Mark Adelson

www.markadelson.com

28 October 2013

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Federal Housing Finance Agency
Securities and Exchange Commission
Department of Housing and Urban Development

Re: Credit Risk Retention, Proposed Rule (78 Fed. Reg. 57928)
OCC Docket ID OCC-2013-0010
Federal Reserve Docket No. R-1411
FDIC RIN 3064-AD74
FHFA RIN 2590–AA43
SEC File Number S7-14-11
HUD RIN 2501–AD53

Ladies and Gentlemen:

1. Thank you for this opportunity to comment on your joint proposed rule on credit risk retention.[1]

2. ***Premium Capture Reserve Account:*** You should restore the premium capture reserve account (PCRA) feature of the original rule proposal of April 2011 (the "Original Proposal).[2] It helps to assure that a securitizer retains *real downside risk* with respect to assets that it securitizes. Real downside risk is not the same thing as the potential for reduced future benefit.

3. The legislative history for the credit risk retention requirement states:

[1] *Credit Risk Retention,* Proposed Rule, 78 Fed. Reg. 57928 (20 Sep 2013).

[2] *Credit Risk Retention,* Proposed Rule, 76 Fed. Reg. 24090 (20 Apr 2011).

Subtitle D—Improvements to Asset-Backed Securitization Process requires securitizers to retain an economic interest in a material portion of the credit risk for any asset that securitizers transfer, sell, or convey to a third party.[3]

4. The phrase "material portion of the credit risk" connotes the idea of *real downside risk*. The market and the public embraced such an interpretation by describing it as a requirement for "skin in the game."[4]

5. Without the PCRA feature in the final rule, it will too easy for a securitizer to fully recover its investment at the closing table, leaving only future gains at risk. Absent the PCRA, a securitizer might be able to avoid true downside risk by monetizing excess spread. Unless the securitizer has real downside risk, the legislative purpose of the credit risk retention requirement may not be accomplished.

6. The use of "fair value" as the basis of calculating required risk retention is not an acceptable substitute for the PCRA feature. Experience has shown that all types of market participants, including major financial institutions, have a terrible track record in determining fair values of illiquid instruments. Moreover, as experience has also shown, the use of fair value is open to manipulation and abuse. The better path is to revert to the PCRA.

7. ***Qualified Residential Mortgage (QRM):*** You should not equate the definition of QRM with the CFPB's definition of QM.[5] As you are well aware, the purposes of the two terms are entirely different: QM relates to consumer protection. It is the centerpiece of the safe harbor for compliance with the new requirement for a lender to determine a borrower's ability to repay a loan.[6] By contrast, QRM is an important component in the new machinery of financial stability regulation that was introduced by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA"). You should not presume that the issues in consumer protection are congruent with those of macro-prudential financial stability regulation. It is unlikely that the optimal regulatory result can be

[3] H.R. Rep. No. 111-157 at 872 (2010).

[4] For a discussion of the origins of the phrase "skin in the game," see Safire, W., *On Language – Skin in the Game*, New York Times, Magazine Section (17 Sep 2006) (http://www.nytimes.com/2006/09/17/magazine/17wwln_safire.html)

[5] See Bureau of Consumer Financial Protection, *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 35430 (12 Jun 2013); Bureau of Consumer Financial Protection, *Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)*, 78 Fed. Reg. 6408 (30 Jan 2013).

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act § 1411, Pub. Law No. 111-203, 124 Stat. 1376 [hereinafter DFA].

achieved by applying such a presumption. Indeed, Congress provided two distinct terms,[7] apparently recognizing two distinct objectives. Even the name of the law – the "Dodd-Frank Wall Street Reform and Consumer Protection Act" – highlights that there are two distinct objectives.

8. You should substantially restore the QRM definition to what it was in the April 2011 Original Proposal. Most elements of that definition were fine, but the item about points and fees and the one about default mitigation seem unnecessary.

Recommendations for QRM Criteria from the Original Proposal	
Item	**Recommendation**
First lien	retain from original proposal
Original maturity	retain from original proposal
Written application	retain from original proposal
Credit history	retain from original proposal
Payment terms	retain from original proposal
Points and fees	OK to drop
Debt-to-income ratios	retain from original proposal
Loan-to-value ratios	retain from original proposal
Down payment	retain from original proposal
Appraisal	retain from original proposal
Assumability	retain from original proposal
Default mitigation	OK to drop

9. Most of the QRM eligibility criteria in the Original Proposal are properly connected to the traditional "three C's" of lending:

- *COLLATERAL* coverage – measured primarily by loan-to-value ratio (LTV)
- borrower *CREDIT* history – measured primarily by payment record[8]
- borrower payment *CAPACITY* – measured primarily by debt-to-income ratio (DTI)

10. Also, the actual specifications for the QRM eligibility criteria in the Original Proposal closely followed the traditional standards for safe, low risk mortgage lending. That was appropriate because the statutory directive[9] provides that the QRM exemption should apply only to loans with characteristics that "result in a lower risk of default…" Any

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[7] The DFA defines the term "qualified mortgage" in § 1412 and the term "qualified residential mortgage" in § 941(b).

[8] In recent years, lenders have used scoring systems, such as FICO scores, to summarize a borrower's payment record and certain other factors. The QRM definition in the Original Proposal properly avoided tying the QRM eligibility criteria to a private-sector system like FICO.

[9] Securities Exchange Act of 1934 § 15G(e)(4)(B), 15 U.S.C. § 78*o*-11(e)(4)(B) (2012).

loan lacking the characteristics that result "in a lower risk of default" should not qualify as a QRM.

11. The QM definition under the Truth-in-Lending regulations is not about identifying loans that have low default risk. It encompasses loans with potentially high risk. There is no minimum level of collateral coverage (*i.e.*, a maximum LTV). There is no requirement of a minimum down payment. The QM definition allows for debt-to-income ratios of up to 43%, which is quite risky. And, it has no requirement for a clean payment history. In short, the QM definition is not based on characteristics that "result in lower risk of default." Therefore, equating QRM with QM seems to violate § 15G(e)(4)(B) of the Exchange Act.

12. Don't bother with the "QM-Plus" idea described in the latest proposal. Just go back to the QRM definition of the Original Proposal.

13. ***Minimum Level of Risk Retention:*** In finalizing the risk retention rule, please recall that the statutory requirement calls for a ***minimum*** risk retention level of 5% for all assets other than (i) QRMs and (ii) those that meet regulatory underwriting standards indicating low risk.[10] The statute clearly contemplates that asset class-specific regulations may appropriately set a ***higher*** minimum level. Therefore, the regulations should provide for required risk retention of ***more than*** 5% in cases involving particularly risky assets.

14. Applying the 5% minimum across the board does not work because the purpose of risk retention can be defeated whenever a securitizer acquires assets at a substantial discount from par (*e.g.*, consider the case of subprime auto loans). Here are two possible substitutes that might work:

    - For assets other than QRMs and those that meet "low risk" regulatory standards, the final regulation should provide for risk retention equal to the greater of (i) 5% and (ii) the expected losses on an asset or asset class.

    - For assets other than QRMs and those that meet "low risk" regulatory standards, the final regulation should provide for risk retention equal to the greater of (i) 5% and (ii) the conditional expected losses on an asset or asset class under a scenario of moderate economic stress. A scenario of moderate economic stress means one in which (i) U.S. gross domestic product declines by 3%, (ii) U.S. unemployment is 10%, and (iii) U.S. equity markets decline by 50%.

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[10] 15 U.S.C. § 78*o*-11(c)(1)(B) and (c)(2)(B) (2012).

15. ***Third-party Risk Retention for Commercial Mortgages:*** The final regulations should not allow third-party risk retention on commercial mortgages. The statute provides that the implementing regulations "***may*** include… retention of the first-loss position by a third-party purchaser."[11] Congress used the word "may," rather than "shall." Thus, the statue does not require that the implementing regulations include such a feature.

16. The purpose of risk retention would be partially undermined by including the "third party" feature in the final regulation. The purpose is best served when the party with the most to gain from a securitization – typically the sponsor – also has the most to lose. Having a third-party's skin in the game is not nearly as effective in keeping unprotected, high-risk assets out of the securitization pipeline.

17. ***Err on the Side of Caution:*** You should err on the side of caution when you finalize the risk retention regulations. This means that if you have to lean slightly to one side or the other, you should lean toward regulatory stringency rather than regulatory laxity. Regulatory laxity, as part of the multi-decade trend of financial deregulation, has been convincingly identified as one of the causes of the financial crisis. The lessons of that experience should be an important part of your process when you weigh the factors that lead to the final rule.

18. ***Conclusion:*** The topic of risk retention was a hot issue even before the ink had dried on the DFA. Since then, you have received thousands of comments, many of which have argued that the PCRA or a narrow definition of QRM would reduce the availability of credit. Some of those arguments have even appeared in Congressional hearings.[12] However, such arguments are inapposite. The point of DFA § 941 is to protect America's financial system and make it more robust. The point was not to expand or sustain the level of credit. On the contrary, if § 941 reveals anything, it is that Congress understood that dangerously lax lending standards had contributed to the crisis and needed to be reined in to protect both the financial system and the real economy.

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[11] 15 U.S.C. § 78*o*-11(c)(1)(E)(ii) (2012) (emphasis added).

[12] U.S. House, Subcommittee on Capital Markets and Government Sponsored Enterprises of the Committee on Financial Services, *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention*, Hearing, Serial No. 112-27 (14 Apr 2011); U.S. House, Subcommittee on Capital Markets and Government Sponsored Enterprises of the Committee on Financial Services, *The Impact of Dodd-Frank on Customers, Credit, and Job Creators*, Hearing, Serial No. 112-143 (10 Jul 2012); U.S. House, Committee on Financial Services, *Monetary Policy and the State of the Economy*, Hearing, Serial No. 112-145 (18 Jul 2012).

19. This letter represents my personal views and not the views of any organization or company with which I am (or have been) associated.

Sincerely,

Mark Adelson

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Schedule of Addressees:

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Docket ID OCC-2013-0010
regs.comments@occ.treas.gov

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rule-comments@sec.gov

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