COMMITTEE ON CAPITAL MARKETS REGULATION

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Carl Kaminski, Senior Attorney
Legislative and Regulatory Activity
Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, DC 20219

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, NW
Washington DC 20051

Robert Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington DC 20429

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Alfred M. Pollard, General Counsel
Attn: Comments/RIN 2590-AA43
Federal Housing Finance Agency
1700 G Street, NW 4th Floor
Washington DC 20552

Robert Ryan, Deputy Assistant Secretary
Office of General Counsel
Dept. of Housing & Urban Development
451 7th Street, SW, Room 10276
Washington DC 20410-0500

Re: Credit Risk Retention, 76 Fed. Reg. 24,090 [OCC Docket No. OCC-2011-0002, RIN 1557-AD40; Federal Reserve Docket No. R-1411, RIN 7100-AD-70; FDIC RIN 3064-AD74; FHFA RIN 2590-AA43; SEC File Number S7-14-11, RIN 3235-AK96; HUD FR-5504-P-01, RIN 2501-AD53]

Dear Mr. Kaminiski, Ms. Johnson, Mr. Feldman, Ms. Murphy, Mr. Pollard, and Mr. Ryan:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the joint Proposed Rules[1] of the agencies regarding Credit Risk Retention under § 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2]

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform* (May 2009 Report), which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.[3] Since

[1] Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011) (hereinafter Proposed Rules).
[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 941(b), 124 Stat. 1376 (2010) (hereinafter Dodd-Frank Act).
[3] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), http://www.capmktsreg.org/research.html (hereinafter CCMR May 2009 Report).

then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

In its May 2009 Report, the Committee generally supported risk retention as an effective way to align incentives with investors, yet noted that it does not "make sense for all securitizations."[4] We also warned that mandatory risk retention "may have broad negative effects on the economy, including greater concentration of risk for financial institutions, higher capital requirements for lenders, increased borrowing costs for consumers, and reduced competition between depository institutions and finance company lenders."[5]

In our view, securitization is an important tool for providing credit but it should be neither unduly advantaged nor unduly disadvantaged by government regulation. Although we support risk retention in principle, we have concerns that the current risk retention proposal may make the securitization market less viable, which will in turn increase our reliance on the few large banks that are able to conduct significant on-balance sheet lending and on government support of credit, including support for residential mortgages and student loans.

We generally support the aspects of the proposal that provide participants with flexibility. Most notably, the proposal allows the required 5% retained risk to take the form of a horizontal slice (first-loss), a vertical slice (5% of each tranche), an L-shaped distribution (2.5% horizontal, 2.5% vertical), a representative sample, or one of several specific options for specialized structures.[6] We generally support the flexibility because it is not yet clear which option the market will favor or how each option will affect the incentives and pricing of offerings, particularly across asset classes. Not all of our members agree with this approach, however. It may be the case that different asset classes require more or less than 5% retention, certain forms of retention are more or less effective (particularly the horizontal first-loss method), or that an originator should be required to retain risk in a different way from a servicer. We urge you to commit to revaluating these questions once the market has had time to react to the changes and more data become available.

The proposal also sensibly contains different rules for different asset classes. For example, it exempts transactions involving certain residential mortgages, auto loans, commercial loans, and commercial real estate loans, as well as certain securitizations insured or guaranteed by the federal government.[7] This tailoring reflects the recognition, as we discussed in the May 2009 Report, that different structures and asset classes function and allocate risk differently from one another.

Our comments, which focus primarily upon the rules concerning residential mortgage-backed securities, first emphasize the need for a broad perspective and coordination, and then turn to specific concerns with the definition of "Qualified Residential Mortgage" and the premium capture cash reserve account.

[4] *Id.* at 144.
[5] *Id.*
[6] Proposed Rules Subpart B, 76 Fed. Reg. at 24,158–63.
[7] Proposed Rules Subpart D, 76 Fed. Reg. at 24,164–67.

Broad Perspective and Coordination

Risk retention is but one component of securitization reforms, and it should be viewed in the context of the overall approach to securitization. It is important to revive the securitization market as a viable mechanism to provide financing. That can only be done with coordination among the varied rules, regulatory agencies, congressional efforts, and policies of foreign countries.

The Dodd-Frank Act itself requires rules concerning other aspects of securitization, including asset-level disclosure,[8] representations and warranties,[9] due diligence,[10] and credit rating agencies.[11] The Federal Reserve wisely suggested that the agencies should "[c]onsider credit risk retention requirements in the context of all the rulemakings required under the Dodd–Frank Act, some of which might magnify the effect of, or influence, the optimal form of credit risk retention requirements."[12] In addition, the SEC has already proposed rules concerning risk retention; it should clarify the status of its proposal containing changes to Regulation AB.[13] Potential reforms of the government-sponsored entities should be considered, as well. Risk retention rules that are too strict will cause increased reliance on the government sponsored entities as sources of credit, which may make it more difficult to phase them out.

The agencies should also take a global perspective in order to ensure that the U.S. securitization market is competitive internationally. Basel III will alter the landscape as it purports to assign a 1250% risk weight to certain resecuritization exposures.[14] It remains to be seen how this provision will be implemented in the U.S. because it depends upon credit ratings, which Dodd-Frank prohibits being used in U.S. regulations.[15] In addition, the European Union already has its own risk retention requirements, which are similar in many respects to the rules proposed in the U.S. Article 122A of the Capital Requirements Directive requires the original lender, originator, or sponsor to retain at least 5% of the credit risk of the transferred assets.[16] That requirement may be satisfied with a vertical slice, horizontal first-loss tranche, or randomly selected exposures. There is, however, no equivalent provision for an L-shaped retention. Like the U.S.'s proposal, the E.U.'s rule exempts from the retention requirement certain transactions. Both sets of rules exempt certain transactions guaranteed by governments, but only the U.S. has specific exemptions by asset class, most notably for qualified residential mortgages.

[8] Dodd-Frank Act § 942.
[9] *Id.* § 943.
[10] *Id.* § 945.
[11] *Id.* §§ 931–939H.
[12] THE FEDERAL RESERVE BOARD, REPORT TO THE CONGRESS ON RISK RETENTION 84 (2010).
[13] Asset-Backed Securities, 75 Fed. Reg. 23,328 (proposed May 3, 2010).
[14] BASEL COMMITTEE ON BANKING SUPERVISION, STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR, 27 (2009).
[15] *See* Dodd-Frank Act § 939A.
[16] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 Amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC As Regards Bank Affiliated to Central Institutions, Certain Own Fund Items, Large Exposures, Supervisory Arrangements, and Crisis Management, (L302/110) Article 122a.

Definition of "Qualified Residential Mortgage"

We are principally concerned that the proposed definition of the term "Qualified Residential Mortgage" (QRM) is too narrow. The increased costs associated with retaining risk, particularly in connection with the accounting and capital requirements we will discuss below, will cause banks to be reluctant to originate mortgages that fall outside of the QRM exception. If that exception is too narrow, then the supply of mortgage credit could be unnecessarily constricted, which would in turn hamper the housing recovery. Indeed, fewer than 20% of the loans sold to Fannie Mae or Freddie Mac over the past decade would have met the standards now proposed for QRMs.[17]

For example, the current proposal restricts QRMs to borrowers who are "not currently 30 days or more past due, in whole or in part, on any debt obligation," and "[w]ithin the previous twenty-four (24) months,... [have] not been 60 days or more past due, in whole or in part, on any debt obligation."[18] These restrictions on credit history are unduly restrictive, particularly considering how easy it is for errors to arise in credit histories. One alternative would be to require, for borrowers who have missed payments in the past 24 months, subsequent timely performance for an extended period of 6 or 12 months. Another approach would be to use quantifiable underwriting criteria such as FICO scores. Although we recognize there are problems with using quantitative scores from a private entity, the proposal contemplates that originators will use credit reports from private entities to satisfy the proposal's credit history requirement.[19] In addition, the proposed test for the maximum debt-to-income ratio is too restrictive and could be relaxed.[20] Similarly, the loan-to-value ratio may be too high, especially for non-cash-out refinancings.[21]

Next, the proposal gives no benefit to having mortgage insurance, although the agencies did call for comments about this issue.[22] The Dodd-Frank Act called for the agencies to consider the relevance of mortgage insurance, "to the extent such insurance ... reduces the risk of default."[23] We think mortgage guarantee insurance, when issued by a creditworthy insurance company, reduces the risk of default for the simple reason that the insurer will conduct due diligence and will not cover borrowers who are not creditworthy. In other words, mortgage guarantee insurance, in addition to protecting investors from loss in the event of default, serves as a second check on a borrower's credit.

The proposed rule also requires an originator to include in the transaction documents containing certain servicing standards.[24] We appreciate the need for regulators to consider

[17] Proposed Rules Appendix A, 76 Fed. Reg. at 24,141.
[18] *Id.* § __.15(d)(5)(i), at 24,166.
[19] *Id.* § __.15(d)(5)(ii), at 24,166.
[20] *Id.* § __.15(d)(8), at 24, 166.
[21] *Id.* § __.15(d)(9)(ii), at 24,167.
[22] *Id.* Comment 111(a), at 24,119.
[23] Dodd-Frank Act § 941(b).
[24] Proposed Rules§ __.15(d)(13), 76 Fed. Reg. at 24,167. These standards include requiring the commencement of loss mitigation efforts after 90 days of delinquency; allowing for loan modifications or other loss mitigation alternatives if the net present value of such an effort exceeds the net present value of foreclosure; addressing how to service second liens; and requiring servicing compensation arrangements that are consistent with the loss mitigation requirements. *See id.* For an extended discussion of this issue, *see* Public Hearing on the State of the Securitization

national uniform servicing standards. But the risk retention proposal is not the appropriate vehicle for establishing such standards, and the Dodd-Frank Act reveals no Congressional intent, much less a requirement, to do so. Moreover, requiring specific servicing standards for QRMs but not for non-QRMs leads to the awkward result that the mortgages subject to these standards are the least likely to need them. The issue of national servicing standards should be taken up elsewhere, when full consideration can be given to the issue and where such standards can actually be applied uniformly rather than only to one segment of the market.

Premium Capture Cash Reserve Account

Similarly, the proposed rules require the funding of a "premium capture cash reserve account" that was not required by the Dodd-Frank; this requirement should be removed. According to the proposal, the premium capture cash reserve account would be designed to capture "excess spread" and "would be used to cover losses on the underlying assets before such losses were allocated to any other interest or account,"[25] including, apparently, the 5% retained risk.

This requirement is so onerous that the agencies expect "few, if any, securitizations" to be structured in a way that would require such an account.[26] Yet these structures were common before the financial crisis, and removing the opportunity for spread will severely disrupt the market by significantly reducing the opportunity to profit on a transaction and therefore eliminating the incentive to engage in such transactions at all. This could reduce the availability of credit and stall the housing recovery.

If a premium capture cash reserve account is maintained in the final rules, then the agencies must at least provide more details. First, the rules as proposed require funding the account with the difference between the gross proceeds, net of closing costs, and either 95% or 100% of the "par value."[27] Yet the proposal does not define the term "par value," and it is not entirely clear what it means in this context, particularly considering the comment that "a sponsor may have an incentive to inflate the value of the underlying collateral and the ABS supported by such collateral (for example, to increase the proceeds from the securitization transaction)."[28] Second, the rules should, but apart from closing costs do not appear to, exclude an originator's out-of-pocket costs associated with a transaction. Third, the size of the reserve account should be permitted to decrease in conjunction with the assets rather than maintaining a stable size to the end. This would more appropriately match the size of the reserve account to the risk in the underlying assets.

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Markets: Hearing Before the Senate Comm. On Banking, Hous. & Urban Affairs and Subcomm. on Sec., Ins., and Inv., 112th Congress (May 18, 2011) (statement of Tom Deutsch, Executive Director of American Securitization Forum), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=30644474-6612-42ce-856b-1f0a557675f5.

[25] Proposed Rules, 76 Fed. Reg.. at 24,113.
[26] *Id.* at 24,113.
[27] *Id.* § __.12(a), at 24,162.
[28] *Id.* at 24,102 n.58.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

Robert Glenn Hubbard

R. Glenn Hubbard	John L. Thornton	Hal S. Scott
Co-CHAIR	Co-CHAIR	DIRECTOR