Housing Partnership Network

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CREDIT RISK RETENTION

To: **DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**
24 CFR Part 267
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DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
12 CFR Part 43
Docket No. OCC-2011-0002
RIN 1557-AD40

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR Part 373
RIN 3064-AD74

FEDERAL HOUSING FINANCE AGENCY
12 CFR Part 1234
RIN 2590-AA43

FEDERAL RESERVE SYSTEM
12 CFR Part 244
Docket No. R-1411
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U.S. SECURITIES AND EXCHANGE COMMISSION
17 CFR Part 246
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COMMENTS BY THE HOUSING PARTNERSHIP NETWORK
ON THE PROPOSED CREDIT RISK RETENTION RULE

Thank you for this opportunity to comment on the proposed credit risk retention rule published in the *Federal Register* on April 29, 2011. The proposed rule implements the risk retention requirements in section 15G of the Securities Exchange Act of 1934 (15. U.S.C. §78o-11) as amended by section 941(b) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.

The Housing Partnership Network (Network) is concerned that the proposed rule will have a deleterious impact on the single-family mortgage market and, more importantly, on the efforts that nonprofit organizations, like those who are members of the Network, are making to advance the homeownership aspirations of America's families, keep people in their homes, help neighborhoods recover from the foreclosure crisis, and bring the stabilizing presence of sustainable homeownership to low-income communities.

The Network is a peer network and business alliance of 97 of the nation's top-performing nonprofit housing developers, owners, lenders, and housing counselors. Building on partnerships with financial institutions, other businesses, governments, and civic leaders, the Network's members tackle the most pressing housing and economic development challenges facing communities. The Network itself helps these strong, accomplished organizations increase their production and community impacts through a unique, member-driven cooperative that shares knowledge and innovation, and pools resources to access the capital markets more efficiently.

Our members operate in all 50 states. Network members are leaders in single-family development, neighborhood stabilization, and housing counseling – all elements of our organizations' mission-driven efforts to provide and sustain homeownership opportunities for low-income households. Of the 97 Network members, there are 46 that develop single-family housing for sale to low-income people and 45 that offer housing and/or financial counseling as part of their businesses. Since 1995, these member organizations have provided counseling support to over 650,000 low- and moderate-income families. More than 100,000 of those families have either bought or retained their homes. In addition, 41 of our members participate in Neighborhood Stabilization Program activities in their communities.

The Network has concerns about the risk retention rule on many levels. If promulgated in its current form, the rule has the potential to affect low-income homeownership opportunities by constricting the availability, accessibility, and affordability of mortgage credit. In the standard established for the qualified residential mortgage (QRM), the proposed rule creates a two-tiered market: One part of the market is designated "safe" by its exemption from the risk retention requirements and the other part of the market – the non-QRM segment – is subject to risk retention, is less supported by regulators, and is, therefore, considered less safe. The problem is that many of the good credit quality, responsibly-underwritten loans that have supported low-income homeownership programs in the past would now fall into that portion of the market that the regulation would relegate to non-QRM status. We can anticipate that the rule will mean higher prices and limited availability for many non-QRM single-family mortgages. We must therefore conclude that the proposed rule fails to achieve its stated goal of identifying an appropriate balance of encouraging responsible lending without placing an undue burden on borrowers.

Skin in the Game

We endorse the motivation behind Section 941(b) of the Dodd-Frank bill. In requiring the sponsors of asset-backed securities (ABS) to retain at least 5 percent of the credit risk when they securitize loans, the law sought to ensure that the sponsors of securities backed by risky or irresponsible loans had “skin in the game.” With this provision, the law sought to address one of the core causes of the housing credit crisis and the subsequent financial meltdown. In the subprime and predatory lending mortgage environment, loan originators and ABS sponsors were able to secure their fees and profits upfront and, at the same time, distribute the mortgage risk to the investors in private label securities (PLS). In this “originate to distribute” model, the originator and the sponsor of the PLS had less incentive to ensure the quality and sustainability of the underlying mortgages because they were able to shift all the costs of future defaults onto the investors. With skin in the game, the sponsors of these mortgages securities will have a greater incentive to ensure that mortgage loans are well-underwritten.

However, requiring the sponsor of the ABS to retain some risk will add a layer of cost to the transaction. On the positive side, the risk retention rule provides regulators with an opportunity to create an economic disincentive for creditors to return to the irresponsible lending practices that characterized the subprime lending boom at its height. The new approach could also discourage some institutions from participating in securitization transactions because of limitations on their abilities to take risk and hold this risk on their balance sheets. Key to getting the final rule right is to ensure that the new risk retention requirement does not also impose these costs and restraints on responsible lending and disadvantage access to credit by otherwise credit-worthy borrowers.

As an amendment to the nation’s securities laws, the risk retention provisions are included, in part, as an additional layer of protection for the investors in ABS. Protecting investors should not be the highest priority for the final rule. Instead, in shaping the final framework for the risk retention rule, regulators should work to protect those practices and products put in place over many years to provide homeownership-ready borrowers with access to the responsible and sustainable credit that they need to buy a home. Investors will have adequate protections: Changes to the nation’s mortgages laws are putting in place a variety of new mechanisms to ensure that mortgages are underwritten soundly through better documentation, to eliminate high-risk and abusive product features, and to require that loan originators adequately assess the borrower’s ability to repay the debt.

Definition of Qualified Residential Mortgages

The definition of a QRM included in the rule is too tightly drawn. A qualified residential mortgage should become the industry standard for a responsible, well-underwritten, sustainable mortgage. Instead, the proposed regulation would impart the QRM label on a slice of the mortgage market comprised of loans with an extremely low risk of default. The rule would relegate the vast majority of mortgages serving low-income households and first-time homebuyers to non-QRM status. We fear that the market would not just distinguish between QRM and non-QRM loans in the pricing and the mechanisms for trading, but also by stigmatizing the non-QRM loans in some way.

The major problem with the proposed rule is that responsibly underwritten, well-performing mortgages are excluded from the QRM definition. This is particularly true with respect to the decision by regulators to include a down payment threshold and specific debt-to-income ratios in the definition of the QRM. The strict standards chosen for the proposed rule will likely set back efforts to advance responsible homeownership opportunities for low-income families.

Instead of defining the QRM as the most pristine of loans with little likelihood of default, an alternative approach would ensure that only the most undesirable loans with risky, anti-consumer product features – like negative amortization, excessive points and fees, or prepayment penalties – were included in the non-QRM bucket and subject to risk retention. In this way, the final rule could play a role in creating an economic disincentive to bad lending practices.

The Twenty Percent Down Payment Standard

The proposed rule over-emphasizes down payment as a feature of the qualified residential mortgage. By choosing a down payment threshold that requires a borrower to have 20 percent down for a mortgage to qualify as a QRM, the rule has the potential to chill the market for low down payment lending. Low down payment lending is fundamental to providing homeownership opportunities for low-wealth households.

In addition, the rule overemphasizes down payment at the expense of other more important underwriting factors that were more central to the financial crisis. The lack of full documentation on loans and the inclusion of inappropriate product features had a greater impact on default rates and were far more central to the financial meltdown that the nation experienced.

To illustrate how onerous the 20 percent down standard is, consider that the median house price in 2009 was $172,100. A twenty percent down payment requirement means that a borrower would have to come up with a down payment of $34,420 – even before coming up with an additional estimated 5 percent of the sales price for closing costs. Very few low- and moderate-income households could accumulate this level of cash savings for a down payment in a reasonable timeframe. In 2007, the median net worth for a non-Hispanic white renter household was $7,500 and for a minority renter household it was $2,500. With these limited resources and relatively lower incomes, it would take a renter household a long time to save for a down payment on the average home. A white paper on the proposed rule estimated that the down payment standard could delay a household's ability to buy a home by up to 14 years.[1] Of course, this issue of homeownership opportunities delayed is even more pronounced for low- and moderate-income families in high-cost markets, where the prices of the average home are well above the national average used here for illustrative purposes.

[1] Center for Responsible Lending, et. al., *Proposed QRM Rule Hurts Creditworthy Borrowers and Housing Recovery, April 13, 2011.*

It is also apparent that choosing a down payment standard as a prominent feature of the QRM is not consistent with a legislative history of the risk retention provision in the Dodd-Frank bill. Congress explicitly omitted down payment from the QRM requirements in the law. Several Members of Congress who were involved in crafting the risk retention provision have issued a written statement indicating that they had no intention of including down payment as one of the QRM criteria.

What is most troubling about the down payment requirement is that experience has shown that we can successfully deliver affordable, sustainable, low down payment homeownership programs for lower-income, lower-wealth households. Many Network members have delivered these types of programs over the years; the model of well-underwritten debt coupled with other borrower supports such as pre-purchase counseling has held up well through an otherwise grim housing market cycle. By focusing the QRM definition on a very strict down payment requirement, the rule would risk setting back the efforts to build assets, wealth, and housing stability for low-income families and low-income neighborhoods.

Impact on a Household's Ability to Refinance its Mortgage

The proposed rule would define a refinance mortgage as a QRM only if the loan had a 75 percent or lower loan-to-value ratio in the case of a straight refinancing and a 70 percent loan-to-value ratio in the case of cash-out refinancing. The decision to require that borrowers have this level of equity in their homes in order for their refinance mortgage to qualify for QRM designation is quite restrictive. According to the white paper issued by leading industry groups, this standard would mean that 25 million current homeowners would not be able to refinance into a QRM because they currently do not have 25 percent equity in their homes.[2] The rule could block many households from lowering monthly payments or moving from a nonstandard mortgage to a standard, more responsible mortgage. Likewise, families who otherwise are quite capable of handling additional debt may be impeded from taking equity out of their homes to meet other important family needs like paying for a child's college education or meeting an unforeseen medical expense.

Treatment of Down Payment Assistance Programs

Another place where the rule has adopted a questionable approach is in the treatment of down payment assistance programs. Under the proposed rule, the QRM definition would allow down payment assistance to count as equity only if that assistance is provided to borrower in the form of a grant or a gift. Any assistance that includes some borrower obligation to repay would not count as equity. In the analysis explaining this decision, the regulators discuss the default experiences for loans that included second mortgages in so-called piggy-back structures and used this experience to justify the adverse treatment for all second loans in the proposed rule.

The rule would benefit from an analysis of the different ways to structure second mortgages, especially in the affordable homeownership space. The final rule could choose a course that distinguishes between good second mortgages and bad second mortgages. Soft second loans have been used successfully for many years prior to the crisis as a part of affordable

[2] Center for Responsible Lending, et. al., *op. cit, p.1.*

homeownership strategies. Many low- and moderate-income homeownership programs apply public money – usually provided by state and local governments using federal HOME, Community Development Block Grant (CDBG), or Neighborhood Stabilization Program (NSP) funds – to lower the cost of the house and help borrowers afford to buy their first homes. There are also numerous examples of down payment assistance programs offered by the Federal Home Loan Banks and private financial institutions that are often provided with concessionary terms. In these instances, the subsidy is often structured as a soft second mortgage, with a limited requirement for the borrower to make payments, some sort of debt forgiveness over time, and/or a recapture of the subsidy at sale from the equity built up through home appreciation. These well-structured soft second loans increase affordability and, at the same time, in the case of public programs, allow the state or local government to recapture public subsidies and redeploy these to support other low- and moderate-income families in the future.

Debt-to-Income Ratios

The debt-to-income (DTI) ratios in the proposed rule reflect an antiquated underwriting standard. The risk retention rule proposes a 28 percent front-end DTI ratio and 36 percent back-end DTI ratio as part of the definition of a QRM. In modern underwriting systems, DTI is often an underwriting variable, but quite less prominent than the proposed rule would suggest. Underwriting systems instead look at the effects of layered risks and offsetting risk factors on loan performance. In these systems, down payment, reserves, and credit history are the most important variables; DTI is also considered, but to a lesser extent. A bright line standard for DTI in the QRM definition will create an artificial and ill-advised dividing line that risks disqualifying otherwise well-underwritten responsible loans.

This is not to argue that underwriters should abandon the consideration of debt-to-income ratios as the nation revisits the rules of housing finance. The front-end standard is also a measure of housing affordability. National policy considers housing affordable if housing costs are equal to or less than 30 percent of a household's income. Likewise, we believe it important to assess a household's other debt obligations to ensure that a family is able to afford to pay both the mortgage and these other debts. The back-end ratio gives lenders some measure of a family's residual income – the money left over to pay for other household necessities.

This is to argue for a more flexible approach that reflects a wider variety of ways to assess a family's ability to pay a mortgage. Many families are willing to stretch a little bit to afford a particular home. And, each family has a different ability to meet its obligations. A household with a higher income can tolerate higher DTI ratios in percentage terms, because the amount of residual income in dollar terms is also higher. The proposed standard likely is too restrictive for many middle-income families. The solution is to allow underwriters some flexibility to establish maximum DTIs in the context of other underwriting factors.

Wrong Time to Make Changes of this Import

Another significant concern is the timing of the proposed changes. Adopting the changes will add an additional layer of uncertainty and conservatism into a market that is already overly constrained as the nation's mortgage markets struggle to return to some semblance of normalcy.

As the wave of foreclosures continues to wash over numerous neighborhoods, the difficulties in achieving stabilization and recovery are exacerbated by the limited access to credit for qualified borrowers who would seek to take advantage of the lower housing prices to buy a home. For the Network members that have been working to respond to the foreclosure crisis, tighter post-crisis mortgage lending standards already make neighborhood stabilization activities harder. The proposed rule will tighten standards even further, adding yet another barrier to finding end loans. The proposed changes are also coming at a time when Neighborhood Stabilization Program funding has come to a close and when policy makers decided not to fund the HUD Housing Counseling Program for fiscal year 2011. It is a difficult time to try to help low- and moderate-income people interested in buying a home and the rule could make things worse.

The rule also arrives at a time when the larger housing policy landscape and regulatory framework for mortgage finance are in great flux. There is a high level of uncertainty in the policy marketplace. The Administration and Congress have yet to decide on the future of Fannie Mae and Freddie Mac, but all signals are that we will not return to the *status quo ante*. Key decision-makers are arguing for radically different visions for the future role of the federal government in the mortgage markets. It is difficult to imagine a rapid resolution to both the transition issues and a consensus on the future state of the market. The legislative process for resolving and working out these different visions is likely to play out over a number of years.

At the same time, the Administration has indicated that it will raise prices on Federal Housing Administration (FHA) loan guarantees and increase the government sponsored enterprises' (GSE) credit standards and g-fee pricing in an effort to bring private capital back into the mortgage markets. International regulators are moving to implement the so-called Basel III capital standards which will likely increase the costs of mortgages by requiring financial institutions to hold more capital against mortgage risks. In this context, regulators should move slowly and with excessive caution.

Effects on Industry Structure

We are also concerned that the rule will have a detrimental effect on the structure of the mortgage industry and the level of competition in single-family mortgage credit markets. As currently drafted, the rule would exempt FHA and other federally-guaranteed mortgages from the risk retention requirements. The rule would also exempt loans put into mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac so long as the two enterprises are in government conservatorship or receivership. The implication is that if and when the GSEs are no longer controlled by the federal government that the risk retention rules will also apply to their activities.

Ironically, one potential result of the risk retention rule is that the QRM standard will make it less likely that private capital will return to the mortgage market, contrary to stated Administration policy. At present, Fannie Mae, Freddie Mac, and FHA are responsible for nearly all the mortgage lending in the country. By excluding both FHA and the GSEs from the risk retention rules, it makes it less likely that private capital will come back into the private label securities market except for the most pristine of mortgages.

Over the longer term, should the GSEs leave conservatorship status or give way to a new housing finance policy framework, the risk retention rules would then relegate all low-down payment lending to the FHA. This would be a highly unsatisfactory outcome. The nation has benefitted by the competition that the private sector has had with FHA over the years both in terms of lower prices and also in terms of the innovation in products, processes, and ease of execution.

We are also concerned about the potential impact of the proposed risk retention requirements on the broader industry for mortgage lending. Some have argued that the risk retention rule will discourage small lenders with small balance sheets from engaging in mortgage finance and that more of the mortgage business will migrate to larger lenders with larger balance sheets and an ability to hold the retained credit risk on their books. If true, the rule could worsen an increasingly troubling trend of consolidation in the mortgage lending business. Nine lenders represented two thirds of industry originations in 2008, compared with 18 in 2007 and 44 in 2006.[3] With increasing industry consolidation comes the potential for decreasing levels of competition – and with lessened competition, fewer consumer choices and higher prices. As regulators move to promulgate the final risk retention rule, we would welcome additional analysis of this issue and consideration of changes to the proposed rule to mitigate the potentially negative effects of the risk retention requirements on industry consolidation.

Toward a Better Definition of QRM

Our suggested goal is to provide a broad definition of a QRM that encompasses the wide array of responsible lending practices, that does not disadvantage good lending practices by including these in the non-QRM segment of the market, and that reflects the Congressional intent that sponsors retain some of the risk where appropriate to ensure that market incentives between sponsors and investors are aligned.

During the time that the risk retention rule has been out for comments from the public, the Board of Governors for the Federal Reserve has issued a proposed rule implementing changes from the Dodd-Frank bill to the Truth in Lending Act (TILA) that would define the term “qualified mortgage (QM)” and apply this standard broadly across nearly all mortgages. The TILA changes would set new standards for good underwriting – most notably requiring lenders to fully document a borrower’s ability to pay, and essentially eliminating the most abusive loan features that arose during the subprime lending boom – features like negative amortizations, prepayment penalties, excessive points and fees, and inordinate balloon payments from mortgage products. While we would urge additional changes to the definition of a QM to allow more flexibility for affordable housing mortgages backed by governmental programs, we would urge the regulators to align these modified QM standards with the definition for the QRM in the risk retention rule.

With this alignment, the final risk retention rule would eliminate down payment as a specific, defined criteria for a QRM. Investors would be assured that the mortgages included in their pools were well-underwritten to a borrower’s ability to repay – with documentation of, and due

[3] Shelley Metz Galloway, Wells Fargo, *Briefing: Fair Lending and HMDA*, PowerPoint presentation, March, 2011, p. 8.

consideration to, a borrower's other debts, credit history, and sources of income and down payments.

Allowing for Underwriting Flexibility

In addition to eliminating down payment as a requirement for a QRM, the final rule should also allow for greater flexibility with respect to other underwriting criteria – especially DTI. Sound underwriting systems weigh a variety of risk factors and then look at these in a comprehensive way to assess a loan's risk. In the application of these underwriting systems, DTI has proven a less important a variable in predicting the ultimate success of a loan. Regulators should avoid applying bright line underwriting standards in the proposed rule. The rule should, in fact, embrace underwriting approaches with a good track record of producing successful, sustainable loans.

Automated underwriting systems (AUS) are but one manifestation of a comprehensive approach. These systems attempt to predict loan success based on the interactive effects of numerous variables. AUS utilize algorithms that compensate for offsetting factors and punish layered risks. Manual systems using matrices and skilled underwriters can also predict loan performance in a way that should give regulators and investors assurances that a loan is well underwritten and deserved of QRM status.

Incorporate Homeownership Counseling into the Definition of a QRM

We strongly urge regulators to broaden the definition of a QRM to include loans to households that have received homebuyer education or counseling. Numerous studies demonstrate the positive impact of homeownership education and counseling on mortgage decision-making. Borrowers are more likely to choose mortgage products with better terms and are less likely to default. Loans to borrowers who have received counseling are more likely to perform better.[4] High quality education and counseling services that adhere to the National Industry Standards for Homeownership Education and Counseling prepare borrowers for homeownership in such a way to offset the presumed risk of lower down payments.

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[4] Pre-purchase studies: Hirad and Zorn, *A little knowledge is a good thing: empirical evidence of the effectiveness of pre-purchase counseling* (2002); Hartarska and Gonzalez-Vega, *Credit counseling and mortgage termination by low-income households* (2005, 2006); Quercia and Spader, *Does homeownership counseling affect the prepayment and default behavior of affordable mortgage borrowers?* (2008); Agarwal et al., *Do financial counseling mandates improve mortgage choice and performance?* (2009a, 2009b). Post-purchase studies: Collins, *Exploring the design of financial counseling for mortgage borrowers in default* (2007); Ding, Quercia and Ratcliffe, *Post-purchase counseling and default resolutions among low- and moderate-income borrowers* (2008); Quercia and Cowan, *Does homeownership counseling affect the prepayment and default behavior of affordable mortgage borrowers?* (2008)

Allow Certain Down Payment Assistance and Second Mortgage Programs to Support QRMs

We would also urge regulators to allow loans that benefit from certain down payment assistance programs to qualify for QRM treatment. In those instances where the purchase assistance is structured as a loan, this second lien should count as "eligible down payment assistance" if the buyer is not required to make any repayment for at least 5 years. Further, those second mortgages made through affordable housing programs that do not require repayment until the home is sold, those that come with an interest rate that is substantially below market, or those that are forgiven over time should be allowed in support of a QRM.

Defining Certain Seasoned Loans as QRMs

We would also support a provision in the final rule that exempts a loan from the risk retention requirement if the originating lender or ABS sponsor had held the loan in portfolio for specified period of time. This approach could foster innovation in the mortgage market by providing a mechanism through which lenders could experiment with new loan features and take the implied risk – while leaving open the door for securitization if the new product performs as expected. The lender will have taken significant risk while the loans were on its books, and nothing will compel the investor to assume the risk in a securitization transaction. However, with the prospect of future liquidity for innovative loans, lenders should have an increased willingness to work with not-for-profits who are working to expand homeownership opportunities.

Alternative Down Payment Approach

The most important change required in the proposed risk retention rule is the elimination of down payment as a standard for the QRM. One of the dangers, however, is that the regulators will accede to comments from the public, but instead of eliminating the down payment requirement, choose a standard less than the 20 percent as proposed in the risk retention rule. Ironically, this outcome could be a worse one for those of us who support the homeownership aspirations of low- and moderate-income households. A 10 percent down payment standard, for example, would not solve for our greatest concern. For most homebuyers in higher-cost markets, even a 10 percent down payment requirement would be too high a hurdle. And, this half-way approach will go even further to stigmatize the low-down payment lending that provides homeownership to low-wealth individuals.

If regulators are unwilling to eliminate down payment entirely as a feature of a QRM, we would recommend that regulators instead raise the QRM down payment criteria to 30 or 40 percent. The goal of this change from the perspective of maximizing consumer benefit and homeownership opportunity would be to create a larger market for non-QRM mortgages. The larger market would allow for greater liquidity for non-QRM mortgages and lessen the risk that the QRM becomes an industry standard for "good underwriting" and "safe loans."

Conclusion

Thank you, in advance, for your consideration of these comments. Please contact Paul Weech at weech@housingpartnership.net or at 202-677-4292 if you would like more information on our views or to explore any of the issues raised by this letter in more detail.

Sincerely,

Paul Weech
Executive Vice President for Policy and Member Engagement