May 31, 2011

Secretary of the Treasury
Office of the Comptroller of the Currency
Department of the Treasury
Docket No. OCC-2011-0002
via *regs.comments@occ.treas.gov*

Chairman of the Board of Governors
Federal Reserve System
Docket No. R-1411
via *regs.comments@federalreserve.gov*

Chairman, Federal Deposit Insurance Corporation
RIN 3064-AD74
via Comments@FDIC.gov

Acting Director, Federal Housing Finance Agency
RIN 2590-AA43
via *RegComments@fhfa.gov*

Chairman, Securities and Exchange Commission
File No. S7-14-11
via *rule-comments@sec.gov*

Secretary of Housing and Urban Development
c/o Office of General Counsel
FR-5504-P-01, "Credit Risk Retention" Proposed Rule
Department of Housing and Urban Development
451 7th St. SW, Room 10276
Washington, D.C. 20410-0500

Dear Messrs. Secretary, Messrs. Chairman, Madam Chairman, and Mr. Acting Director:

This letter presents comments of The Heritage Foundation[1] ("Foundation") on the Notice of Proposed Rulemaking on "Credit Risk Retention" published jointly by your Agencies (76 *Fed. Reg.* 24090, April 29, 2011)("NPRM"). The proposed rule implements section 15G of the Securities

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[1] The Foundation is a District of Columbia nonprofit corporation that is recognized as exempt under section 501(c)(3) of the Internal Revenue Code, with the mission "to formulate and promote conservative public policies based on the principles of free enterprise, limited government, individual freedom, traditional American values, and a strong national defense." The Foundation submits these comments as permitted by law (5 U.S.C. 553(c), 2 U.S.C. 1602(8)(B)(x), and 26 U.S.C. 4911(d)(2)(E)).

214 Massachusetts Avenue, NE • Washington, DC 20002–4999 • (202) 546-4400 • heritage.org

Exchange Act of 1934 (15 U.S.C. 78o-11) as enacted by section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203, July 21, 2010). The Foundation recommends changes in (1) the proposed down payment rules so as to maintain the effective functioning of the mortgage markets, and (2) the proposed Qualified Residential Mortgage (QRM) rules so as to eliminate the unwarranted, anti-competitive advantages granted to the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

I. Reduce 20 Percent Down Requirement, To Maintain Effective Functioning of Mortgage Market

Proposed section __.15(c)(1) and (d)(10) of the Common Rules, in defining the term "qualified residential mortgage," require a 20 percent down payment in a mortgage transaction for purchase of a one-to-four family property. David C. John of the Foundation, in "Qualified Residential Mortgage Regulations Threaten the Housing Market," Web Memo No. 3270 (May 25, 2011)[2] (page 2, footnote omitted), explains why the 20 percent down requirement is unreasonable:

> This is utterly at odds with the realities of today's housing market, where in 2010 only 16 percent of first-time buyers and 37 percent of repeat buyers would have qualified for QRM status. Counting both groups together, fully 75 percent of 2010 home buyers would not have qualified for this quality of loan.
>
> These numbers are doubly significant for the recovery of housing since many home owners have seen the value of their property drop precipitously over the past few years and may not have much, if any, equity left. While failure to qualify for QRM status may not prevent consumers from obtaining a mortgage, it would force them to pay higher interest rates on the mortgages they do obtain. For current home owners, having to pay higher mortgage interest rates would, in turn, reduce the value of the house they can afford, which could put additional downward pressure on housing prices.

The National Association of Realtors profile (at page 71) cited in footnote 4 of "Qualified Residential Mortgage Regulations Threaten the Housing Market" reflects that, at a down payment rate of 10%, 32 percent of first time buyers in 2010 and 60 percent of repeat borrowers would meet QRM standards (assuming that they also met the credit quality tests); thus, the reduction of the proposed 20 percent down payment requirement to a 10% down payment requirement would take better account of current needs in the economy. Recognizing that financial market and housing market factors may change over time, the rule should provide for a periodic review and reconsideration by your Agencies of the specified down payment requirement.[3]

For the reasons stated above and in the attached copy of "Qualified Residential Mortgage Regulations Threaten the Housing Market," the Foundation requests that your Agencies make the following changes in proposed section __.15:

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[2] A copy of David C. John, "Qualified Residential Mortgage Regulations Threaten the Housing Market," Web Memo No. 3270 (May 25, 2011) is attached and is incorporated in these comments by reference.

[3] Your Agencies may wish also to consider providing in the rule for such a periodic review and reconsideration of the other requirements in the QRM definition, to help your Agencies ensure, in light of experience, that they are focused on the proper elements of credit quality.

1. In proposed section __.15 (d)(10), strike "20" and insert in lieu thereof "10".

2. At the end of proposed section __.15, add the following new subsection:

   "(f) *Periodic review of down payment percentage*. (1) Two years after this section first takes effect, and from time to time thereafter, the Federal banking agencies, the Commission, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency shall jointly review the percentage specified in subsection (d)(10)(i)(B) of this section and determine, through a rulemaking in accordance with section 553 of title 5, United States Code, whether to increase or decrease such percentage to a specified percentage of not less than 10 percent nor more than 20 percent.

   "(2) In making the determination to which paragraph (1) refers, the agencies shall take into account (i) the importance of free and competitive markets in housing and finance, and (ii) the need for stability in markets in housing and finance."

The proposed changes are consistent with the authority granted to your Agencies by section 15G(e)(4)(B) of the Securities Exchange Act of 1934, as amended, to jointly define the term "qualified residential mortgage" and will serve American economic interests more effectively than the proposed rule.

II. Eliminate the Unwarranted, Anti-Competitive Advantages for Fannie Mae and Freddie Mac

Proposed section __.3 in Subpart B of the Common Rules provides that "[e]xcept as otherwise provided in this part, the sponsor of a securitization transaction shall retain an economic interest in the credit risk of the securitized assets in accordance with any one of §__.4 through §__.11 of this part." Proposed section __.11 then provides that the guaranty provided by Fannie Mae and Freddie Mac operating under the conservatorship or receivership of the Federal Housing Finance Agency (FHFA), or any statutory successor limited-life regulated entity operating with capital support from the United States, will satisfy the risk retention requirements and that Fannie Mae and Freddie Mac are not subject to premium capture cash reserve account requirements nor prohibitions on hedging by sponsors, affiliates, and issuing entities. The NPRM (in part III.B.8, at 24112, footnotes omitted) justifies this treatment of Fannie Mae and Freddie Mac as follows:

> The primary goals of the conservatorships are to help restore confidence in the Enterprises, enhance their capacity to fulfill their mission, mitigate the systemic risk that contributed directly to instability in financial markets, and maintain the Enterprises' secondary mortgage market role until their future is determined through legislation. To these ends, FHFA's conservatorship of the Enterprises is directed toward minimizing losses, limiting risk exposure, and ensuring that the Enterprises price their services to adequately address their costs and risk. Any limited-life regulated entity established by FHFA to succeed to the charter of an Enterprise also would operate under the direction and control of FHFA, acting as receiver of the related Enterprise.
>
> Concurrently with being placed in conservatorship under section 1367 of the Safety and Soundness Act, each Enterprise entered into a Senior Preferred Stock Purchase Agreement (PSPA) with the United States Department of the Treasury (Treasury). Under each PSPA, Treasury purchased senior preferred stock of each Enterprise. In addition, if FHFA determines that the Enterprise's liabilities have exceeded its assets under generally accepted accounting principles (GAAP), Treasury will

> contribute cash capital to that Enterprise in an amount equal to the difference between its liabilities and assets. In exchange for this cash contribution, the liquidation preference of the senior preferred stock purchased from each Enterprise under the respective PSPA increases in an equivalent amount. The senior preferred stock of each Enterprise purchased by Treasury is senior to all other preferred stock, common stock or other capital stock issued by the Enterprise, and dividends on the aggregate liquidation preference of the senior preferred stock purchased by Treasury are payable at a rate of 10 percent per annum. Under each PSPA, Treasury's commitment to each Enterprise is the greater of (1) $200 billion, or (2) $200 billion plus the cumulative amount of the Enterprise's net worth deficit as of the end of any calendar quarter in 2010, 2011 and 2012, less any positive net worth as of December 31, 2012. Accordingly, the PSPAs provide support to the relevant Enterprise should the Enterprise have a net worth deficit as a result of the Enterprise's guaranty of timely payment on the asset-backed securities it issues. By their terms, the PSPA with an Enterprise may not be assigned or transferred, or inure to the benefit of, any limited-life regulated entity established with respect to the Enterprise without the prior written consent of Treasury.
>
> In light of the foregoing, §__.11 of the proposed rules provides that the guaranty provided by an Enterprise while operating under the conservatorship or receivership of FHFA with capital support from the United States will satisfy the risk retention requirements of the Enterprise under section 15G of the Exchange Act with respect to the mortgage-backed securities issued by the Enterprise. Similarly, an equivalent guaranty provided by a limited-life regulated entity that has succeeded to the charter of an Enterprise, and that is operating under the direction and control of FHFA under section 1367(i) of the Safety and Soundness Act, will satisfy the risk retention requirements, provided that the entity is operating with capital support from the United States. If either Enterprise or a successor limited-life regulated entity were to begin to operate other than as provided in the proposed rules, that Enterprise or entity would no longer be able to avail itself of the credit risk retention option set forth in §__.11.
>
> For similar reasons, the proposed rules provide that the premium capture cash reserve account requirements in §__.12, as well as the hedging and financing prohibitions in §__.14(b), (c), and (d), of the proposed rules shall not apply to an Enterprise while operating under the conservatorship or receivership of FHFA with capital support from the United States, or to a limited-life regulated entity that has succeeded to the charter of an Enterprise and that is operating under the direction and control of FHFA with capital support from the United States.

Proposed section ___.21(a) in Subpart D of the Common Rules, concerning Qualified Residential Mortgages, provides that "This part shall not apply to: . . . (5) any securitization transaction that: (i) Is collateralized solely (other than cash and cash equivalents) by existing asset-backed securities issued in a securitization transaction: . . . (A) For which credit risk was retained as required under subpart B of this part . . . ." Reading section ___.21(a)(5)(i)(A) in light of section __.11, it is clear that Fannie Mae and Freddie Mac need not meet QRM requirements. The NPRM explains this treatment (at 24119) by cross-reference to the earlier explanation quoted at length above:

> For the reasons explained in Part III.B.8 of this Supplemental Information, under § __.11 of the proposed rules, the guarantee provided by an Enterprise while operating under the conservatorship or receivership of FHFA with capital support from the United States would satisfy the risk retention requirements of the Enterprise with respect to the mortgage-backed securities issued by the Enterprise.

David C. John of the Foundation, in "Qualified Residential Mortgage Regulations Threaten the Housing Market," explains the error of this exclusion by section ___.21(a)(5)(i)(A) of Fannie Mae and Freddie Mac from QRM requirements:

> Not having to retain a 5 percent interest in their mortgage-backed securities will allow Fannie Mae and Freddie Mac a significant cost advantage over potential private-sector rivals, enable them to securitize any grade of mortgage without penalty, and undermine efforts to improve the quality of mortgages.

In proposing to exclude Fannie Mae and Freddie Mac from Qualified Residential Mortgages risk retention requirements, your Agencies failed to give sufficient weight to the importance of preserving competition in the mortgage marketplace. Your Agencies' proposal to exclude Fannie Mae and Freddie Mac from the QRM requirements constitutes unwarranted government interference with free market competition and inappropriately puts the Government's proprietary interests ahead of the economic interests of the American people.

The Foundation notes that your Agencies' proposal to give by regulation to Fannie Mae and Freddie Mac a major advantage over their private sector competitors is contrary to executive branch policy, in light of the conclusion in "Reforming America's Housing Finance Market: A Report to Congress" (February 2011)(pages 1-2, emphasis added), which stated:

> <u>Under our plan, private markets – subject to strong oversight and standards for consumer and investor protection – will be the primary source of mortgage credit and bear the burden for losses.</u> Banks and other financial institutions will be required to hold more capital to withstand future recessions or significant declines in home prices, and adhere to more conservative underwriting standards that require homeowners to hold more equity in their homes. Securitization, alongside credit from the banking system, should continue to play a major role in housing finance subject to greater risk retention, disclosure, and other key reforms. Our plan is also designed to eliminate unfair capital, oversight, and accounting advantages and promote a level playing field for all participants in the housing market.
>
> The Administration will work with the Federal Housing Finance Agency ("FHFA") to develop a plan to responsibly <u>reduce the role of the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") in the mortgage market and, ultimately, wind down both institutions</u>.

For the reasons stated above and in the attached copy of "Qualified Residential Mortgage Regulations Threaten the Housing Market," the Foundation requests that your Agencies change the proposed Common Rules as follows:

1. Add at the end of proposed section __.11(a)(1) the following new subsection:

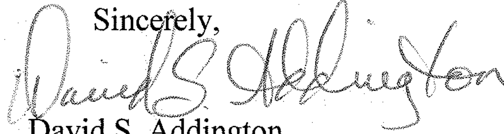
   "(d) *Rule of Construction*. Nothing in this part shall be construed to exclude the applicability to the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation of Subpart D or any portion thereof."

2. In proposed section ___.21(a)(5)(i)(A), after "this part" insert ", except by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation".

* * * * *

The Foundation urges your Agencies to make the specific changes in the Common Rules specified above and to make additional changes to the Common Rules as necessary to correct the other shortcomings identified in the attached copy of "Qualified Residential Mortgage Regulations Threaten the Housing Market."

Sincerely,



David S. Addington
Vice President for Domestic and Economic Policy

Attachment as stated

WebMemo

Published by The Heritage Foundation

No. 3270
May 25, 2011

Qualified Residential Mortgage Regulations Threaten the Housing Market

David C. John

The housing market is still weak,[1] and federal regulators are considering a regulation that could make matters even worse. Known as the Qualified Residential Mortgage (QRM) rule, the draft rule could have the effect of requiring many home buyers to have at least a 20 percent down payment in order to qualify for a best interest rate mortgage.[2] In addition to making it harder for qualified consumers to obtain loans, the proposed regulation would preserve the roles of Fannie Mae and Freddie Mac, the government-sponsored finance agencies whose collapse has already cost taxpayers in excess of $150 billion. It would also further concentrate mortgage lending in the largest financial institutions.

Skin in the Game. The QRM is part of a risk-sharing provision in the Dodd–Frank financial regulation bill that was supposed to require lenders to do a better job of underwriting mortgages. Under the old system, lenders and brokers received a fee for writing a loan and another fee for selling it to underwriters, who included it in mortgage-backed securities. Since their income came from the fees, these brokers and lenders had no further interest in the loan and found they could maximize their income by making dozens of loans, regardless of whether the borrowers had any ability to repay the mortgages. The flood of bad mortgages caused billions of dollars in losses to homeowners, lenders, and investors.

Congress responded by including a risk-retention rule that would require the creators of mortgage-backed securities to retain 5 percent of the pool. Since they would share in any losses, legislators felt that this would encourage securitizers to ensure that the mortgages they buy meet good credit standards. As a further incentive to quality underwriting, securitizers would not be required to retain a 5 percent share of securities that meet specific minimum credit standards defined in the QRM regulations.

As the mortgage disaster illustrated, better underwriting is an absolutely essential step toward both housing recovery and a restoration of faith in mortgage-backed securities. However, it is very unlikely that the Dodd–Frank provision would have the effect that supporters expect.

Disqualifying 75 Percent of Buyers. The proposed regulations define "qualified residential mortgages" as those with a loan-to-equity ratio of 80 percent or less for home purchasers, 75 percent for refinancing, and 70 percent for refinancing where the homeowner receives cash as a result of the transaction.[3] In addition, prospective purchasers would need a very clean credit history. In order to meet this standard, a purchaser would either have to have a 20 percent down payment or that amount in equity from a previous home. Refinanc-

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http://report.heritage.org/wm3270

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ers would need even more cash or equity. This is utterly at odds with the realities of today's housing market, where in 2010 only 16 percent of first-time buyers and 37 percent of repeat buyers would have qualified for QRM status.[4] Counting both groups together, fully 75 percent of 2010 home buyers would not have qualified for this quality of loan.

These numbers are doubly significant for the recovery of housing since many home owners have seen the value of their property drop precipitously over the past few years and may not have much, if any, equity left. While failure to qualify for QRM status may not prevent consumers from obtaining a mortgage, it would force them to pay higher interest rates on the mortgages they do obtain. For current home owners, having to pay higher mortgage interest rates would, in turn, reduce the value of the house they can afford, which could put additional downward pressure on housing prices.

Preserving Fannie Mae and Freddie Mac and Expanding FHA. Contrary to the stated goal of the Obama Administration and many in Congress of eliminating Fannie Mae and Freddie Mac,[5] the draft regulations exempt both those entities and the Federal Housing Administration (FHA) from the requirement to retain a 5 percent stake in mortgage pools that are converted into securities.

Thus, at the very time that Congress is considering bills[6] to reduce the advantages the two housing giants have in order to encourage private-sector competitors to begin to take over Fannie Mae and Freddie Mac's functions, regulators are seeking to give them another advantage. Not having to retain a 5 percent interest in their mortgage-backed securities will allow Fannie Mae and Freddie Mac a significant cost advantage over potential private-sector rivals, enable them to securitize any grade of mortgage without penalty, and undermine efforts to improve the quality of mortgages. Sadly, prior to 2007, both housing giants showed serious weaknesses in securitizing poor-quality mortgages and buying investment securities containing poor-quality mortgages. There is little reason to expect them to do better now.

Exempting FHA from the risk retention rules will also distort housing markets. Since FHA requires only a 3.5 percent down payment, its cost advantage over private-sector entities that would have to retain a 5 percent interest in mortgages would allow it to dominate the housing market for non-QRM loans.

Driving Smaller Institutions out of Business. Even if the 20 percent down payment requirement and the exemptions for Fannie Mae, Freddie Mac, and the FHA were eliminated, the risk-retention rule is likely to have a negative effect on private securitizers other than large banks. Because the 5 percent retention will be for a lengthy period of time, only larger, well-capitalized entities will be able to meet this requirement. Smaller entities or thinly capitalized non-bank mortgage lenders will not be able to afford it.

Serious Rethinking Is Necessary. While well-intentioned, the draft Qualified Residential Mortgage regulations would have serious negative consequences for individual borrowers and for

1. Jeffry Bartash, "Construction of New Homes Falls in April," *MarketWatch,* May 17, 2011, at *http://www.marketwatch.com/story/construction-of-new-homes-fall-in-april-2011-05-17* (May 24, 2011).
2. Proposed Regulation, "Credit Risk Retention," Federal Deposit Insurance Corporation (FDIC), at *http://www.fdic.gov/news/board/29Marchno2.pdf* (May 25, 2011).
3. In addition, the draft regulations require the borrower to have enough cash to cover all closing costs; have not had a delinquent payment late by 60 days or more for the past 24 months; and not spend more than 27 percent of total income on housing-related expenses or more than 36 percent of income on debt repayment.
4. National Association of Realtors, "Profile of Home Buyers and Sellers 2010," p. 71.
5. David C. John, "End Fannie Mae and Freddie Mac to Build Tomorrow's Housing Finance System," Heritage Foundation *WebMemo* No. 3147, February 10, 2011, at *http://www.heritage.org/Research/Reports/2011/02/End-Fannie-Mae-and-Freddie-Mac-to-Build-Tomorrows-Housing-Finance-System.*
6. David C. John, "Two Promising Starts towards Ending Fannie Mae and Freddie Mac," Heritage Foundation *Foundry,* March 31, 2011, at *http://blog.heritage.org/2011/03/31/two-promising-starts-towards-ending-fannie-mae-and-freddie-mac.*

efforts to reform the housing market by eliminating Fannie Mae and Freddie Mac. This appears to be yet another example of overloaded regulators producing draft regulations without considering major issues and weighing their consequences. Rather than rushing into final regulations, the regulators should take the time to fully understand the issues and to extensively revise the draft QRM regulations.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.