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October 30, 2013

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street, SW., Suite 3E-218 Mail Stop 9W-11
Washington, DC 20219
Docket No. OCC-2013-0010
RIN 1557-AD40

Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549-1090
Attn.: Elizabeth M. Murphy, Secretary
File No. S7-14-11

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551
Attn.: Robert deV. Frierson, Secretary
Docket No. R-1411

Federal Housing Finance Agency
Constitution Center, (OGC) Eighth Floor
400 7th Street, NW.
Washington, DC 20024
Attn.: Alfred M. Pollard, General Counsel
RIN 2590-AA43

Federal Deposit Insurance Corporation
550 17th Street NW.
Washington, DC 20429
Attn.: Comments, Richard E. Feldman
Executive Secretary
RIN 3064-AD74

Department of Housing and Urban Development
Regulations Division
Office of General Counsel
451 7th Street, SW., Room 10276
Washington, DC 20410-0500
RIN 2501-AD53[1]

Re: Credit Risk Retention; Proposed Rule

Thank you for this opportunity to comment on the Proposed Rule for Credit Risk Retention, and specifically to comment on the proposed definition of the Qualified Residential Mortgage (QRM) and related issues. The bulk of this comment addresses questions 89(a) and (b), "Is the agencies' approach to considering the QRM definition…appropriate? Why or why not?" and Question 90, "Does the proposal reasonably balance the goals of helping ensure high quality underwriting and appropriate risk management, on the one hand, and the public interest in continuing access to credit by creditworthy borrowers, on the other?"

Over the past two years, the UNC Center for Community Capital (CCC) has conducted research to understand the potential impact of QRM on access to credit and on risk, and we believe that **aligning QRM with the Qualified Mortgage (QM), as you propose, strikes the right balance between safety and soundness on the one hand and a healthy flow of mortgage credit on the other.** The revised proposed

[1] Janneke Ratcliffe and Kevin Park. Credit Risk Retention Proposed Rule. July 29, 2011. http://ccc.sites.unc.edu/files/2013/02/QRM_Comment_7-28-2011.pdf

rule recognizes that access to credit needs to be measured in the balance with safety and soundness. Aligning QRM with QM ensures both mortgage safety and ample access to credit, keeps mortgage rates affordable for more borrowers, reduces compliance costs, and accurately reflects congressional intent.

Applying the QM definition[2] alone leads to drastic reductions in the overall default rate[3] among a national sample of both prime and subprime loans. In contrast, narrowing the QRM definition beyond QM would cut out a major share of performing mortgages, while only marginally reducing default rates further. Generally, the basic QM definition achieves an optimal ratio between good loans accepted and defaults excluded. (Quercia, Ding and Reid, 2012, Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages.)[4]

In response to the original 2011 Proposed Risk Retention Rule's definition for QRM that also proposed a 20 percent down payment requirement and a strong credit history on top of the QM factors, CCC submitted commentary[5] (incorporated by reference). In that commentary, we expressed concern about the analysis used to justify the borrower-based factors proposed for several reasons:

- First, the analysis presented as part of the proposal was based on only Enterprise-acquired loans, a subset of loans that did not represent the overall market, nor the riskiest lending.
- Second, the original analysis did not factor in the impact of the then-under-review QM rule.
- Third, the measure used to justify the proposed borrower-based factor cutoffs was misleading. We urged caution in applying hard cutoffs for borrower risk factors, which run along a continuum. The original proposed rule analysis presented a ratio of defaults on loans above the cutoff to those below as justification for selecting the particular cutoffs, but we pointed out that a comparable result could be achieved for any of a number of different cutoff points.
- Fourth, we identified issues with each borrower based risk factors proposed, particularly the proposed 20 percent loan-to-value cutoff. We presented evidence that low down payment mortgages could be extended safely, and that a high down payment requirement would have disparate impact, unnecessarily creating barriers to homeownership for minority households and others with lower wealth – those who most benefit from access to well regulated and safely structured products.

The *Balancing Risk and Access* study referenced above was undertaken to present an alternative and more representative measure of various possible QRM definitions, and to do so in the context of the QM

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[2] Without applying the DTI cutoff. At the time of the study, the QM rule had not been finalized, so the analysis applied only the statutorily required product features to identify QM rules. Incorporating the debt-to-income cutoff would have reduced the QM-eligible default rate further. Loans designated as QM were those with full documentation, not interest-only or negative amortizing loans, do not include a balloon payment, do not have adjustable interest rates with fixed terms under five years, do not have a maturity of greater than 30 years, and do not include a prepayment penalty. We also exclude FHA loans from the QM product loan category. The analysis was limited to first lien, owner-occupied, single-family mortgage loans originated between 2000 and 2008. See paper for further details on data.

[3] Default is defined as 90+ day delinquency.

4 Roberto Quercia, Lei Ding and Carolina Reid. January, 2012. Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages. http://ccc.sites.unc.edu/files/2013/02/QRM_Underwriting.pdf

[5] Janneke Ratcliffe and Kevin A. Park. Credit Risk Retention Proposed Rule. July 28, 2011. http://ccc.sites.unc.edu/files/2013/02/QRM_Comment_7-28-2011.pdf

rule. To that end, the research examined the performance of a nationally representative group of both prime and subprime loans originated from 2000 to 2008. The study found that applying the QM definition by itself to this broad universe of loans reduced the overall default rate by nearly half, to a 5.8 percent level, during one of the worst housing crises in American history.[6] For comparison, nearly a third of conventional subprime loans analyzed defaulted.

However, applying high down payment requirements in addition would have excluded 60 percent of creditworthy borrowers. The results were particularly striking for African-American and Latino home buyers. A mandatory 20 percent down payment requirement would exclude about 75 percent of African-American and 70 percent of Latino borrowers who could be successful homeowners.

The analysis of various down payment and underwriting scenarios generally showed that the basic QM definition would achieve the optimal balance between reduced risk and access to credit. The revised proposed rules reflect that, and we strongly support defining QRM as a QM mortgage.

There are two additional comments we would like to make on the proposed rule.

First, the revised proposed rule references a new analysis by the U.S. Securities and Exchange Commission (SEC)[7] that suggests defaults may occur at a rate higher than found in *Balancing Risk and Access* under the QM=QRM scenario.

Specifically, the SEC analysis suggests that the new rules will result in a much higher default rate among their defined pool of QM loans. The difference in default rates can be explained by two key factors-- the SEC study does not fully capture the effect of QM and it looks at much narrower segment of the market:

- First, The SEC study includes loans with risky features linked to default – including hybrid ARMs and loans with prepayment penalties – as part of their QM sample, even though these features are actually restricted under QM.

- Second, the SEC study uses a very different and narrow sample of loans – only Private Label Security (PLS) mortgages originated primarily in 2004, 2005 and 2006, the height of the subprime crisis.[8] Such mortgages are the worst of the worst – evidenced by the fact that the SEC sample has an overall default rate of 45 percent compared to an 11 percent overall default rate for our study sample.

The SEC analysis, while providing important insight into the PLS market, is not predictive of how the QRM restrictions would improve default risk, just as analysis based on Enterprise-acquired loans only

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[6] Again, the QM rule had not been finalized, so the analysis applied only the statutorily required product features to identify QM rules. Incorporating the debt-to-income cutoff would have reduced the QM-eligible default rate further.
[7] Joshua White and Scott Baugess. August 2013. Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention. Division of Economic and Risk Analysis (DERA), U.S. Securities and Exchange Commission. http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf
[8] White and Baugess, p.4.

was inadequate. As the attached brief points out, analysis of the broader mortgage market is the best way to measure of the impact of the proposed rule: "The divisions between prime and subprime and between government-sponsored enterprise (GSE) loans and PLS loans that existed during the subprime boom, are not likely to prevail into the uncertain future. With GSE reform still ahead, we should not rely solely on non-GSE market activity to make inferences about market activity post reform." For a more in depth discussion of the SEC analysis, and the CCC's concerns about using that study as the basis for decision-making on QRM, please see the attachment *Risk, Access and the QRM Reproposal* by Carolina Reid of Berkeley and CCC's Roberto Quercia.

Second, the revised proposed rule also introduces an alternative approach, the "QM-plus approach" and asks, in question 97(a), "Does the QM-plus approach have benefits that exceed the benefits of the approach discussed above? And question 99 "...What other benefits might be obtained under the QM-plus approach?"

While *Balancing Risk and Access* did not test for the scope of all of the QM-plus elements, it does note that after applying a trio of less restrictive criteria than the QM-plus (e.g. LTV of 80 percent, FICO above 690, and DTI of 30 percent), "the vast majority of borrowers—approximately 85 percent—would not have qualified for a QRM mortgage." Moving the LTV to 70 percent would certainly exclude almost all performing loans in the sample. In effect, QM-plus would make risk retention the norm. This would potentially result in less fragmentation of the market, as a large portion of the market would be non-QRM eligible, and therefore more liquid. This scenario assumes that the narrower the QRM, the broader the pool of financing will be for non-QRM borrowers.

However, we cannot know whether this would be the outcome of a QM-plus approach, particularly given the fragility of the housing market. QM-plus could have unintended consequences and, given the uncertain future, undesirable ones. The risk of stifling credit flows to such a large share of the market does not seem adequately offset by commensurate risk reduction, at least not in the current environment. The agencies are correct to be concerned about imposing further constraints on mortgage availability, particularly those that would disproportionately impact lower wealth households, who tend to be younger or communities of color. Indeed, as new households of color will drive housing demand in the coming years,[9] such a rule could have serious consequences for the health of the market and larger economy for the long term.

As proposed, the QRM rule leverages the risk retention mechanism to reinforce the QM restrictions, which are largely product based. Putting creditworthy but less wealthy borrowers in the safest loan products has been demonstrated to reduce defaults[10] and should be the aim of reform.

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[9] George S. Masnick, Dnaiel McCue and Eric S. Belsky "Updated 2010-2020 Household and New Home Demand Projections" Working Papter W10-9 September 2010 Harvard Joint Center for Housing Studies www.jchs.harvard.edu/sites/jchs.harvard.edu/files/w10-9_masnick_mccue_belsky.pdf.

[10] Lei Ding, Roberto Quercia, Wei Li and Janneke Ratcliffe. Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models. Journal of Real Estate Research. Vol 33. No 2-2011. pp 245-277.

Further, we concur with the view laid out in the revised proposed rule that aligning QRM with QM will be least disruptive to normalizing the mortgage market. As the revised proposed rule notes, "setting a QRM definition that is distinct from the QM definition may interact with the raft of other regulatory changes in ways that are near-impossible to predict. ...the indirect costs stemming from the interaction of the QRM definition with existing regulations and market conditions are more difficult to quantify and have the potential to be large..."(pp. 263-264). Moreover, With GSE reform underway, it is difficult to predict what the market will look like down the road. We note that the agencies retain the right to make adjustments as the market evolves. Over time, evidence as to the availability and quality of credit for the non-QRM/non-QM market and the cost of risk retention would become available as the basis for determining the QRM.

By proposing the same definition for QRM as QM loans, regulators effectively align the two rules and potentially prevent additional fragmentation among different types of mortgages, which we believe is the best way to simplify compliance and facilitate a safe, robust housing market and sensible regulatory oversight.

High and sustainable levels of homeownership can be achieved without abandoned credit quality; indeed, the recent crisis has shown that it requires attention to good underwriting and servicing. Given the fragility of the current market, a broad QRM has the potential to restore access to credit more equitably, support broader homeownership and help the market recover, without compromising systemic safety and soundness.

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Risk, Access and the QRM Reproposal

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The authors acknowledge the contribution of Debbie Gruenstein Bocian of the Center for Responsible Lending to this article.

Summary

Financial institution regulators in August 2013 released a reproposal of the Credit Risk Retention Rule called for under the Dodd–Frank Wall Street Reform and Consumer Protection Act proposing to align the definition of the Qualified Residential Mortgage (QRM) with the Qualified Mortgage (QM) definition set forth under the Ability-to-Repay rule.[11] Regulators originally proposed a narrower QRM definition that would require borrowers to make substantial down payments to qualify – potentially excluding many qualified borrowers from mortgage access.[12]

To understand the potential effects of the rule originally proposed, the UNC Center for Community Capital and Center for Responsible Lending undertook an analysis of a nationally representative group of 19.5 million loans originated from 2000 to 2008, including both prime and subprime loans (Quercia, Ding and Reid, 2012).[13] The study, *Balancing Risk & Access: Underwriting Standards and Qualified Residential Mortgages*, found that applying the QM definition[14] by itself to this broad universe of loans reduced the overall default rate[15] by nearly half, to a 5.8 percent level. Additionally, our study found that further narrowing the QRM

[11] See Credit Risk Retention Proposed Rule (2013); Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, Department of Housing and Urban Development.

[12] See Credit Risk Retention Proposed Rule (2011); Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, U.S. Securities and Exchange Commission, Federal Housing Finance Agency, Department of Housing and Urban Development. https://www.federalregister.gov/articles/2011/04/29/2011-8364/credit-risk-retention

[13] Roberto G. Quercia, Lei Ding and Carolina Reid. January, 2012. Balancing Risk & Access: Underwriting Standards and Qualified Residential Mortgages. http://ccc.unc.edu/contentitems/balancing-risk-and-access-underwriting-standards-for-qualified-residential-mortgages/

[14] Without applying the DTI cutoff. At the time of the UNC Center for Community Capital/Center for Responsible Lending study, the QM rule had not been finalized, so the analysis applied only the statutorily required product features to identify QM rules. Incorporating the debt-to-income cutoff would have reduced the QM-eligible default rate further.

[15] Throughout "default" is defined as incurring a 90-day or greater delinquency.

definition using various down payment and credit score cutoffs, while reducing the overall default rate somewhat further, also cut out a major share of the mortgages that performed successfully. Our findings generally showed that the basic QM definition achieved the optimal balance between reduced risk and access to credit. This finding supports the reproposed QRM definition.

The reproposal references a report by U.S. Securities and Exchange Commission (SEC) economists who examined the impact of the various scenarios on a subset of loans in private label securities (White and Baugess, 2013).[16] While the SEC study provides additional analysis on the potential effects of QRM, the numbers are significantly different from those in our paper. Because of the importance of QRM to establishing a strong mortgage market that works for a broad range of U.S. households, it is worth reviewing the similarities and differences between our two studies. For example, we both find that a restrictive QRM definition would exclude a large percentage of loans; indeed, the SEC report finds that less than 1 percent of the loans in their sample would qualify under the original proposed QRM definition. However, unlike our study which finds a default rate of just 5.8 percent for QM loans, they report a much higher 34 percent default rate among their defined pool of QM loans.

This difference is due to two key factors. First, they include loans with risky features linked to default – including hybrid adjustable-rate mortgages (ARMs) and loans with prepayment penalties – as part of their QM sample, even though these features are actually restricted under QM. Second, the SEC study uses a very different and narrow sample of loans – only Private Label Security (PLS) mortgages originated primarily in 2004, 2005 and 2006, the height of the subprime crisis.[17] Such mortgages are the worst of the worst, evidenced by the fact that the SEC sample has an overall default rate of 45 percent compared to an 11 percent overall default rate for our study sample. The results from such a narrow slice of bad mortgages should not be used to determine policy for the overall mortgage market.

We maintain that analysis that considers the broader mortgage market is the best measure of the impact of the proposed rule(s) on access to credit and safety and soundness. The divisions between prime and subprime and between government-sponsored enterprise (GSE) loans and PLS loans that existed during the subprime boom are not likely to prevail into the uncertain future. With GSE reform still ahead, we should not rely solely on non-GSE market activity to make inferences about market activity post reform. When the broader pool of mortgages is considered, we find that QM effectively eliminates the worst performing mortgages and that stricter QRM guidelines provide only marginal benefits.

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[16] Joshua White and Scott Baugess. August 2013. Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention. Division of Economic and Risk Analysis (DERA), U.S. Securities and Exchange Commission. http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf

[17] White and Baugess, p.4.

In addition, our research highlights the importance of more explicitly considering access to credit in the QRM debate, particularly for lower-wealth borrowers and communities that historically have been undeserved by the mainstream credit market. Setting restrictive down payment requirements across the board will limit access to credit for a large percentage of U.S. households and have the largest impacts on communities of color. Homeownership and the housing finance system play a unique role in ensuring strong families, strengthening neighborhoods and boosting the overall economy. For this reason, it is critical to redesign the system to account for shifting demographics and changing consumer profiles and not exclude these families from the mainstream mortgage market going forward.

Background

Financial institution regulators in August 2013 re-proposed rules for defining Qualified Residential Mortgages (QRMs), the category of mortgages that will be exempt from risk retention requirements set out by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The regulators recommend using the same standard for QRM as they have for Qualified Mortgages (QM), the standard under which a loan is presumed to meet the ability-to-repay requirement. The QM definition excludes loans with product features that are associated with high subsequent defaults. By proposing the same definition for QRM as QM loans, regulators sought to align the two rules and to balance the goals of maintaining high credit standards with preserving access to affordable mortgages for creditworthy borrowers. In addition, the alignment of QM and QRM is likely to facilitate market activities and streamline oversight.

This is a promising advance from the original (2011) proposed rule, which called for a much narrower definition of a QRM – one that required a 20 percent downpayment and a strong credit history. Our analysis of 19.5 million loans originated between 2000 and 2008 found that the QM requirements alone eliminate a significant share of defaults (Quercia, Ding, Reid, 2012). Specifically, we found that imposing the QM requirements nearly halved the overall default rate of the sample, from 11 percent to 5.8 percent (before applying the QM debt-to-income requirement).[18]

While an overall default rate of 5.8 percent is still high by historical standards, it is important to remember that we are assessing default risk during a period of unprecedented market turmoil, in which households not only experienced house value declines in the order of 40-50 percent in some areas, but also the longest and deepest recession on record. Much of this turmoil was caused by the poor underwriting and risky loan product features that characterized the subprime lending boom. QM addresses these important areas of risk by ensuring that loans are underwritten to a borrower's ability to repay and by eliminating loan product features that significantly increase the likelihood of default.

[18] See footnote 4.

While imposing additional down payment or credit score requirements would reduce default rates even further, our analysis found that adding further requirements beyond QM would eliminate a large share of performing loans (which we define as QM-eligible loans that had not gone delinquent as of February 2011). To illustrate, when looking at the 7.9 million loans originated in 2004-2008 (the subset of loans that we matched to Home Mortgage Disclosure Act data and that cover the peak of the mortgage boom and bust), adding a requirement of a 10 percent down payment would reduce the QM-loan default rate from 5.8 percent to 4.7 percent.[19] However, this reduction in the default rate would only be achieved by excluding nearly one-third of QM-eligible performing loans. Importantly, our study finds that a down payment requirement would fall particularly hard on lower-wealth borrowers and would restrict access to credit for 60 percent of African American and 50 percent of Latino borrowers who are currently successful homeowners from obtaining mainstream mortgages.[20]

Based on these data, we commend the alignment of QRM with QM. To the regulator's question: "Does the [re]proposal reasonably balance the goals of helping ensure high quality underwriting and appropriate risk management, on the one hand, and the public interest in continuing access to credit by creditworthy borrowers, on the other? (p.271)," our analysis indicates "Yes."

In a related analysis cited in the reproposal, "Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention," U.S. Securities and Exchange Commission (SEC) economists analyzed the impact of QM and originally proposed QRM rules on a subset of loans issued in private label securities (PLS). By examining PLS loans, the SEC study contributes to our understanding of the performance of different loan classes. However, because they focus on only a small slice of the mortgage market (and, in fact, the segment of the market with the worst lending standards and poorest performance), their results differ significantly from those presented in our paper.

We believe it is important to examine the reasons for the differences between the SEC study and our own and to emphasize the importance of looking at data across the broader mortgage market to evaluate the potential impact of QRM. Below, we outline our three major concerns with the SEC study regarding its relevance to the QRM rule-making process.

I. The SEC paper includes loans with risky product features in its QM sample even though these features are limited by the QM rule. As a result, the paper overstates the risk of QM loans and the marginal benefit of narrower QRM standards.

One of the core arguments in the SEC paper is that the default risk for QM loans in their PLS sample is 45 percent and that imposing additional QRM restrictions would lower defaults to more acceptable levels. However, the SEC paper includes certain loans with risky characteristics,

[19] Because we examine the performance of both refinance and purchase loans, we assess the impact of different LTV thresholds (measured at origination) rather than actual down payment amounts.
[20] See footnote 4.

such as hybrid adjustable-rate loans and loans with prepayment penalties, into their QM universe despite the fact that such loans would be ineligible for QM designation. By including such loans in the QM category, they significantly inflate the default rate of QM loans and overstate the subsequent benefits of stricter QRM guidelines.[21]

One of the most harmful abuses of the subprime market was the widespread use of adjustable, short-term interest rates, which lenders sold to borrowers without regard to their long-term affordability. As noted by the Federal Deposit Insurance Corporation, "Between 2004 and 2007, significant volumes of hybrid ARMs were originated to borrowers who did not have the ability to repay the loans according to their terms."[22] In order to meet QM guidelines, adjustable-rate loans must now be underwritten to their highest possible rate in the first five years, not just the starting rate, making them unlikely to qualify under the QM debt-to-income ratio. However, the SEC authors include 2-28 and 3-27 hybrid adjustable-rate mortgages within their QM bucket. While we do not know what share of the loans included in their QM-eligible classification were actually hybrid ARMS, and the authors do not report on the default risk associated with this feature (or even with adjustable-rate loans in general), we do know they represented a sizeable share of the overall PLS market and performed significantly worse than other loans.

Additionally, their analysis does not account for QM restrictions on prepayment penalties. Prepayment penalties were widely used by subprime lenders to lock borrowers into high-rate, abusive loans, and research has shown that loans with prepayment penalties are far more likely to default than those without.[23] Prepayment penalties are severely restricted in the QM guidelines and virtually no prepayment penalties that were issued during the time frame studied by the authors would have met these restrictions.[24] Again, the SEC authors included mortgages with

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[21] The SEC study also includes other types of loans within their calculations that are likely to affect their findings and lead to the differences in the reported QM default rates between our two studies. For example, the SEC analysis appears to include both first and second liens in their reported default rate. Because many of these second liens were simultaneous with first liens ("purchase money seconds"), it is likely that one borrower's default could result in a double count of mortgage defaults – both the first and the second – artificially raising the default rate. It is unclear how the second liens are distributed between the non-QM, QM and QRM categories; however, it seems likely that loans with purchase money second liens are more likely to be excluded from the QRM category because of combined loan-to-value limits, thus exaggerating the gap between QM and QRM defaults. In addition, in contrast to our work, the SEC study includes loans on non-owner-occupied housing. Others things equal, the authors find that loans on non-occupied housing are associated with a 10 percent increase in default in the QM-eligible set of loans, thus contributing to the high default rate in their QM set. In a declining market, non-owner-occupied loans are more likely to default since investors are less likely to prioritize the use value of the home and strategically default when their returns are no longer assured. While investor-owned properties are not excluded in QM, the difference in treatment of non-owner-occupied housing between the two papers may account for some of the difference in results.

[22] Federal Deposit Insurance Corporation. Supervisory Insights: Hybrid ARMs: Addressing the Risks, Managing the Fallout. http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/article01_Hybrid.html

[23] Indeed, the SEC authors' own models show that prepayment penalties have a strong and significant impact on default rates. In their multivariate analysis, they find that the presence of a prepayment penalty has a significant and material (+~10%) impact on default.

[24] Prepayment penalties are prohibited for higher-priced and adjustable-rate loans, the majority of historic PLS loans. The maximum possible penalty must be included in points and fees, which are limited to 3 percent for QMs; most PLS prepay penalties exceeded that limit.

this feature in the QM category, likely contributing to their over-estimation of the QM delinquency rate. Prepayment penalties were also extremely common in the PLS sector.

The misclassification of hybrid ARMs and loans with prepayment penalties in their QM definition not only overinflates the default risk of the QM market, it also means that the SEC overstates the benefits of additional QRM restrictions. There is a strong correlation between loan product features and borrower's risk profiles, including their credit score and their combined loan-to-value (CLTV). This means that a large share of the benefits that the SEC paper ascribes to stricter QRM standards would be achieved through QM. Moreover, even their study confirms that the more restrictive QRM definition would have excluded a large majority of loans from the market; the SEC report finds that less than 1 percent of the loans in their sample would qualify under the original proposed QRM definition.

II. The SEC study analyzes mortgages securitized by private-label securities (PLS), which is not representative of the broader mortgage market.

Another concern we have with the SEC study is that the analysis relies on a small subset of data comprising mortgages from PLS pools and does not consider either loans held in portfolio or loans securitized by the GSEs. As the authors themselves point out, PLS loans have much higher default rates across the board than GSE loans (the total sample they examine has a 45 percent serious delinquency rate, compared to 5.3 percent for GSE loans). Our sample, which includes a broad cross-section of prime and subprime loans, including PLS and conventional, has an overall default rate of just 11 percent. Indeed, the PLS sample default rate of 45 percent suggests that these mortgages were the worst of the worst – originated at the height of the subprime boom in markets such as California, Florida, Nevada, and Arizona, markets which saw house values decline by over 40 percent, layered with non-traditional product features that increased the risk of default, and largely issued through broker and wholesale channels rather than retail lending outlets.

While it is helpful to see an analysis of data on this market segment, the SEC study should not be read as indicative of how QM would impact the overall market or how additional QRM restrictions would improve default risk. Furthermore, as the authors point out, only 16 percent of their PLS data has complete information to do their analysis, and this subsample is not even representative of their larger dataset. Importantly, their own analysis suggests that, as a result, they are likely overstating the impact of including CLTV on delinquency rates.[25]

The broader historical market – including both prime and subprime loans – is the best measure of the impact of the proposed rule(s) on access to credit and safety and soundness. While several analyses confirm that QM loans perform much better than non-QM loans, the baseline default figures vary widely depending on the subgroup of loans used. For example, an analysis of loans made from 2005-2008 in CoreLogic's database that found that QM-eligible loans had roughly

[25] See White and Bauguess p. 29-30.

half the default rate (90+day delinquency) of those that did not (23 percent vs. 44 percent).[26] By contrast, analysis of GSE loans made from 1997 to 2009 shows overall default rates overall of less than 6 percent.[27] A more recent analysis of CoreLogic data and Fannie Mae-reported data by the Urban Institute finds a 25.5 percent default rate on PLS mortgages through 2013, which falls to 12.62 percent for loans meeting the QM standard, and an overall default rate of just 4.87 percent for Fannie Mae loans through 2012 (that falls to 3.66 percent for QM-eligible loans).

The divisions between prime and subprime and between GSE loans and PLS loans that existed in the run up to the crisis are not likely to prevail into the uncertain future. As currently proposed and as long as the GSEs are backed by the government, GSE loans are deemed to meet the risk retention requirement, and loans eligible for GSE purchase are automatically designated as QM for the time being. However, with GSE reform under way, it is difficult to predict what the market will look like down the road. As the reproposal notes, "setting a QRM definition that is distinct from the QM definition may interact with the raft of other regulatory changes in ways that are near-impossible to predict. …the indirect costs stemming from the interaction of the QRM definition with existing regulations and market conditions are more difficult to quantify and have the potential to be large…"(pp 263-264).

By proposing the same definition for QRM as QM loans, regulators effectively align the two rules and prevent additional fragmentation among different types of mortgages, which we believe is the best way to facilitate a safe, robust housing market and sensible regulatory oversight.

III. Our analysis provides powerful evidence that the QM standard adequately reduces risk while maintaining access to affordable mortgages for America's families.

The objective of weighing the marginal benefit of stricter QRM requirements against the costs of cutting off access to the mainstream mortgage market is an important one. One of the key goals of our paper was to estimate the impact of stricter QRM standards on access to credit, particularly for lower-wealth households and borrowers of color. Our paper constructed two simple metrics for evaluating the tradeoffs of reducing the number of defaults against the number of successful borrowers who would not be able to obtain a QRM loan as a result of stricter down payment and credit score requirements.[28]

Not surprisingly, we find that stricter down payment and credit score standards do lead to lower default rates, but once QM is in place, these reductions in default rates are marginal compared to how many performing loans would be excluded from the market. One measure of this is our

[26] Credit Risk Retention, 2013. P.258

[27] Credit Risk Retention, 2011.

[28] For the full details about the data and methodology, see Roberto G. Quercia, Lei Ding and Carolina Reid. January, 2012. Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages. http://ccc.unc.edu/contentitems/balancing-risk-and-access-underwriting-standards-for-qualified-residential-mortgages/

"exclusion ratio," which is calculated as the number of performing loans that would be excluded by requiring a given down payment for each default prevented. For example, we find that setting a 10 percent down payment requirement would have restricted access to credit for nine borrowers who are currently performing on their mortgage to prevent just one foreclosure; the exclusion ratio for a 5 percent down payment is, by contrast, 6:1.

Figure 1. Exclusion Ratios

Number of Performing Loans Excluded: Number of Foreclosures Prevented

Proposed Standard	Exclusion Ratio
QM + 20 Percent Down Payment	10: 1
QM + 10 Percent Down Payment	9:1
QM + 5 Percent Down Payment	6:1

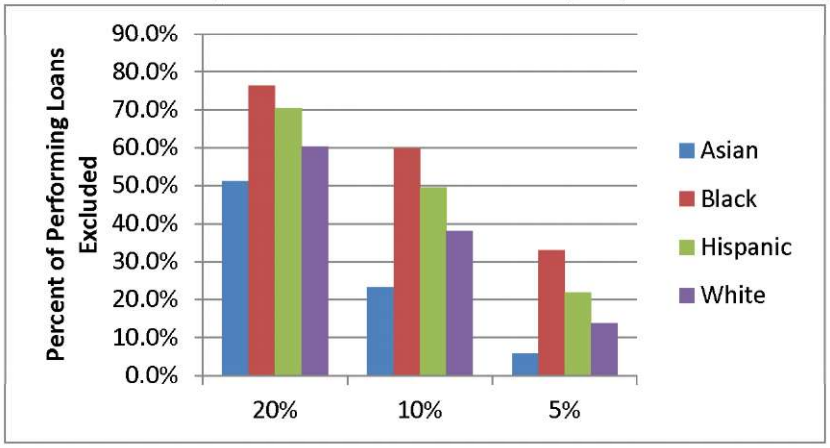
Source: Figure 7 from *Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages,* available at http://ccc.unc.edu/contentitems/balancing-risk-and-access-underwriting-standards-for-qualified-residential-mortgages/.

In general, our analysis shows that the higher the down payment requirement, the more likely QRM would exclude borrowers from the market who have demonstrated their ability to pay their mortgage – despite one of the worst economic and housing downturns in our history – for only marginal improvements in the default rate.

In interpreting these ratios, it is important to note that our study was completed before the final QM rule was issued and, therefore, does not include the DTI standard as part of the QM definition. Inclusion of DTI into the QM standard would lower the default rate for QM loans and would likely lessen the impact of any additional QRM standards on delinquencies, strengthening our argument that aligning QRM with QM achieves the optimal outcome.

In addition, we show that stricter QRM guidelines would have a disproportionate impact on lower-wealth borrowers, including low- and moderate-income households and households of color. For example, we show that the impact of a 10 percent down payment requirement would be particularly acute for African American and Latino home buyers. Such a requirement would have excluded about 60 percent of African-American and 50 percent of Latino borrowers who are currently successful homeowners from obtaining mainstream mortgages. Thirty-three percent of successful African American borrowers and 21 percent of successful Latino borrowers would have been unable to obtain a mortgage with a 5 percent down payment requirement.

Figure 2. Percent of Performing Loans Excluded from the QRM Mortgage Market, Alternate LTV Definitions, by Borrower Race/Ethnicity[29] (2004–2008 Originations)



Source: Figure 8 from "Balancing Risk and Access: Underwriting Standards and Qualified Residential Mortgages, http://ccc.unc.edu/contentitems/balancing-risk-and-access-underwriting-standards-for-qualified-residential-mortgages/

The SEC study authors provide a valid critique of our ratios, noting that they do not have an "economic interpretation" and that they do not rely on econometric analysis.[30] However, despite their simplicity (or, perhaps, because of it), they provide a vivid illustration of the real tradeoffs between risk reduction and restrictions in access to credit.

QM protects both borrowers and markets from the abusive lending practices that were prevalent during the subprime boom – the evidence of the risk of these practices can be found in the extraordinarily high rates of default in the PLS market. Restricting these features, as well as requiring that lenders underwrite to a borrower's ability to repay (and at the same time consider factors that influence default, including down payments, as part of common sense underwriting), will do much to ensure the safety and soundness of mortgage lending going forward. By contrast, the real risk of establishing a more restrictive definition for QRM is that many qualified households – and particularly lower-income households and households of color – will be excluded from the mainstream mortgage market. Ultimately, the weight of the evidence in our paper suggests that aligning QM with QRM achieves the real goal: a safer mortgage market for all American households.

[29] Loan status as of February 2011.

[30] The SEC study goes on to conduct a similar analysis with their data. In addition to the critiques outlined above in how they constructed their QM sample, we also take issue with how they measure the potential impact of QRM on the size of the mortgage market. They focus on the total dollar loan volume in contrast to our measure, which focuses on the number of loans originated. Focusing only on loan volume underestimates the impact on lower-wealth households, since the measured costs of a proposed guideline that cuts off access to 10 $100,000 loans would be considered the same as cutting of access to one $1 million loan. As informative as the dollar volume may be, it does not say much about the impacts of the QRM definition on the access to credit of different segments of the market.