated by the FHFA on the HLP data set because the HLP data set is made up solely of agency loans.

Exhibit 18



If you have any questions, please feel free to let me know or contact Jeff Lischer, NAR Managing Director for Regulatory Policy, 202.383.1117 or jlischer@realtors.org. or Ken Fears, NAR Manager, Regional Economics, 202.383.1066 or kfears@realtors.org.

Sincerely yours,

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