Comment on the proposed Credit Risk Retention Rule

October 30, 2013

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Office of the Comptroller of the Currency(OCC)
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Washington, DC 20219
Docket Number OCC-2013-0010

Robert deV. Frierson, SecretaryBoard of
Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R—1411

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

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
File Number S7-14-11

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Attention: Comments/ RIN 2590-AA43
Federal Housing Finance Agency
Constitution Center, (OGC) 8th Floor
400 7th Street, SW
Washington, DC 20024

Regulations Division
Office of General Counsel
Department of Housing and Urban
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451 7th Street, SW, Room 10276
Washington, DC 20410

Re: Credit Risk Retention Re-proposal

Dear Sirs and Madam:

The Dodd-Frank Act was intended to restore sound underwriting practices. Enacted over three years ago, it introduced three new factors into housing finance: (1) a high quality mortgage—called the Qualified Residential Mortgage (QRM)—that would have a minimal incidence of default; (2) a set of minimum mortgage standards called the Qualified Mortgage (QM); and (3) a requirement that the securitizer of any mortgage not a QRM retain at least 5 percent of the risk of any mortgage pool it sponsors. The terms of the QM were specified by the Consumer Financial Protection Bureau in January 2013, and the proposed terms of the QRM were specified in an August 28 release by the six agencies[1] charged with responsibility to design the QRM.

In framing the QRM-QM concepts, Congress sought to implement a simple idea: protect the financial system from another mortgage-induced collapse by controlling mortgage quality. The QM was intended to create a minimum credit standard— investors would be protected from borrower legal challenge only if the mortgage met certain minimum standards—while the QRM was intended to be a mortgage of unquestioned quality, the functional equivalent of a traditional

[1] The Federal Reserve, Comptroller of the Currency. FDIC, SEC. Federal Housing Finance Agency and Department of Housing and Urban Development

prime mortgage. We believe Congress took this step because they recognized that creating a stable housing finance market depended on a return to the use of traditional underwriting standards, as articulated by then-FDIC Chairman Sheila Bair shortly before the Dodd-Frank Act was adopted:

> Traditional mortgage lending worked so well in the past because lenders required sizeable down payments, solid borrower credit histories, proper income documentation, and sufficient income to make regular payments at the fully-indexed rate of the loan. Not only were these bedrock principles relaxed in the run-up to the crisis, but they were frequently relaxed all at once in the same loans in a practice regulators refer to as "risk layering."
>
> As all of you know, the long-term credit performance of a portfolio of mortgage loans can only be as sound as the underwriting practices used to originate those loans.[2]

In the Credit Risk Retention Re-Proposal (the Reproposal), the six agencies, by regulatory action, effectively eliminated the QRM; only the standards of the QM remain. Instead of outlining a traditional low default risk standard for QRM mortgages, they made the QRM essentially the equivalent of the QM. Initially, they sought a QRM that demonstrated "low credit risk even in stressful economic environments;"[3] now, they propose a QRM that meets only the bare minimum standards of the QM. This is a violation of the clear intent of the act, and will open the agencies to legal challenge if they proceed to finalize their most recent proposal. By itself, as we will show, the QM is insufficient to support the credit quality on which a stable mortgage market depends, and will lead to precisely the result that the QRM standard was intended to prevent—a return to the policies that created the housing bubble, the mortgage meltdown and ultimately the financial crisis.

For example, the agencies admitted in their joint release that, in the case of mortgages originated between 2005 and 2008 that would have met the QM standard, 23 percent subsequently became seriously delinquent or defaulted. Accepting a 23 percent rate of delinquency and default for the QRM is a stunning reversal from the QRM standard set by these same agencies in their first proposed rule. [4] To put this 23 percent default rate in perspective, loans underwritten according to the traditional underwriting standards would have had a cumulative default rate of about 4.5 percent between 2005 and 2008, about one-fifth the rate of loans meeting the QM standard.[5]

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[2] Remarks by FDIC Chairman Sheila C. Bair to the Wharton School, University of Pennsylvania International Housing Finance Program; Philadelphia, Pa.
June 18, 2010, http://www.fdic.gov/news/news/speeches/chairman/spjun1810.html

[3] Original proposed QRM rule, p. 101.

[4] P 258 of Reproposal

[5] In March 2013, Freddie Mac released a Loan Performance dataset containing 15 million fixed rate fully documented 30 year mortgages that had been acquired by Freddie between 1999 and 2011. We examined loans that meet traditional underwriting standards as they existed in the late 1980s. We define a traditional prime mortgage with reference to underwriting standards in place in 1990, as confirmed by a random sample of 26,000 mortgages that Fannie Mae acquired between 1988 and 1990. Freddie Mac had similar underwriting standards during this period. In terms of LTVs, ninety-one percent of home purchase loans had a LTV of 90 percent or less, ninety-three percent of non-cash out refinances had an LTV of 80

The preferred response, in our opinion, is to implement the Dodd-Frank Act by creating a combination of the QM and a standard for a traditional prime mortgage that Congress intended for the QRM. For this reason, we have filed this comment with the agencies, detailing how it is possible to comply with the clear language and intent of the act and still provide a flexible set of standards for prime mortgages—which have low credit risk even under stress.

That the Reproposal could emerge from agencies with responsibility for the safety and soundness of the financial system is a sobering reminder of how quickly credit lessons can be supplanted by other issues. This became clear when the agencies admitted that they are "concerned about the prospect of imposing further constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect groups that have historically been disadvantaged in the mortgage market, such as lower-income, minority, or first-time home buyers."[6] The agencies' abandonment of a low risk standard was confirmed when they admitted that loans meeting the standards of QM would have had a 23 percent rate of default between 2005 and 2008.

Abandoning mortgage quality standards in the interest of expanding credit availability might be a regulatory goal if it could be done without sacrificing mortgage market stability, but the mortgage meltdown and the financial crisis shows that it cannot. Congress understood this and framed the Dodd-Frank Act accordingly. Reducing underwriting standards, in addition to creating instability in the financial system, doesn't even help its intended beneficiaries. Indeed, Barney Frank, one of the key drafters of the Dodd-Frank Act and a long-time supporter of the affordable housing goals, eventually recognized that this was an enormous error, stating in August 2010: "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[7] That, however, is the direction the agencies are taking by eliminating effective credit standards for the QRM, and reducing the QRM to the minimal standards of the QM.

The Data Demonstrates Credit Performance

If the agencies' assumption is that the requirements of a QM mortgage alone will be sufficient to protect the stability of the financial system, it is incorrect. Data has now become available that allows us to show how mortgages created under the QM standards would perform under both normal and stress conditions.

In March 2013, Freddie Mac released a loan performance dataset containing 15 million fixed rate, fully documented, 30 year mortgages that had been acquired by Freddie between 1999 and

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percent or less, and ninety-two percent of cash out refinances had an LTV of 75 percent or less. In addition, borrowers had good to excellent credit histories (today this would be represented by a FICO score of 660 or greater), and a total debt-to-income ratio (DTI) of 43 percent or less. Nonprime were generally missing one or more of these characteristics: they might have had a higher CLTV or DTI or a lower FICO score.

[6] P 263

[7] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, available at http://www.gopusa.com/commentary/2010/08/23/kudlow_barney_frank_comes_home_to_the_facts/ (accessed September 23, 2013).

2011 ("Freddie dataset"). This release included 15 million loans (53 percent of all loans made by Freddie during this period) and contains data about LTVs (i.e. down payments), FICO scores, debt-to-income (DTI) ratios, combined LTVs and loan purpose (purchase, rate and term refinance, or cash out refinance). The remaining $13 million not released consisted of higher risk loans, the preponderance of which date to 1999-2007. These include adjustable rate mortgages, interest-only mortgages, and mortgages acquired under affordable housing programs. The exclusion of these riskier loans means that the dataset very likely consists of the best loans available in the market during this period. Using this dataset we can determine, for example, how the purchase loans in the 1999 cohort with particular credit characteristics performed between 1999 and 2012 (in general. these loans benefited from 7 years of unusually strong home price gains), and how the mortgages in the 2007 cohort performed in the stress conditions between 2007 and 2012 (in general these loans suffered from 5 years of home price declines). As a result, we can predict with a high degree of confidence how various mortgages that would be permissible under QM (and now QRM) will perform in the future if QM standards are the only underwriting standards in effect.

The QM's primary reform would require the lender to determine that the borrower is able to repay the loan at the time the mortgage is agreed, and that after the loan has been closed the borrower will not have a debt-to-income ratio that exceeds 43 percent.[8] It would also eliminate: (i) mortgages with negative amortization, balloon payments or no amortization (interest only); and (ii) mortgages that lack adequate documentation, exceed 30 years in duration, and involve points and fees that exceed 3 percent. However, unlike the original QRM proposal, it contains no requirement for down payment, loan purpose, or any demonstrated level of a borrower's prior credit performance. Even the 43 percent debt-to-income limitation is insufficient, as discussed below.

Thus, a home purchase loan that qualifies under QM could have a 580 FICO credit score, no down payment, and a 43 percent DTI. A loan in the 1999 cohort of the Freddie dataset with a 580, a down payment of 3 percent, and a DTI of 43 percent or less, would have conformed in every way to the QM-QRM requirements. Yet a loan of this kind had a 10 percent failure rate even after benefiting from over seven years of unusually large home price increases. And loans from the 2007 Freddie cohort with a 580 FICO credit score, no down payment, and a 43 percent

[8] However this 43 percent limitation is largely illusory. First, the Dodd-Frank Act granted FHA the authority to set its own definition of QM. On September 30, 2013 FHA announced its proposed QM rule, which adopts in whole FHA's current underwriting standards, which routinely allow for DTIs in excess of 43 percent. Second, the CFPB exempted Fannie Mae and Freddie Mac approved loans from the 43 percent requirement. The CFPB's action was another reminder of how quickly credit lessons can be supplanted by other concerns: "In light of the fragile state of the mortgage market as a result of the recent mortgage crisis, however, the Bureau is concerned that creditors may initially be reluctant to make loans that are not qualified mortgages, even though they are responsibly underwritten. The final rule therefore provides for a second, temporary category of qualified mortgages that have more flexible underwriting requirements so long as they satisfy the general product feature prerequisites for a qualified mortgage and also satisfy the underwriting requirements of, and are therefore eligible to be purchased, guaranteed or insured by …the GSEs while they operate under Federal conservatorship or receivership…" p. 6, http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf

DTI had a 42 percent failure rate under the adverse conditions that prevailed between 2007 and 2012.[9]

Underwriting standards that result in loans with this default rate under stress conditions should not be acceptable to anyone and clearly fail to meet the CFPB's own expectation that the QM reflects "underwriting standards that have historically resulted in comparatively low rates of delinquency and default during adverse economic conditions"[10] and should not be acceptable to anyone.

Experience over many decades has taught that standards for borrower equity in the home, credit history, and DTI, along with loan purpose, are the main determinants of default. Common sense standards for these risk factors were the foundation of the stable mortgage system we had before the introduction of the affordable housing goals in 1992.[11] These three standards alone have long been known as the 3 Cs of Credit—Collateral, Character, and Capacity. If we wish to return to a stable system of mortgage finance, we must once again define a prime mortgage—the basic idea that Congress intended when it directed the agencies to develop the QRM as a supplement to the QM.

Low Risk or Prime Loans Must Be Determined by Examining Performance under Stress

History has demonstrated that defining low risk loans is only accomplished effectively by examining loan performance under stress. In 1934 FHA examined the lending practices during the stress period from1926 to 1933, and determined that in many cases LTVs and CLTVs had been excessive, excessive use of second mortgages allowed homebuyers to acquire homes with minimal equity, and borrower incomes were insufficient to assure an ability to pay. As a result, FHA established a minimum downpayment of 20%, a requirement of good to excellent credit, a maximum loan term of twenty years along with a relatively low DTI, taking into account residual income.

When the US economy went in recession in 1957, Congress reduced the FHA's downpayment requirement from 15 percent to 3 percent in steps between 1957 and 1961. By the 1960s this shift away from relatively low credit risk to much higher risk resulted in a dramatic increase in FHA

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[9] Failure rates experienced by Freddie Mac for its 1999 cohort of 30 year fixed rate, fully documented loans with a down payment of 3-4 percent, a FICO score of 580-620, and a total debt ratio of less than or equal to 43 percent and 2007 cohort of 30 year fixed rate, fully documented loans with a down payment of 0-4 percent, a FICO score of 580-620, and a total debt ratio of 43 percent. These loans would have met all QM requirements.

[10] Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act," 12 CFR Part 1026, 725, http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf

[11] This is a small sample of the extensive literature on this topic gong back 80 years. National Housing Act of 1934, FHA Underwriting Manual, 1936, Federal Housing Administration, "FHA Experience with Mortgage Foreclosures and Property Acquisitions", Washington, D.C., January 1963, John P. Herzog & James S. Earley, 1970, "Home Mortgage Delinquency and Foreclosure," NBER Books, National Bureau of Economic Research, Inc, number 70-1, George M. von Furstenberg and R. Jeffery Green "Home Mortgage Delinquencies: a Cohort Analysis", The Journal of Finance, Volume 29, Issue 5, pages 1545–1548, December 1974

defaults. Further credit loosening took place in the mid- to late-1960s, as a result of congressionally authorized no-money down programs targeted at low-income borrowers. Since many FHA loans were geographically concentrated, the impact was largely localized and did not spread widely through the economy.

By the 1970s, the most egregious of these practices were curtailed or ended; however FHA's claim rates remained permanently elevated as most FHA loans were now nonprime. During the high rate period of the early 1980s, Fannie reduced its underwriting standards in order to obtain upfront fee payment on lower quality mortgages. These changes resulted in losses on loans acquired between 1981 and 1984.

In 1985 Fannie Mae examined the defaults it had experienced during this stress period[12] and determined that LTVs and CLTVs had been excessive, second mortgages allowed homebuyers to acquire homes with minimal equity, many borrower credit histories were of poor quality, and high borrower DTIs left them with a diminished ability to pay.[13] Accordingly, Fannie re-established the traditional underwriting standards in place in earlier years. Both FHA's study of the 1920s and early 1930s and Fannie's study of the early 1980 were similar to the approach undertaken by the agencies in the original proposed QRM rule which examined loan performance under the stress period of 2005-2008.

The agencies' first attempt to structure a QRM was politically unsuccessful, largely because they included a downpayment of 20 percent among the standards they required. This produced a form of sticker shock in the housing and housing finance complex; many complained that such a standard would deprive otherwise qualified borrowers of the opportunity to buy homes.

We believe this occurred because the agencies were working from a static model, with a set credit standard, a set maximum DTI and a set minimum downpayment that only varied based on loan purpose. However, the Freddie dataset makes it possible to balance these elements in determining which loans meet the low risk standard under stress. The data may be analyzed to determine when a high credit score might compensate for a low downpayment or a low DTI might compensate for a low credit score or a low downpayment.

By undertaking this risk-balancing approach, the coverage of the QRM rule may be substantially broadened. We tested the agencies' original QRM definition against the 2007 stress vintage of the Freddie data set and found that it resulted in a cumulative average default rate through June 30, 2012 of 2.6 percent and an eligibility rate of 39 percent. Such a rate was deemed much too low by many commentators.[14]

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[12] In the inflationary period of the late 1970s and the early 1980s, Fannie had reduced its underwriting standards to compensate for its losses on fixed rate mortgages. This resulted in large numbers of defaults in the late to mid-1980s.

[13] In the early 1980s Fannie acquired large quantities on non-traditional mortgages in order to offset the losses it was suffering as the result of rapidly rising interest rates.

[14] For purposes of this analysis, a FICO score of 690 was substituted for the original QRM credit standard, since this was the score referenced by the agencies in delineating default performance.

Applying our risk- balancing approach to the 2007 Freddie stressed vintage, we set the maximum cumulative stress default rate at less than 6 percent for low risk or prime loans for any loan purpose; 6 percent to less than 12 percent for medium risk nonprime loans for any loan purpose; and greater than or equal to 12 percent for high risk nonprime loans for any loan purpose. These results define the loan characteristics for low, medium, and high risk under stress which then may be used to classify loans in other vintages as low, medium, or high risk (Risk Classification Method).

The low risk or prime loans resulted in a cumulative stress default rate of 2.9 percent, similar to the agencies' original QRM result. Medium risk nonprime loans had a cumulative stress default rate of 8.9 percent and high risk nonprime loans had a cumulative stress default rate of 21.2 percent. Overall the entire 2007 vintage had a cumulative stress default rate of 12.2 percent. The results of our Risk Classification Method are detailed in the tables contained in Appendix A.

This approach results in an eligibility rate of 78 percent for home buyers whose mortgages were acquired by Freddie during 2011, doubling the 39 percent QRM eligibility rate for home purchase transactions under the original QRM proposal, while maintaining sound credit standards.

In part, we are able to make these adjustments because we are using a FICO score to measure borrower creditworthiness. The sensitivity of FICO scores permits a high FICO score to compensate for a low downpayment. The agencies did not use FICO scores in their first attempt at developing a QRM—perhaps because of concerns that it be weakened over time. This appears to have locked the agencies into a 20 percent downpayment in order to find a mortgage that would have a comparatively low rate of default in adverse economic conditions. By introducing FICO scores, our analysis finds many combinations of the other key determinants— CLTV, DTI, and loan purpose—which yielded low risk loans with downpayments of less than 20 percent that still retained high eligibility for homebuyers.

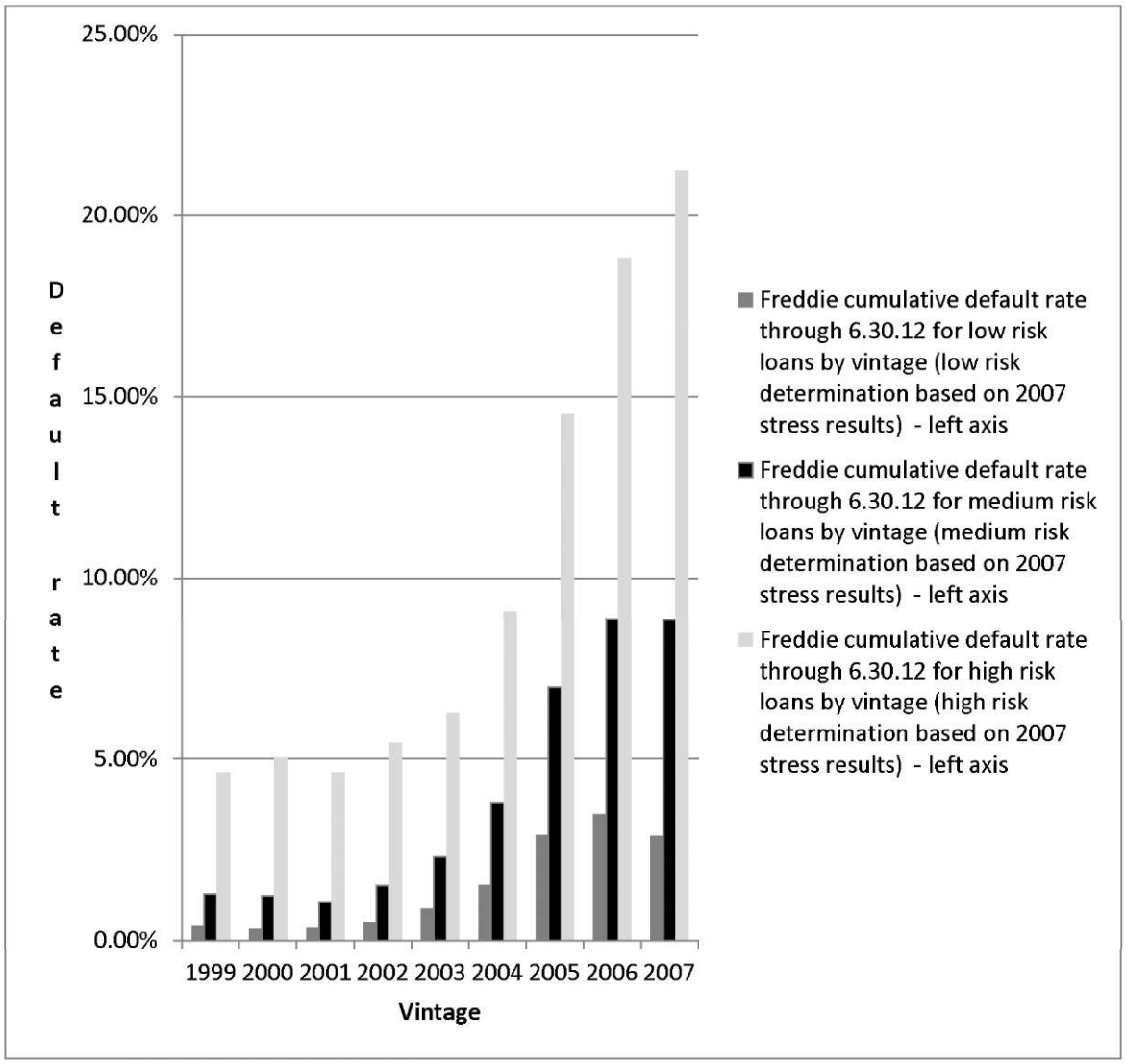
To avoid losing the flexibility provided by the FICO credit score, the agencies could simply specify that their conclusions are based on the FICO credit score "or any other measure of credit behavior or performance of comparable statistical robustness." Language like this would enable the agencies to change to another credit measurement system if FICO scores—which are used almost universally in the private sector—should one day become inadequate or periodically review the scoring standard established for continued robustness.[15]

Chart 1 compares the cumulative default rate through June 30, 2012 for the 1999-2007 vintages of loans in the Freddie data set. As previously described, the loans in each vintage were labeled as low, medium or high risk using Risk Classification Method described above. While earlier vintages benefited from substantial home price increases, nonprime mortgages consistently

[15] The Federal Reserve undertook a comprehensive study of credit scoring methodologies in 2007. Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, April 2007.https://www.google.com/search?q=Report+to+the+Congress+on+Credit+Scoring++and+Its+Effects+on+the+Availability+and+Affordability++of+Credit+&ie=utf-8&oe=utf-8&aq=t&rls=org.mozilla:en-US:official&client=firefox-a

performed much worse than traditional mortgages regardless of vintage. The low risk category from the 2007 vintage has an average cumulative default rate of under 3 percent and is thus a loan that meets the definition of a QRM that the agencies were seeking. This compares to the 23 percent default rate on QM loans that was noted above. Further, no individual low risk category exceeds a default ratio of 6 percent in stressed conditions. For comparison purposes, we have also included a medium and high cumulative default rate for 1999-2007 vintage loans.

Chart 1: Cumulative Default Rate for Low, Medium, and High Risk Loans by Vintage Year (1999-2007)



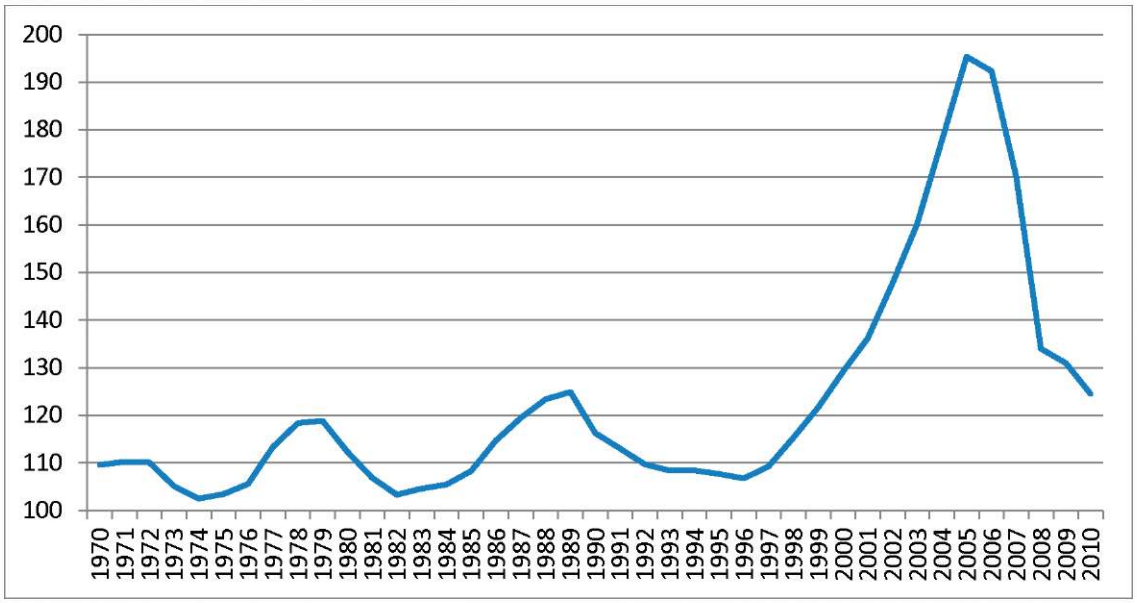
Creating a stable housing finance system

The housing price bubble was an extreme example of the instability that has plagued the US housing finance system for almost a century. A system of housing finance in which prime loans are the predominant underwriting standard will help reduce dangerous escalations of home price levels. Downpayment requirements, in particular, prevent homebuyers from using leverage to bid up prices, which are translated into non-cash out and cash out refinances. Downpayments encourage homeowners to stick with their investment. As shown in Chart 2 below, before 1992, there were two periods in recent times—1979 and 1989—in which price booms developed, but these were short-lived and largely local phenomena. The bubble that developed between 1997 and 2007 was as large and destructive as it was because underwriting standards had eroded substantially before and during this period.

Once they begin, housing price bubbles feed on themselves; rising prices encourage a reduction in lending standards as lenders see fewer risks and borrowers seek more leverage in order to buy more expensive homes. Rising prices suppress the delinquencies and defaults that are the normal signals that risks are increasing. Without these signals, investors keep entering the market, adding further impetus to the increase in housing prices. By 2002, for example, potential investors around the world could see that mortgage-backed securities (MBS) based on pools of subprime loans were producing high yields with relatively few losses. By 2004 subprime lending had become a much more prevalent. Believing that "this time it's different," investors kept the bubble growing until at least 2006, when prices had reached such levels that buyers could no longer afford to buy homes even with historically lenient underwriting standards.

Chart 3, using Robert Shiller's data, shows the size of the 1997-2007 housing bubble in relation to previous bubbles.

Chart 2: Shiller Home Price Index



The lesson here is that once a bubble begins investors do not get the signals that enable them to exercise the market discipline that alone will prevent the downward slide in mortgage underwriting standards. The only way to prevent the development and growth of destructive bubbles is by establishing and enforcing prime loan standards that require substantial downpayments and other traditional lending standards. The QRM was intended to do this. By eliminating the QRM and the 3Cs of lending, the agencies have restored the conditions that gave rise to the 1997-2007 bubble, the mortgage meltdown and ultimately the financial crisis. Charts 3 and 4 below, using the Freddie dataset, show how underwriting standards deteriorated in the years after 1992. A similar deterioration can be expected if, as the agencies propose, QRM is eliminated and we are left solely with the standards required by QM. Accordingly, in order to assure a stable housing finance market in the future, the standards Congress intended to create through the QRM must somehow be replaced.

Chart 3 below shows the rapid increases in two of the many types of nonprime loans: home purchase loans with a minimal or no down payment and higher than traditional DTIs for home purchase and refinance loans. Both types of nonprime loans increased borrower leverage. It is this leverage that increases demand and drives home prices higher. As noted above in Chart 1, the Freddie dataset clearly shows that nonprime loans with higher leverage produce a consistently higher default rate when compared to traditionally underwritten mortgages.

Chart 3: Examples of Growth of Non-Prime Loans 1990-2007

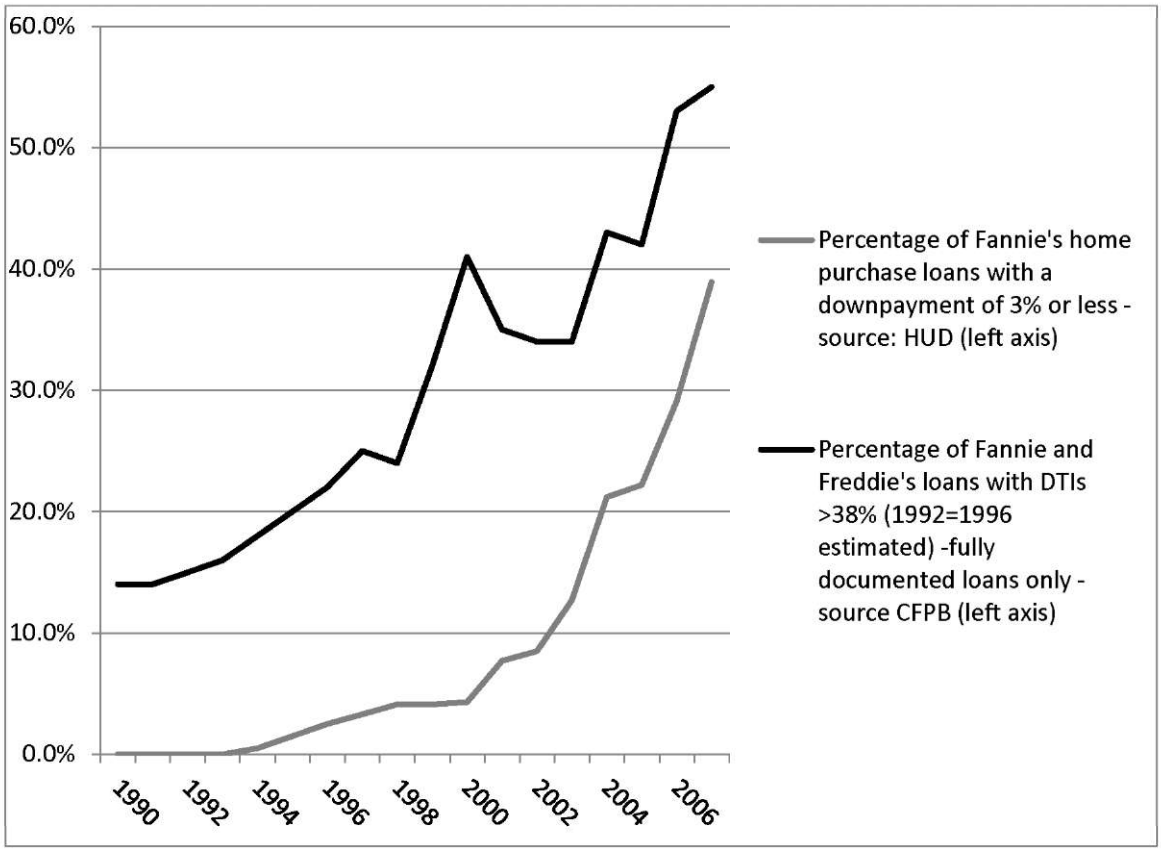
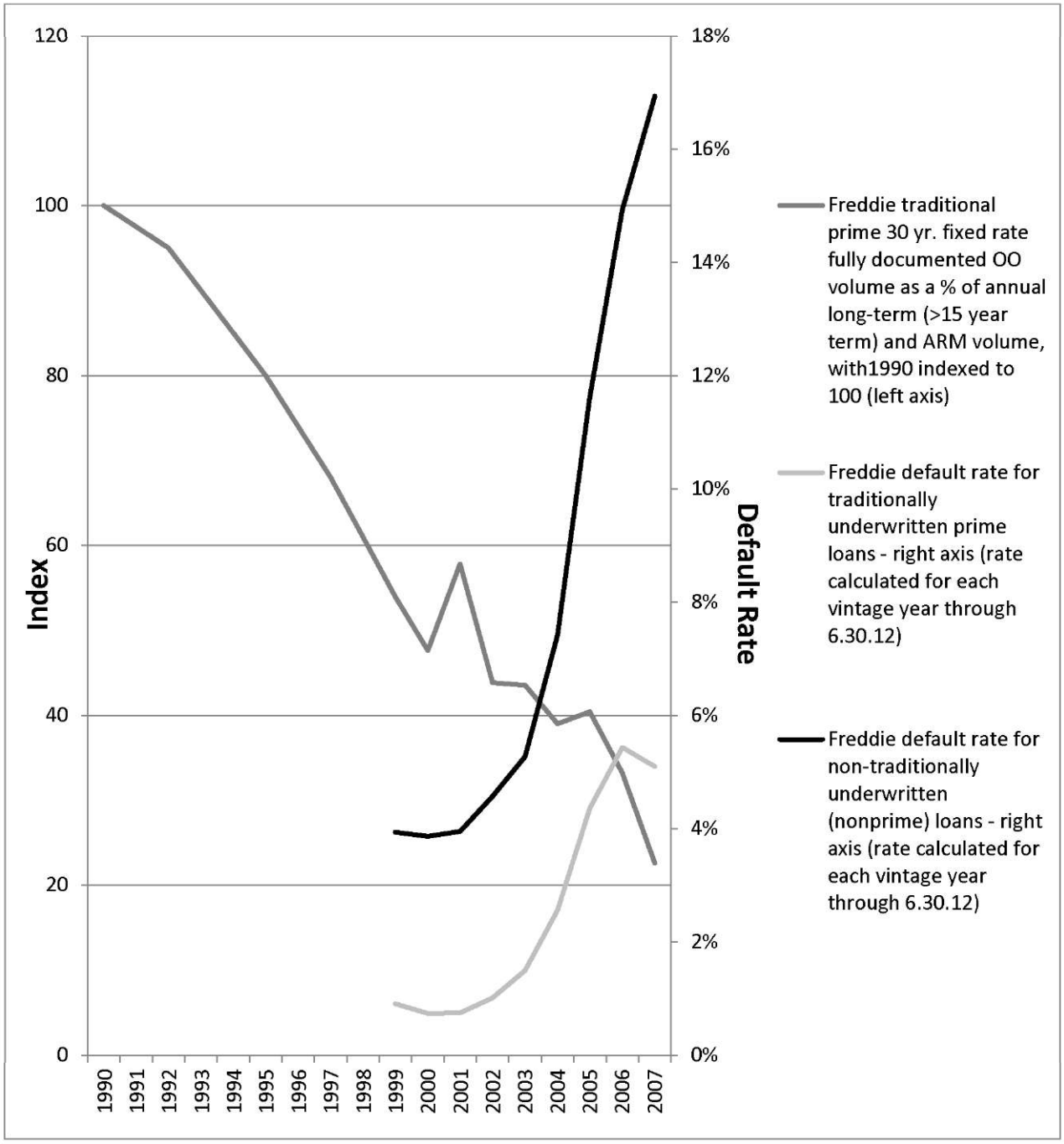


Chart 4, again based on the Freddie dataset, shows that traditionally underwritten 30 year, fixed rate, owner-occupied, fully documented mortgages acquired by Freddie Mac declined dramatically in quality from 1990 to 2007. Traditional prime mortgages were replaced by nontraditional, nonprime mortgages which performed much worse than traditional mortgages for all vintages.

Chart 4: Trends in and Performance of Traditional Prime and Nonprime Mortgeges



The Importance of Loan Purpose

Up to now, we have shown our Risk Classification Method defines loans that meet the QRM low risk under a stress standard. But these compensating elements are not sufficient in themselves to recreate the traditional prime mortgage without taking account of the purpose of a loan. The agencies' original QRM definition recognized this fact by varying the definition based on loan purpose. The Freddie data set provides incontrovertible evidence that any definition of a prime loan must take into account of loan purpose. See Charts 5-7 below.

The definition of a prime loan set out in Appendix A reflects this and provides separate definitions based on whether the loan purpose is for home purchase, rate and term refinance, and cash out refinance. Community activist and consumer groups often assert that QM loans will perform in a manner not dissimilar from prime loans, as long as they are fully documented and have 30 year fixed rate terms. As shown below, Charts 5 and 6, using the Freddie dataset, show that this contention is in error.

By examining the experience of the 11 million 30-year fixed rate loans from 1999-2007 in the Freddie dataset, we can see clearly how FICO score[16], CLTV, DTI, and loan purpose affected the incidence of default among these loans in a stress environment.

Chart 5 below shows the effect of a high CLTV of 96-100% on 30 year, fixed rate, fully-documented, owner occupied home purchase mortgages with a 580-620 FICO score in Freddie Mac's 2007 vintage. This loan had a default rate under stress of 40%, which is 100 times the default propensity for a loan with a CLTV of 60% or less and a FICO score of 770 or more. Add in the effect of DTI (not shown) and the loan with a 96-100% CLTV, 580-620 FICO, and a 50% DTI has a default rate of 162 times greater than a loan with a CLTV of 60% or more and a FICO score 770 or greater.

[16] FICO credit score or any other measure of credit behavior/performance of comparable statistical robustness.

Chart 5: Effect of a Combined Loan-to-Value Ratio and FICO on Default Rates of Home Purchase Loans (2007 Vintage)

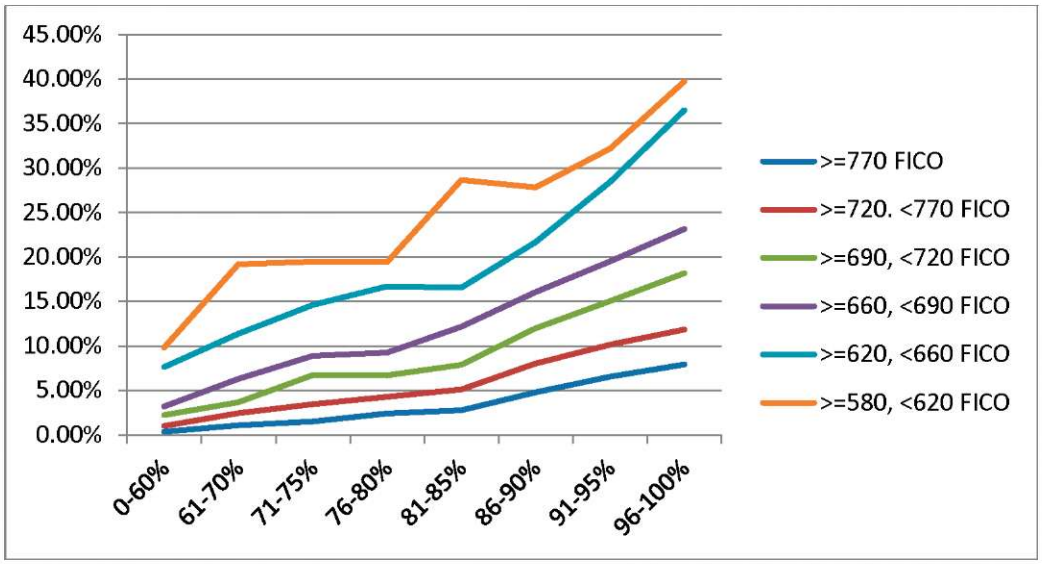


Chart 6 shows the effect of a cash-out refinance on 30 year, fixed rate, fully-documented, owner occupied mortgage in Freddie Mac's 2007 vintage. For example, a cash-out loan with a CLTV of 86-90% and a 580-620 FICO had a default rate under stress of 33%, which is 22 times the default rate for a loan with a CLTV of 60% or less and a FICO score of 770 or greater. Add in the effect of a DTI (not shown) and the loan with a CLTV of 86-90%, a 580-620 FICO and a DTI greater than 50 % and the loan's default rate is 46 times that of one with a CLTV of 60% or less, a FICO score of 770 or more, and a DTI of 33% or greater.

Chart 6: Effect of a Combined Loan-to-Value Ratio and FICO on Default Rates of Cash-Out with Refinance Loans (2007 Vintage)

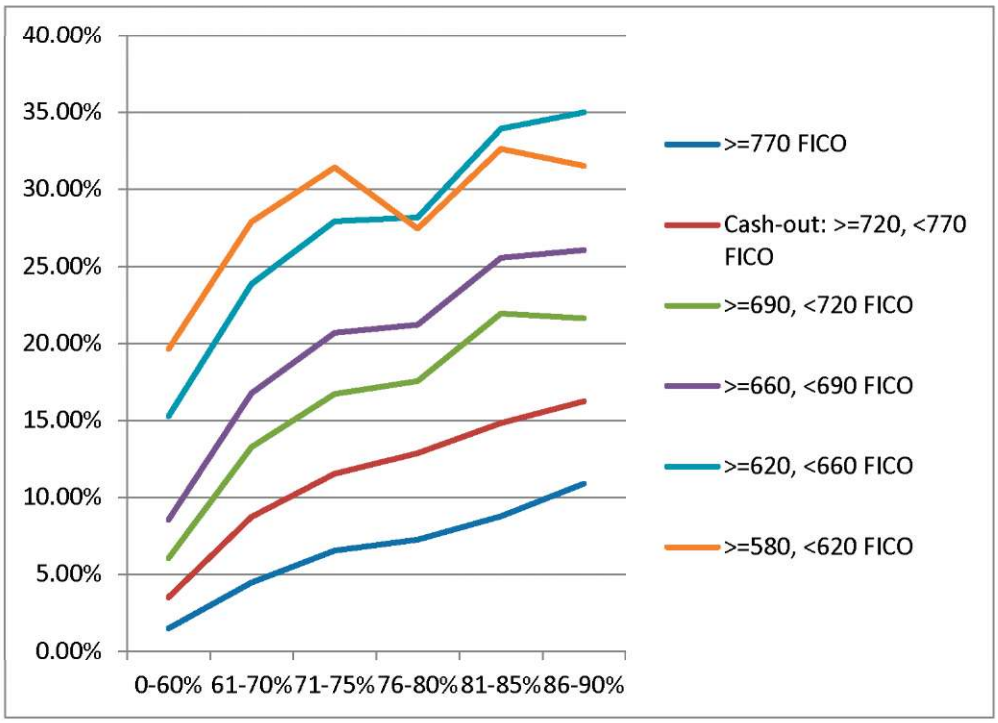
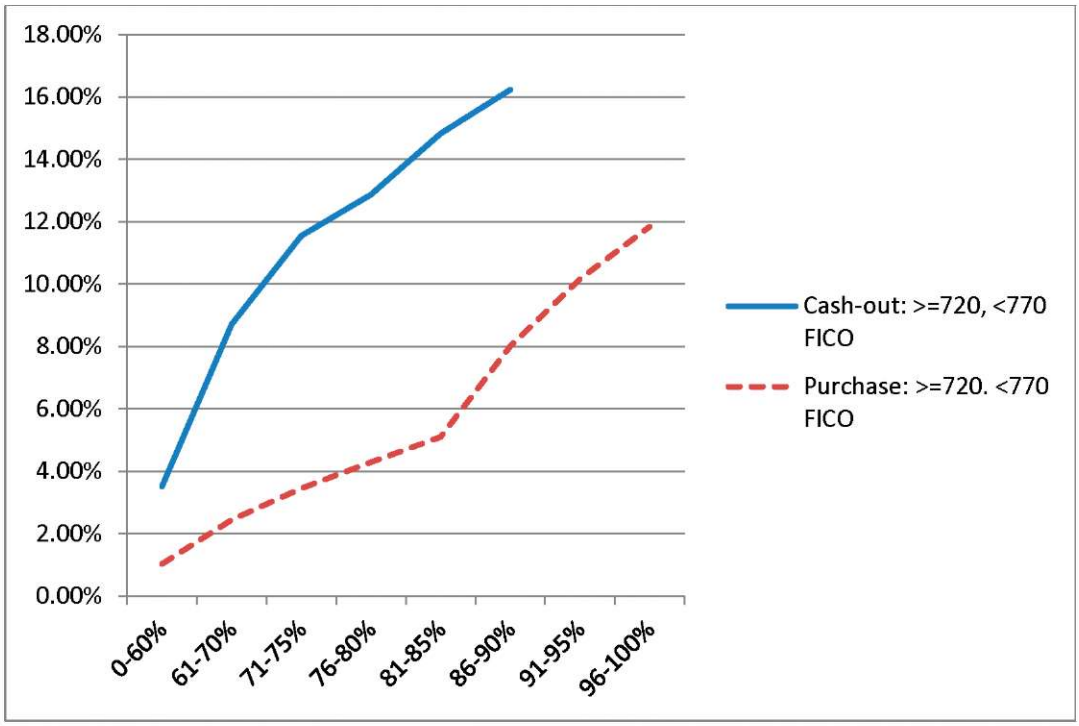


Chart 7 demonstrates that cash-out refinances consistently performed substantially worse than purchase loans with similar CLTVs. The 720-769 FICO categories for each are shown in the chart below. Also, cash-out loans with 660-679 FICO scores had virtually the same default propensity across all LTV categories of home purchase loans with 580-619 FICOs (not shown).

Chart 7: Comparison of Cash-out with Refinance and Home Purchase Default Rates based on CLTV (2007 Vintage)



Improving QM standards to conform with QRM

The QM rule provides important penalties for creating some risky loans. The failure to determine that a borrower has the ability to repay the loan, or violating other provisions of QM, can subject the lender to severe penalties and even a defense to foreclosure. Under ordinary circumstances this would induce lenders to insist on traditional underwriting standards in order to assure that the loans they make will not default. However, the QM has elements that substantially diminish credit quality: especially by the automated underwriting systems of Fannie and Freddie. This removes much of a lender's incentive to employ traditional underwriting standards, and in effect undercuts Congress's intention in directing the agencies to develop a QRM that will be a traditional prime loan.

Accordingly, in addition to complying fully with the minimum lending standards of QM, Fannie and Freddie should be limited to acquiring or approving *only prime loans,* as defined in this comment, through their automated underwriting systems. In other words, the automated underwriting systems of Fannie and Freddie should not be allowed to "accept" mortgages that are not prime loans. Fannie and Freddie should be phased-out over five or seven years, but while they continue to operate they should not be allowed to put the taxpayers at risk by inflating the number of non-prime loans in the US economy, or on their own books, which are prone to high levels of default. The same is true of acquisitions by the FHLBs' mortgage programs.

Considering the Federal Home Loan Banks, in a remarkable act of repeating what disastrously failed before, the Housing and Economic Recovery Act of 2008 applied the same kinds of quotas for making risky loans (so-called "goals") to them as to Fannie and Freddie. FHLBs also should be limited to Prime loans. We already know what happens when the government's credit is used to inflate mortgage risk through multiplying poor quality loans.

In sum, with the demise of an independent QRM, the credit quality objective of the Dodd-Frank Act has been lost. To create a robust housing finance system, we need a combination of QM and Prime mortgage loan standards.

Sincerely,

Edward J. Pinto
Resident Fellow

Peter J. Wallison
Arthur F. Burns Fellow
in Financial Policy Studies

Alex J. Pollock
Resident Fellow

Appendix A:

Defining a "Prime Loan"

The purpose in defining a prime loan is to ensure mortgage quality and foster the accumulation of adequate capital behind housing risk. This creates a robust and stable housing finance market that over time will flourish without government guarantees. Experience has also shown that a clear definition of credit quality can prevent deterioration in underwriting standards. In the last cycle, beginning in 1992, government policies promoted a broad decline in credit standards with disastrous results.

A prime loan is one that has "low credit risk even in stressful economic environments"[17] The methodology used to define a prime or low credit risk loan may be found in Appendix B.

This definition of a prime loan must be controlling for purposes of any law or regulation applicable to banks, thrifts, or credit unions or any securities regulation applicable to residential mortgage backed securities.

Any loan that does not meet the prime loan standards outlined below is a non-prime loan.

To be a prime mortgage, a loan must first meet all the minimum requirements of QM which include:

- No negative amortization, interest only, or balloon payments;
- Maximum loan term of thirty years unless otherwise stated;
- Adjustable rate loans underwritten at the maximum rate in first five years;
- Income, assets, employment, debts, and credit considered and verified;
- Ability-to-repay
- Rate, points and fee limitations;

In addition, a prime loan must meet these requirements:

- Finance an owner-occupied home
- Sustainable lending value must be used for purposes of determining original and current combined loan-to-value. A sustainable lending value (as further described below) is "[t]he value of a property as determined by a prudent assessment of future marketability of a property taking into account long term sustainable aspects of a property, the normal and local market conditions, and the current use and alternative appropriate uses of a property. Speculative elements are not to be taken into account in the assessment of the mortgage lending value. The mortgage lending value must be documented in a clear and transparent manner." See Appendix B.

[17] Original proposed QRM rule, p. 101.

- Any loan with an LTV greater than 60 percent could be insured by mortgage guaranty insurance down to 60 percent; however, a fully amortizing loan with a term of fifteen years or less and an LTV greater than 80 percent could be insured by mortgage guaranty insurance down to 70 percent.
- If a prepayment fee is charged, it must not provide for a fee in excess of 3 percent of principal for the first years, 2 percent for the second, and 1 percent for the third, and the originating lender must offer the applicant the option of a similar loan with no prepayment fee. When complying with this section, such fee is not included in the 3 percent upfront fee ceiling.
- No second mortgage at origination and second mortgages must be prohibited by the mortgage documents for a period of six months after origination.[18] The mortgage documents must grant the mortgage holder and mortgage insurer (if any) the right of prior approval with respect to any second mortgage taken out after six months.
- The mortgage note and mortgage:
    - Must require the borrower to declare his or her intent regarding owner occupancy;
    - Must require the borrower to acknowledge that if the intent to occupy changes within twelve months of the date of the loan, the borrower has an affirmative obligation to notify the lender;
    - Advises the borrower that upon receipt of such notice, the lender has the right to increase the interest rate on the loan by a stipulated percentage and the loan becomes a recourse obligation
- <u>Meet these requirements (Yes = QRM eligible, No = QRM ineligible)</u>:

[18] FHA had a similar provision dating back to the 1930s (see FHA Underwriting Manual. 1938)

Home Purchase QRM loan standards:

Home Purchase	DTI	LTV Range							
>20, -<=30 year term		<=60%	60.01-70.00%	70.01-75.00%	75.01-80.00%	80.01-85.00%	85.01-90.00%	90.01-95.00%	95.01-100%
FICO score									
>=770									
	<=33%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**
	>33%, <=38%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No
	>38%, <=43%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No
	>43%, <=50%	**Yes***	**Yes***	**Yes***	**Yes***	**Yes***	No	No	No
	>50%	**Yes***	**Yes***	**Yes***	**Yes***	**Yes***	No	No	No
>=720, <770									
	<=33%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No
	>33%, <=38%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No	No
	>38%, <=43%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No	No
	>43%, <=50%	**Yes***	**Yes***	**Yes***	**Yes***	No	No	No	No
	>50%	**Yes***	**Yes***	**Yes***	No	No	No	No	No
>=690, <720									
	<=33%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No	No
	>33%, <=38%	**Yes**	**Yes**	**Yes**	**Yes**	No	No	No	No
	>38%, <=43%	**Yes**	**Yes**	No	No	No	No	No	No
	>43%, <=50%	**Yes***	**Yes***	No	No	No	No	No	No
	>50%	**Yes***	**Yes***	No	No	No	No	No	No
>=660, <690									
	<=33%	**Yes**	**Yes**	No	No	No	No	No	No
	>33%, <=38%	**Yes**	No	No	No	No	No	No	No
	>38%,	**Yes**	No	No	No	No	No	No	No

	<=43%								
	>43%, <=50%	**Yes***	No	No	No	No	No	No	No
	>50%	**Yes***	No	No	No	No	No	No	No
>=640, <660									
	<=33%	**Yes**	No	No	No	No	No	No	No
	>33%, <=38%	**Yes**	No	No	No	No	No	No	No
	>38%, <=43%	**Yes**	No	No	No	No	No	No	No
	>43%, <=50%	**Yes***	No	No	No	No	No	No	No
	>50%	**Yes***	No	No	No	No	No	No	No
>=620, <640									
	<=33%	**Yes**	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No	No
<620									
	<=33%	No	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No	No

*with residual income test

No cash-out with refinance QRM loan standards:

No cash-out refinance	DTI	LTV Range						
>20, -<=30 year term		<=60%	60.01-70.00%	70.01-75.00%	75.01-80.00%	80.01-85.00%	85.01-90.00%	>90.01
FICO score								
>=770								
	<=33%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No
	>33%, <=38%	**Yes**	**Yes**	**Yes**	No	No	No	No
	>38%, <=43%	**Yes**	**Yes**	**Yes**	No	No	No	No
	>43%, <=50%	**Yes***	**Yes***	No	No	No	No	No
	>50%	**Yes***	**Yes***	No	No	No	No	No
>=720, <770								
	<=33%	**Yes**	**Yes**	No	No	No	No	No
	>33%, <=38%	**Yes**	**Yes**	No	No	No	No	No
	>38%, <=43%	**Yes**	No	No	No	No	No	No
	>43%, <=50%	**Yes***	No	No	No	No	No	No
	>50%	**Yes***	No	No	No	No	No	No
>=690, <720								
	<=33%	**Yes**	No	No	No	No	No	No
	>33%, <=38%	**Yes**	No	No	No	No	No	No
	>38%, <=43%	**Yes**	No	No	No	No	No	No
	>43%, <=50%	**Yes***	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No
>=660, <690								
	<=33%	**Yes**	No	No	No	No	No	No
	>33%, <=38%	**Yes**	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No

	>43%, <=50%	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No
>=640, <660								
	<=33%	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No
>=620, <640								
	<=33%	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No
<620								
	<=33%	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No

*with residual income test

Cash-out refinance QRM loan standards:

Cash-out refinance	DTI	LTV Range						
>20, -<=30 year term		<=60%	60.01-70.00%	70.01-75.00%	75.01-80.00%	80.01-85.00%	85.01-90.00%	>90.01
FICO score								
>=770								
	<=33%	**Yes**	**Yes**	**Yes**	**Yes**	**Yes**	No	No
	>33%, <=38%	**Yes**	**Yes**	No	No	No	No	No
	>38%, <=43%	**Yes**	**Yes**	No	No	No	No	No
	>43%, <=50%	**Yes***	No	No	No	No	No	No
	>50%	**Yes***	No	No	No	No	No	No
>=720, <770								
	<=33%	**Yes**	**Yes**	No	No	No	No	No
	>33%, <=38%	**Yes**	No	No	No	No	No	No
	>38%, <=43%	**Yes**	No	No	No	No	No	No
	>43%, <=50%	**Yes***	No	No	No	No	No	No
	>50%	**Yes***	No	No	No	No	No	No
>=690, <720								
	<=33%	**Yes**	No	No	No	No	No	No
	>33%, <=38%	**Yes**	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No
>=660, <690								
	<=33%	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No
	>43%,	No	No	No	No	No	No	No

	<=50%							
	>50%	No	No	No	No	No	No	No
<660			No					
	<=33%	No	No	No	No	No	No	No
	>33%, <=38%	No	No	No	No	No	No	No
	>38%, <=43%	No	No	No	No	No	No	No
	>43%, <=50%	No	No	No	No	No	No	No
	>50%	No	No	No	No	No	No	No

*with residual income test

Appendix B:

Sustainable Lending Value

Housing bubbles by suppressing delinquencies and defaults induce non-prime, risky lending; investors see high yields and few defaults, while other market participants come to believe that housing prices will continue to rise, making good loans out of weak ones we can minimize. Future bubbles and the losses suffered when they deflate by focusing on and maintaining standards of prime credit quality.

It makes housing booms more extreme and busts more severe to confuse the current market price of a property with its sustainable lending value. These are two different things. Marked differences between the current market price of a property and its sustainable lending value are evident under boom conditions and represent dangerous aberrations from sustainable lending values.

To be a defined as a prime loan, the maximum LTV ratio of a mortgage loan must be calculated using the sustainable lending value, not merely the current market price. The sustainable lending value (SLV) is based on the long-term trend lines of local house prices and one or more fundamental price drivers such as household income, consumer prices, construction costs, and rents. History has shown while house prices will experience cyclical overshoots and variations they regress to their mean, or trend, behavior over time—with time considered as including multiple real estate cycles.

Marked differences between the current market price of a property and its sustainable lending value are evident under boom conditions and represent dangerous aberrations from sustainable lending values. By making an assessment based on fundamental trends, SLV will cause speculative elements not be taken into account in determining a lending value. Institutions would establish standards and procedures for the independent validation of their SLV methodologies so as to demonstrate the SLV's ability to associate movements in home prices with selected fundamental drivers to the housing market.

Under a regime of prime loans of which the maximum LTV is "Loan-to SLV" (LTSLV), buyers could pay any price they wanted and were able to, but their debt would be capped based on the sustainable value, with any additional price being provided solely with down payment equity—in other words the maximum LTV will fall in boom markets. This will create a counter-cyclical effect keeping market prices nearer to mortgage lending value. This is in sharp contrast to the strongly pro-cyclical effect of basing debt on exaggerated current market prices.

Any mortgage loan for which the LTV is greater than the LTSLV is by definition a non-prime loan.