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Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Proposed Rule on Credit Risk Retention
Federal Reserve Board: R-1411; FDIC: 2013-0109-0001; et. al.

Ladies and Gentlemen:

The Federal banking regulators, SEC, FHFA, and HUD (agencies) have published for comment a revised proposal to implement the Dodd-Frank financial reform law's requirement for risk retention for securitizations. In this revised proposal, the agencies propose to equate the definition of qualified residential mortgage (QRM), which provides an exception to risk retention, with the "qualified mortgage" (QM) definition already finalized by the Consumer Financial Protection Bureau (CFPB). At the same time, the agencies' have requested comment on an alternative proposal with significantly more stringent QRM criteria, including a 70% LTV requirement. I strongly believe this alternative approach is far superior to the agencies' proposal of equating the "QRM" definition with that of "QM".

As is clear from the statutory language, and forcefully argued in the comment letter of Barney Frank, the former Chairman of the House Financial Services Committee and primary author of the risk-retention requirement, "QM" and QRM" were meant to be different standards as they address fundamentally different policy goals. The CFPB alone was authorized to write the "QM" standard and its mandate was consumer protection, not system stability. Appropriately, the CFPB wrote QM rules to protect consumers against abusive or unaffordable loan features – almost minimum mortgage standards. Given the CFPB's consumer protection mandate, it obviously focused on factors related to a borrower's basic *ability to pay,* with heavy reliance on documenting a borrowers' income and limiting debt to income (DTI) ratios. Appropriate to its focus on *protecting consumers*, the QM rule places little emphasis on a borrower's credit history and has no requirement for a down payment.

The purpose of Dodd-Frank's risk retention requirement was quite different. Risk retention was meant to promote systemic stability by providing stronger economic incentives for sound underwriting judgment. As we saw in the years leading up to the subprime crisis, securitization's severance of the decision to originate and fund a mortgage from the risk of the borrower defaulting, resulted in a volume driven business, as originators and securitizers were paid up front, with little, if any "skin in the game" should the loans default later on. Millions of loans were originated and securitized with scant regard to whether the borrower could or would actually repay the loan over the longer term. Mortgages with steep payment resets, abusive prepayment penalties, poor income documentation and little, if any money down, became all too common in Wall Street securitizations. Many innocent families were victimized by these shoddy practices and ended up losing their homes. However, many sophisticated home buyers also exploited the system with speculative purchases paid for with loosely underwritten mortgages and small down payments (if any). It was also easy to walk away from these mortgages, as the lofty default rates for mortgages with high loan-to-value ratios suggest. Losses following default have also been much more severe for high loan-to-value loans.

Risk retention was designed to force securitizers to pay better attention to default risk by making them take 5% of the credit losses on securitized mortgages. The QRM exception to the risk retention rule - added relatively late in the legislative process-was meant to encompass only mortgages "which were virtually certain to be repaid" as Chairman Frank explains in his comment letter. The agencies' original risk retention proposal tried to define QRMs in a way that was aligned with this objective, with a tough down payment requirement, stringent DTI ratios, and other tight standards. This new proposal, however, would essentially eviscerate risk retention as a tool to reform the securitization market. As the agencies acknowledge, the vast majority of mortgages will likely meet the QM test, making risk retention a small exception, rather than the overarching rule.

The agencies acknowledge high default rates among mortgages meeting the QM test for those originated from 2005 - 2008. A whopping 23% of loans meeting this standard had either experienced a 90 day delinquency or were in foreclosure as of the end of 2012, compared to 44% for non-QM loans. (I note that this number includes portfolio loans, and would likely be even higher if only securitized loans were included.) The agencies seek to rationalize this high delinquency rate by pointing out that in 2009 - 2010, prime, fixed-rate QM mortgages experienced a 90 day delinquency rate of only 1.4%. But this is a skewed sample, given the dramatic tightening of lending standards during this time period, in the wake of the subprime meltdown. Moreover, it is the job of regulators to craft a financial regulatory system which is resilient under a wide variety of market conditions. Thus in crafting these rules, the agencies should not so easily discount the poor performance of QM loans originated during the 2005-2008 period.

The agencies further defend the proposed use of QM in defining QRM by stating that a tighter standard "may have ramifications for the availability of credit" which would not be outweighed by the agencies' highly generous view of expected default rates for QM loans. This is a curious statement as the agencies themselves acknowledge that any increase in credit costs from a 5% risk retention requirement will range from 0 to 30 basis points. This seems like a small price for system stability.

The agencies should, of course, work for a financial system which makes credit available on responsible terms, but any regulation of lending standards will in some senses decrease the availability of credit. We should not repeat the mistakes of the recent past when, in the name of credit availability, regulators were far too tolerant of lax lending standards. Prescriptive rules are important to prudential oversight of mortgage lending, but they will not be sufficient to overcome powerful, counter-veiling economic incentives. The structure of the securitization process itself needs to be reformed to promote sound underwriting. By becoming part of the securitization structure, risk retention will support the regulators' prudential supervisory efforts.

Moreover, this rationale assumes that freed of risk retention, securitizers will pass on any savings to borrowers in the form of lower rates. But I would suggest that the experience of the pre-crisis years proved just the opposite. Without any obligation to absorb losses from the risk of defaulting loans, securitizers and the originators with whom they worked had every incentive to make high cost loans to vulnerable subprime borrowers, because they commanded higher premiums when the securities those mortgages backed were sold off to investors. Though the QM standard does place limits on rates and fees, securitizers will have every incentive to extract as much return from borrowers as possible, particularly from less-sophisticated lower income households. And given the relatively high DTI standard included in the QM definition, many borrowers will get loans they ultimately will not be able to handle.

Indeed, by equating QM and QRM, securitizers could pool loans with no down payments, 43% DTIs, and average FICO scores of 640, and pass on 100% of the risk to investors. Some have argued that the "market" would not accept such pools of mortgages, and would force securitizers to retain risk in them. I wish I could believe that was true. But in a search for yield prior to the crisis, this was not how bond investors behaved and in this era of ZIRP, the search for yield is even more intense. Again, regulators failed to do their jobs prior to the crisis based on the notion that markets would correct on their own. They should not make that mistake again. As we learned the hard way, securitization created a market failure which risk retention is designed to correct.

I have also heard it argued by some in the industry that securitizers did retain risk prior to the crisis, and it did no good. This argument is somewhat incongruous with another industry argument that says risk retention would constrain credit. If securitizers really were retaining risk during the subprime craze, it certainly didn't seem to constrain people getting mortgages. But in fact, through financial engineering, much of this risk retention was illusory. Residual interests in the "equity tranche" of securitizations could be razor thin. By selling off the "excess spread," securitizers were more than compensated for any credit risk they kept. [1] Moreover, equity tranches were frequently repackaged into collateralized debt obligations (CDOs) where securitizers thought they had eliminated risk through the magic of re-securitization.

I am sympathetic to the concerns of community advocates that the original proposal's 20% down payment requirement could stigmatize loans with smaller down payments, making it more difficult to find investors willing to invest in those loans. Of course, the intention of the original proposal was not to make a 20% down payment the norm - rather only to make sure that securitizers retained risk in loans with smaller down payments. Loans with considerably less down would continue to be available through portfolio lending, retained risk securitizations, as well as through FHA. However, raising the LTV requirement to 70% will help avoid any notion of stigma, as well as help ensure that the vast majority of securitizations require risk retention. Since very few mortgages have 30% down, there will be no implication that the QRM standard is intended by regulators to be the new "norm".

Most importantly, a 70% LTV furthers the Dodd-Frank Act's statutory goal of making risk retention the "norm" to promote system stability. The agencies present ample evidence that 70%

[1] It is regrettable that this new proposal further weakens risk retention by eliminating the previous proposal's requirement for a premium capture cash reserve account (PCCRA). Hopefully, by applying the 5% horizontal risk retention to the fair value of the securitization transaction, instead of par value, it will eliminate the ability of securitizers to escape risk by monetizing excess spread.

LTV loans are virtually always repaid, consistent with Congressional intent that QRMs comprise a very narrow exception. The 70% LTV alternative also includes three other common sense requirements that should be included in any final definition of QRM: that the QRM must be secured by a 1 to 4 unit dwelling that is the borrower's principal residence, that it must be a first lien, and that the borrower's credit history must meet certain requirements.

Two other aspects of the agencies' proposal bear mentioning:

Horizontal or Vertical Slice: The current proposal allows securitizers to retain 5% risk through any combination of a horizontal or vertical "slice". This will be done through retaining security interests in the first loss equity tranche (horizontal), each of the tranches, from senior to subordinate (vertical), or some combination, so long as the total adds up to the required 5%. Since the rule contemplates that risk be retained by securitizers holding assets on their balance sheets, there could be potential major accounting consequences, as well as opportunities for gaming, particularly when risk is held horizontally. At least for vertical retention, another option would be to require clauses in securitization agreements giving securitization trusts the right to claim 5% of losses from securitizers as they occur. This would be held as a contingent liability, not an asset, on securitizers' balance sheets, against which reserves would need to be held. This could reduce consolidation risk, as well as appropriately ease the burden of risk retention over time, depending on how the mortgages in the securitization perform. If the mortgages perform well, projected losses, and the attendant need for reserves, would be reduced.

Disclosure: In defining QRM, the proposal does not impose any additional disclosure requirements to help investors make intelligent decisions about whether to invest, even though they will be expected to bear 100% of the losses. Particularly if the agencies finalize rules which essentially eviscerate risk retention, they should at least give investors greater tools to conduct their own due diligence. The SEC has proposed rules to provide loan level data to MBS investors, though those could be substantially strengthened to apply to all securitizations and to permit investors the right to actually pull and review loan files. I would encourage the agencies' to tie the QRM exception to completion by the SEC of substantially stronger disclosure requirements.

In concluding, let me acknowledge the tremendously difficult task before the agencies. A broad array of politically powerful interests have lobbied heavily against risk retention. Yet, much of this same coalition opposed efforts to tighten lending standards prior to the crisis. Congress created regulatory agencies as independent entities for times such as these, when protection of the broad public interest requires that regulators stand up to the self-interest of powerful and well-financed constituencies. I encourage them to do so.

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