C H A P A

Citizens' Housing and
Planning Association, Inc.

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RE: Proposed Regulations for Credit Risk Retention
12 CFR Part 244, docket No. 2011-411, RIN 7100-AD-70

Ladies and Gentlemen:

Thank you for providing this opportunity to comment on the proposed regulations for credit risk retention in accordance with the Dodd-Frank Act.

Citizens' Housing and Planning Association (CHAPA) is a statewide nonprofit organization that promotes affordable housing and community development throughout Massachusetts and New England. We have been involved in programs to help low and moderate income households become homeowners for more than 20 years, helping to design programs, overseeing sales and resales in affordable developments and as a regional intermediary for HUD pre- and post-purchase counseling agencies throughout New England. We've seen the fallout from the current foreclosure crisis close up and have helped revise state laws to better protect tenants and owners at risk of losing their homes. We also operate a program to facilitate the sale of foreclosed properties to responsible owners and have experienced all the challenges inherent in current servicing practices. Our members represent all segments of the housing market, including developers, consumers and tenants, bankers, community groups and state, local and federal officials.

We recognize the importance of addressing the problems in the residential mortgage market that contributed to the recent foreclosure crisis. Our comments primarily focus on mortgage backed securities and the proposed definition of a qualified residential mortgage (QRM).

Purpose of Risk Retention
Credit risk retention (Section 941 of the Dodd-Frank Act) is intended to better align the interests of securitizers with investors, by requiring them to share in losses if assets default. The Senate Banking Committee report noted broad industry support for it as a mechanism to restore investor confidence in all types of securitization.[1] By extension, it is also seen as a necessary step to revive private label mortgage securitization (PLS) and the role of the FHA and the GSEs in the mortgage market. However, that goal of increasing PLS market share (3% today[2]) must be balanced against the government's long-standing support for policies that support homeownership. The private market represented only 22% of the MBS market in 2003 and its subsequent growth relied on risky and abusive mortgages and complex financial instruments.

Role of Private Securitization in the Mortgage Market
The great uncertainty about the future role of government agencies in guaranteeing and securitizing residential mortgages makes it difficult to project how active the PLS market is likely to become in the next year and over the longer term and thus how much credit risk retention requirements and the definition of qualified residential mortgage (QRM) will affect the market. Our comments assume that the PLS market share will grow over time.

It is unclear what role private MBS will play in housing finance in the near future and how it will function. Many experts have creditably argued that while risk retention is important, alone it will not restore investor confidence in PLS (most securitizers in the recent crisis had a 5% interest through their ownership of the lowest rated tranches, directly or through their servicing affiliates.) The problems with PLS go far beyond risk retention[3] and additional regulatory restrictions will be needed to address them. These include the lack of transparency in the structure of private securitizations, the conflict between investors and securitizers who are reluctant to modify loans because of their roles as servicers and/or second lien holders, problems with credit rating agencies and the massive consolidation in the industry.

It is also unclear what role private MBS will play in the long run since there are still important differences between private (non-GSE, non-government agency) and GSE securities, in terms of underwriting standards and the way in which payments are distributed:

- PLS began as a way to securitize mortgages that didn't meet GSE standards and the growth in 2004-2006 was based on the development of increasingly risky mortgage products. While GSE mortgages had to meet published underwriting standards, there were no published standards for the mortgages underlying the PLS of recent years and it became difficult for investors to get good information on the quality of the underlying mortgages.
- Private securitizations have also been more complexly structured and thus more difficult for investors to understand. GSE securitizations are a simple pass-through (the interest and principal payments and losses are passed directly to investors, after servicing and GSE guarantee fees are deducted). By contrast, private MBS often allocated the payments from borrowers to different investors in different ways depending on the piece of income flow (tranche) that the investor bought and its priority relative to other tranches. Investors received lower interest rates than the risks would justify because it was difficult to understand the complex instruments and they lacked the good information on the quality of the underlying mortgages.
- The GSEs guarantee that the investors will receive timely payments of interest and principal, meaning their securities have no credit risk, PLS issuers do not provide a guarantee, meaning investors assume both the credit and interest risk.

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1 Senate Committee Report 111-176, pages 128-131.

2 "GSE Market Share Increases in 1Q", Kerri Panchuk, Housing Wire, July 1, 2011. http://www.housingwire.com/2011/07/01/gse-market-share-increases-in-1q

3 Kurt Eggert, "Beyond "Skin in the Game"": The Structural Flaws in Private-Label Mortgage Securitization That Caused the Mortgage Meltdown", prepared for the Financial Crisis Inquiry Commission hearing in Sacramento, CA, September 23, 2010 http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0923-Eggert.pdf

Economists agreed that securitization is necessary if the U.S. is to continue to support the widespread availability of 30-year fixed rate mortgages. *If* the government role in securitization is to diminish, PLS will have offer investors a low-risk product and higher risk instruments will have to be structured transparently so investors understand what they are buying. As detailed in a recent study by Levitin and Wachter, *this will require restrictions not only on the types of mortgages they securitize but actual structure of the securities*. They recommend that regulators "concentrate on ensuring sufficient standardization of MBS products—and by necessity, standardization of the underlying mortgage products—to make the disclosure of information about credit risk a meaningful basis for pricing."[4]

Effect of Risk Retention/ Definition of QRM
Economists and securities experts disagree on how fully 5% risk retention will address the problems in the private MBS industry[5] but most agree that the direct cost of risk retention is probably low (5-20 basis points for mortgages subject to the rule).[6] Indirect costs, however, are *potentially* high, depending on the definition of QRM and how the market reacts.

Based on the legislative history of the Dodd-Frank Act, we believe that the definition of QRM in the proposed rule goes beyond what Congress intended. While early versions of Dodd-Frank required risk retention for all MBS, the final law included language to explicitly encourage high quality mortgages by requiring an exemption for mortgages "with underwriting and product features that historical loan performance data indicate result in a lower risk of default". It listed numerous factors regulators might consider in defining QRM, including income documentation and verification, the consumer's ability to repay, features to limit payment shock and avoidance of high-risk products such as interest-only, negative amortization and balloon mortgages. It did *not* include loan to value (LTV) ratios.

The definition of QRM in the proposed rule defines low-risk in a way that will exclude most mortgages being written today. Proponents argue that this approach is necessary to ensure the development of a robust market for non-QRM mortgages. We disagree with this approach for several reasons.

- One concern, which is difficult to quantify, relates to the dangers of perception. Some argue that QRM may be treated as the definition of a "safe" mortgage and that lenders and investors may shun non-QRM mortgages, defeating the goal of reviving private securitization and shifting even more mortgage lending to government agencies.
- The second concern, both quantifiable and more important, is that the proposed definition will exclude many high-quality low-risk mortgages that could be included without seriously raising the risk of default. Appendix A of the proposed rule shows that even in today's highly conservative lending environment, only 30% of the loans purchased or securitized by the GSEs in 2009 meet the proposed definition, while 45% would qualify by eliminating the LTV standard alone and 54% would qualify by eliminating the debt-to-income (DTI) standards alone. The loan purchase table in that Appendix also shows that eliminating the LTV or DTI limits would not significantly raise default rates. It indicates that while mortgages purchased or securitized by the GSEs from 1997-2009 that met the proposed QRM standard had a 1.01% serious delinquency rates, adding in mortgages that deviated from the QRM standard just for LTV only raised the serious delinquency rate by 1.28% (i.e. total rate of 2.29%). Similarly, the serious delinquency rate for loans that met all QRM standards but the DTI limits was only 1.56% higher (for a total serious delinquency rate of 2.57%). By contrast, the serious delinquency rate for loans mortgages that met all QRM standards except product features was 4.85% (a difference of

4 Adam J. Levitin and Susan M. Wachter, "Information Failure and the U.S. Mortgage Crisis", Research Paper No. 10-19, University of Pennsylvania Law School, Institute for Law and Economics, October 2010, pp. 3-4. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1687301

5 Christopher James, "Mortgage-Backed Securities: How Important Is 'Skin in the Game'"?, *FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, San Francisco, CA, December 13, 2010 http://www.frbsf.org/publications/economics/letter/2010/el2010-37.html

6 FDIC officials estimate it will add 10 basis points to non-QRM mortgages; housing economist Tom Lawler estimated at most 20 basis points in a blog on CalculatedRisk.com on March 31, 2011; and the Massachusetts Housing Partnership estimated 5 basis points after reviewing their portfolio.

3.84%) and for those that met all standards except credit history, 4.70%.

Recommendations
If regulators decide to adopt a narrow QRM definition in order to create a large and robust market for non-QM mortgages, it may make sense to make the definition even narrower to reduce the perception problem and to adopting new terminology (e.g., "exceptional mortgages") to describe QRM.

If regulators decide to modify some of the QRM standards to increase mortgage cover, we recommend replacing the 20% downpayment requirement with a more reasonable minimum (perhaps 3-5%) given the current uncertain housing market and the reality that falling house prices were the largest single factor behind the recent foreclosure crisis (followed by irresponsible underwriting practices and mortgage products) and the current uncertain housing market. However, responsible soft-second mortgage programs and some types of mortgage insurance can and should be allowed to mitigate that risk. It might also make sense to allow some flexibility on the minimum based on local housing market trends.

Thank you for your consideration.

Karen B Wiener

Karen Wiener
Acting Executive Director