Amherst® Securities Group LP

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Re: Credit Risk Retention

Ladies and Gentlemen:

The proposed guidelines for credit risk retention are a joint effort by the Office of the Comptroller of the Currency, the Federal Reserve System, the FDIC, the OCC, the SEC, the FHFA, and HUD, in an effort to meet the risk retention requirements of Dodd Frank. This proposal was released on March 31, 2011, with a comment period ending June 10, 2011. This analysis constitutes the Amherst Securities Group L.P. comment.

Our comments are limited to the residential mortgage market; we argue that risk retention will not have the desired effect. We also argue that the definition of a "*qualified residential mortgage*" (QRM) is far too restrictive, and could have a detrimental impact on credit availability, particularly if the scope of the GSEs is further limited. Credit availability issues could be compounded if the Fed does not provide an absolute "safe harbor" for qualified mortgages (QM); that's another set of rules out for comment at the same time. Moreover, the combination of very flexible risk retention rules and very stringent QRM rules combine to provide an environment that is very "large bank friendly," thus disadvantaging entities without large balance sheets. Finally, we argue that risk retention for re-REMICs makes no sense, and will have an unnecessarily chilling effect on that market.

Risk Retention, As Proposed

The idea of risk retention is intellectually appealing—it gives the sponsor of the securitization some skin in the game. However, it is not clear that risk retention produces any net benefit, as it fails to really address the conflicts of interest in the securitization process. We now discuss how the proposed rules help (or . . . don't help) address these conflicts.

The guidelines propose a 5% minimum risk retention, to be borne by the deal sponsor (underwriter), unless the security is collateralized exclusively by QRMs (in which case, the risk retention is zero). For securities collateralized by *non*-QRM loans, the proposal allows many forms of risk retention—a vertical strip, a horizontal strip, or a combo [½ vertical strip + ½ horizontal strip].

Horizontal risk retention is closely prescribed—the owners of the horizontal risk retention cannot receive any prepayment of principal made on the underlying loans, nor can they receive principal payments from sale or foreclosure on any underlying asset—until the more senior classes are paid off in full, as doing otherwise would reduce the capital of the horizontal interest to absorb losses on the underlying securities. Even so, we are concerned that horizontal risk retention exacerbates some of the inherent conflicts of interest in the securitization process. This can best be illustrated by an example: Carrington Capital Management is a subprime servicer, who owned the credit enhancement tranche (the CE class) of many of the deals it services. There is evidence that the servicer engaged in actions to maximize the cash flows to the CE tranche, to the detriment of the other investors in the deal. [1] These actions included heavy use of capitalization modifications, in which the past due payments were added to the outstanding balance of the loan. This allowed the loan to be called current to the benefit of Carrington, enabling them to recover advances, but to the detriment of borrowers and investors, as the borrowers are less likely to be able to continue paying on a higher balance mortgage.

The proposed risk retention guidelines also allow sponsors to hold a 5% sample of loans that are matched in characteristics to the loans placed into a securitization. This type of risk retention will likely be the most appealing to

[1] *See Friday, February 25, 2011 American Banker article by Jeff Horowitz, "Carrington's Dual Role as Servicer and Investor in MBS Questioned"*

banks (who serve as originators, servicers, and the sponsors of the securitization), as it allows them to avoid the FAS 166/167 consolidation issue. Otherwise, the sponsor of the securitization would have to hold a 5% piece of the deal; this, in conjunction with owning the servicing, could require the sponsor to consolidate the securitization on their balance sheet. (One restriction on the use of the 5% representative sample: the sponsor would have to designate a pool of at least 1000 assets for securitization, a high threshold for a jumbo deal.) The representative sample must be drawn from the designated pool.

A few points to note about these risk retention provisions:

- Subject to some important restrictions, the sponsor may allocate its risk retention obligation to the originators of the securitized assets.
- The GSEs are exempt from the risk retention guidelines while they are in conservatorship or receivership. (Page 86 of the document containing the proposed credit risk rule states, "*The proposed rules provide 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…")*

It seems logical to have Fannie and Freddie exempt from risk retention for a number of reasons. First, if they had to retain a share of the securitization, these retained portions would have to be placed in portfolio. And the GSEs are currently under pressure to reduce the size of their portfolios; they must remain under the portfolio cap, and this cap continues to decline at 10% per annum. Second, the GSEs are critical to the market at the present time. If they changed their policies due to risk retention, such that only QRM-eligible mortgages were originated, it would further reduce credit availability; to the detriment of the already fragile housing market.

The Premium Capture Reserve Account

Intuitively, the purpose of the premium capture reserve account is to prevent an upfront "profit" on the securitization, as this would essentially negate the benefit of risk retention. That is, if the sponsor had an immediate gain on the sale of the assets that were not retained, the effective amount of risk retained would be lower than 5%. And the problem is especially acute if the risk retention method chosen is the 5% horizontal slice, as the sponsor is actually holding a much smaller piece of the market value of the deal. An example will make this clearer. Assume a sponsor securitized a package of loans purchased at par (and assuming no costs), and held a 5% horizontal strip. Let us further assume this strip is worth 3 points, and the remaining 95% par amount of the deal was sold for 105.5% of par. In this simple example, the sponsor would have realized proceeds of $100.22 (105.5 x .95) —giving $0.22 of immediate profit, plus the retention of the horizontal strip. The sponsor has no real "skin-in-the-game" here, having already booked a small profit.

The rules, as drafted, would not allow this upfront "profit." The sponsor would be required to fund a premium capture reserve account in connection with the securitization transaction. This would be in addition to the "base" risk retention requirement of the proposed regulations. If vertical or horizontal risk retention is used, the premium capture provisions require that a sponsor retain a premium reserve account equal to the difference (if a positive number) between the gross proceeds received by the issuing entity from the sale of ABS interests to persons other than the sponsor and 95% (net of closing costs) of the par value of all ABS interests in the transaction. In our example above, (assuming no costs) the premium reserve would be $5.22 (100.22-95). If a matched sample of loans is used for risk retention, the premium capture account is the gross proceeds received from the sale of ABS interest to persons other than the sponsor and 100% of the par value of all ABS interests in the transaction. That premium capture reserve will be held by the trustee, in the name of and for the benefit of the issuing entity. The premium reserve account would be used to cover losses on the underlying assets first, before any other interest, including any

first-loss horizontal strip. The money in the premium capture reserve would not be released to the sponsor until the all interests (including junior or residual interests) are paid in full or the issuing entity is dissolved.

There are some anti-evasion provisions, so that the gross proceeds amount includes the par value of any ABS interest that (1) the sponsor does not expect to hold to maturity or (2) the interest is an interest only tranche, and is not the most subordinate security in the transaction.

The regulators have stated in the proposal that they expect few, if any, securitizations would be structured to monetize excess spread at closing, and thus require the capture of a premium capture reserve account. We agree—even with these anti-evasive measures, it appears to us that there are ways to structure the deal such that it does not immediately monetize excess spreads, but the sponsor is getting paid relatively quickly on the securitization. For example, under the rules, we believe it would be permissible for the sponsor to retain a short senior tranche that pays off relatively quickly. It would also be permissible for the sponsor to retain an excess spread first loss class with no initial principal. (This is the Carrington trade on steroids, the sponsor retains the excess spread tranche, totally misaligning incentives between sponsors and investors.)

Taking a step back, it is not clear this part of the proposal was drafted as you, the regulators, intended it. The American Securitization Forum (ASF) have had conversations with individuals from the Regulators responsible for these rules, and have been told that the purpose of the premium capture reserve account was to ensure that risk retention constituted 5% of the market value of the securities. This is reinforced by a Federal Reserve Bank of New York staff presentation that has been obtained by the ASF, and would be very much in the spirit of Dodd Frank. As drafted, the proposal is based on the par value of the securities, not the market value. Moreover, it is not clear that all the regulatory agencies are on the same page as to the intent of these provisions,

Basing the premium capture reserve account on the par value of the securities, rather than the market value, has some unintended consequences. First, it will often mean more than 5% risk retention, as it does not allow for the recovery of the costs of origination. So, if the loans for the securitization were purchased at $101, the sponsor would be retaining more than 5%, as he could only sell $95 of par. Second, it would make interest rate locks, a real convenience to the borrower, less available, as bonds that have been locked at a higher rate would by definition sell over par. Third, it would also make hedging more difficult. If the sponsor had an interest rate hedge on the bond, and interest rates declined, the sponsor would have a loss on the hedge and a gain on the bond. This gain would have to be retained by the sponsor, and deposited in the premium capture reserve account. If the premium capture reserve account provisions were re-written to be based on market value, a 5% vertical slice would never be subject to this account, as it is by definition 5% of the market value of the deal.

In short, the premium capture reserve account, as currently drafted is unnecessarily cumbersome and would be yet another hurdle to structure around. Yes, there are ways to avoid the premium capture reserve account, but they raise the costs of securitization, as the structures produced will be less efficient. It in turn raises the hurdle to the restart of the securitization market.

Risk Retention and Conflicts of Interest

Don't get us wrong, we are no lover of the risk retention rules—we don't think they really do anything. We now outline some conflicts of interest in the securitization process, and show how the risk retention rules fail to address the conflicts of interest.

- *Originators who are also portfolio lenders may be incented to adversely select loans for securitization*. If an originator makes a marginal loan, and has the ability to choose to put it into a securitization with a 5% risk retention or hold it with 100% risk retention, it's a "no-brainer" — the loan goes into a securitization. The difference between no risk

retention under the current regime and 5% in this context is immaterial. Moreover, an originator can choose to originate to one standard for portfolio, but to a different one for securitization.

- *Underwriters (deal sponsors) are generally incented to select loans and structures to maximize profit—i.e., to push adverse selection to the market limit.* Note that under the proposed risk retention guidelines, the responsibility for holding risk rests with the deal *sponsor* (underwriter) unless the *originator* explicitly agrees to hold the risk. The idea is that the sponsor will police the originator, as the sponsor will be reluctant to buy risky loans due to the 5% risk retention. This clearly breaks down if the originator is also the sponsor; 5% of a bad loan is better than 100% of a bad loan. Moreover, if the risk factor is a non-disclosed characteristic, the effective risk retention may be zero, as the originator/sponsor is able to construct the matched basket of loans to eliminate loans with this characteristic (a loan from a correspondent with poorer performance than other correspondents, for example). If the originator and the deal sponsor are different entities, the 5% risk retention will be more helpful, but is still not a solution. For the sake of the relationship with the originator, the deal sponsor may be reluctant to turn down certain loans. The fear is if the deal sponsor rejects some loans, the originator will do less over time with the deal sponsor, channeling more of his business to "more cooperative" deal sponsors.

- *Trustees are responsible for the enforcement of representations and warranties (reps and warrants), but the servicers are the only ones with the information to detect the violations.* The thought is that with 5% risk retention, "better" loans without rep and warrant enforcement issues will be created. Moreover, the sponsor (underwriter) will have a 5% strip, and may be more proactive in trying to enforce reps and warrants. In fact, the originator, the servicer and the sponsor are very often the same party. When this occurs, the servicer/sponsor is not going to actively opt to put loans back to itself. Moreover, when this entity is a bank, it is likely that the risk retention will be held in the form of a group of loans that were never in the security; hence they have 0% stake in a positive outcome on detecting rep and warrant violations. It has always been clear that you need an unconflicted 3rd party, with a mandate to look out for investor's interests, access to the loan files, that is positively incented to detect rep and warrant violations. Risk retention is *not* the solution.

- *Servicers are often 2nd lien investors.* Risk retention does not address the inherent conflicts of interest in this relationship. These conflicts of interest produce some distortions in the way banks service their 1st liens. Moreover, what is the purpose of defining a qualified residential mortgage as a "good" loan if a borrower can go out and re-lever that loan tomorrow? We believe that this issue needed to be directly addressed in the risk retention discussion.

- *Servicers may have additional items on their agenda, resulting in a failure to maximize the NPV of the loans [Examples: Countrywide owned Balboa, a forced placed insurer; Carrington owned many of the residuals on their deals].* Conflicts of interest are not explicitly dealt with in the risk retention guidelines.

- *Goals of different investor groups are not necessarily aligned.* When a deal is doing poorly, interests of different groups of investors diverge rapidly. In particular, senior investors want non-performing loans to be removed as quickly as possible from the pool; more junior investors want loans to remain outstanding as long as possible so their coupon stream continues. Horizontal risk retention in situations in which the deal sponsor is also the servicer makes these conflicts of interest even stronger. The servicer is incented to keep the excess spread, paid to the horizontal slice, playing as long as possible, producing outcomes that are disadvantageous to both borrowers and other investors. This was exactly the Carrington Capital Management situation we discussed earlier.

- *Rating agencies are issuer paid.* This is not addressed in these guidelines.

  BOTTOM LINE—It is not clear what the purpose of skin-in-the-game (risk retention) really is. We thought it was aimed at insuring the production of higher quality mortgages, as the sponsor would be forced to absorb some of the

losses. However, we do not believe the guidelines achieve this goal, nor do they do much to address the conflicts of interests in securitizations. If there is one bitter lesson that mortgage investors have learned from the experience of the past few years is that they must (1) demand properly underwritten mortgages where the borrower has skin-in-the-game, (2) require subordination levels that are appropriate to the risk, and (3) make sure there is a mechanism to address some of the conflicts of interest in securitizations. Thus, by simply letting the market work, the desired result will be achieved; investors can't be fooled twice in exactly the same way. By contrast, crafting a cumbersome set of rules, which will prove to be anti-competitive, makes it more difficult to increase the role of the private sector in housing finance.

Qualified Residential Mortgage (QRM)

Securities will not be subject to risk retention if 100% the loans backing the security are qualifying residential mortgages (QRM). *But what exactly is a QRM*? A QRM in this context must be a loan which meets a very narrow set of criteria; the criteria were selected to ensure that the credit risk in QRM loans is minimal. In particular, the loan must:

- Be a closed end 1st lien mortgage to purchase or refinance a 1-4 family property, at least one unit of which is the principal dwelling of the borrower. (Investor loans cannot be QRM loans).
- Have a maximum maturity of 30 years.
- No other lien on the mortgage can, to the creditor's knowledge, exist at closing of the mortgage transaction (*i.e.*, a junior lien cannot be used in conjunction with a QRM to purchase a home).
- The Agencies wanted to incorporate credit score, but were reluctant to use FICO or another measure designed by a private entity, as models may change materially at an entity's discretion. Instead, a set of derogatory factors was used; each lowers a borrower's credit score significantly; thus using derogatory events was thought to be a good proxy for credit scores.
- A mortgage can qualify as a QRM if the borrower was not >30 days past due, in whole or in part on any obligation at the time of closing, and the borrower had not been >60 past due on any debt obligation within the preceding 24 months.
- A borrower must not have, within the preceding 36 months been a debtor in a bankruptcy proceeding, had property repossessed or foreclosed upon, engaged in a short sale or deed-in-lieu of foreclosure, or been subject to a Federal or State judgment for collection of any unpaid debt.
- Mortgages cannot be structured with interest only payments, negative amortization, or balloon payments, or prepayment penalties.
- Interest rates on hybrid ARMs cannot increase more than 2%/year (or 6% over the life of the loan). Thus, 5/1 hybrids with a 5/2/5 cap structure (5% at the first reset, 2% at subsequent resets. 5% life cap) would not qualify, as the initial reset could potentially introduce too big a payment shock.
- The maximum LTV would be 80% for purchase loans, 75% for rate and term refi loans, and 70% for cash out refinancing. The LTV must reflect the appraised value of the home if the purchase price was higher than the appraised value. Down payments can include gifts, but not loans.
- The maximum front-end DTI would be 28%; the maximum back-end DTI would be 36%.

The QRM determination is made at mortgage origination. However if a loan is subsequently deemed to be non-QRM, the exemption would not be revoked. This is a critical step; it means that a sponsor who has relied on the

QRM exemption to do the securitization would not lose that exemption after the fact due to erroneous inclusion of a non-QRM loan. However, the sponsor must repurchase non-QRM loans within 90 days of such determination.

These requirements are clearly very restrictive. The Notice of Proposed Rulemaking contained statistics on the amount of GSE loans that would have been qualified for the QRM exemption, based on proprietary data provided by Fannie and Freddie. The number for the last year available (2009) was 30.5% (page 202-203 of the document, reproduced as Exhibit 1 (below). These numbers are particularly frightening, as 2009 was a year in which the GSEs produced very high quality product. For Freddie Mac, excluding HARP Refi loans, the average original LTV was 66, with a 762 average FICO score.

The two most binding constraints are DTI and LTV. Again, focus on the 2009 results. If the front-end and back-end DTI constraints ("PTI/DTI" in the table) were relaxed, an additional 24.5% of borrowers would have qualified. If the LTV constraints were relaxed, an additional 15.3% of borrowers would have qualified (the published numbers include the HARP Refi loans). If the FICO constraint (690) were relaxed, the number of additional borrower included was 1.7%. If the product type restrictions (no non-owner occupied, 40-year loans, IO loans, negative amortization loans, loans with a balloon payment, or ARM loans that permit payment shocks in excess of the range permitted by the proposed QRM standards) were relaxed, an additional 3.4% of the borrowers would qualify. Note that there is no allowance in these standards for compensating factors. If a borrower was putting 50% down, but had a 38% back-end DTI, the loan would not qualify for QRM treatment.

The proposed rule calls for comments on a broader definition of QRM; this would relax the two largest constraints by allowing for a higher DTI ratio (41% rather than 36%, 38% if the loan can experience more than 20% payment shock over the life of the loan), and a higher LTV ratio (90% on purchases and rate/term refis, 75% on cash-out refis.) To calculate the impact of these expanded criteria, we ran the original QRM standards through Freddie Mac loan level data, and then modified it for the expanded criteria. The results of this analysis are shown in Exhibit 2 (next page). Our calculations, based solely on back-end DTI Freddie data, suggest 38% of 2009 production would be QRM

Exhibit 1: QRM: What Percentage GSE Loans Qualify?

Year	QRM	PTI/DTI Relaxed	LTV Relaxed	FICO Relaxed	Product Type Relaxed	All Loans
1997	20.44%	13.04%	13.74%	5.81%	3.75%	$ 286,497,878,371.00
1998	23.29%	13.30%	17.10%	6.24%	2.17%	$ 691,033,994,509.00
1999	19.48%	14.83%	12.95%	5.37%	3.16%	$ 481,450,519,442.00
2000	16.44%	17.00%	8.40%	4.53%	3.70%	$ 356,779,731,420.00
2001	19.37%	14.33%	13.11%	4.62%	3.01%	$ 1,039,412,013,403.00
2002	22.37%	15.35%	10.72%	4.62%	4.28%	$ 1,385,056,256,240.00
2003	24.57%	16.68%	10.02%	4.98%	4.55%	$ 1,924,265,340,603.00
2004	17.03%	17.68%	6.25%	4.34%	6.35%	$ 937,643,914,289.00
2005	14.41%	18.78%	5.45%	3.36%	6.74%	$ 939,069,358,457.00
2006	11.52%	17.59%	3.91%	2.73%	7.11%	$ 887,443,942,464.00
2007	10.72%	16.14%	4.95%	2.24%	5.44%	$ 1,027,460,511,244.00
2008	17.39%	22.01%	9.22%	2.12%	4.64%	$ 793,136,249,487.00
2009	30.52%	24.47%	15.26%	1.74%	3.38%	$ 1,176,445,135,548.00
Total	**19.79%**	**17.36%**	**9.86%**	**3.91%**	**4.62%**	**$ 11,925,694,845,477.00**

Source: QRM Proposal

Exhibit 2: Impact of QRM Provisions on Freddie Mac Mortgages

QRM QUALIFICATION

Purpose	Orig. Year	Balance	All & DTI≤36	All & DTI≤41	All & Any DTI	All, Relaxed LTV, DTI≤36	All, Relaxed LTV, DTI≤41
Purchase	2007	198,271	14	18	28	15	19
	2008	124,125	20	26	41	24	31
	2009	91,437	35	44	62	42	54
	2010	76,607	35	45	62	41	53
Rate/Term Refi	2007	89,919	8	9	14	12	16
	2008	92,414	21	25	36	31	38
	2009	250,415	40	46	57	57	67
	2010	222,710	34	39	48	51	58
Cashout Refi	2007	117,982	11	14	21	13	16
	2008	95,901	18	23	35	22	27
	2009	124,748	36	42	55	44	52
	2010	74,817	32	39	50	39	48
Total	2007	406,172	12	15	23	14	18
	2008	312,440	20	25	37	25	32
	2009	466,601	38	45	58	51	61
	2010	374,134	34	40	51	46	55

PERCENT OF LOANS WITH QRM CHARACTERISTIC

Purpose	Orig. Year	Balance	DTI≤36	DTI≤41	LTV	LTV, Relaxed	FICO	Product	Hybrid
Purchase	2007	198,271	37	50	70	78	76	56	87
	2008	124,125	43	57	67	83	85	74	94
	2009	91,437	56	72	79	92	94	87	99
	2010	76,607	57	74	83	93	94	86	96
Rate/Term Refi	2007	89,919	34	44	50	95	71	43	82
	2008	92,414	48	61	58	95	85	73	90
	2009	250,415	66	78	65	95	94	94	99
	2010	222,710	66	77	58	87	93	94	95
Cashout Refi	2007	117,982	43	56	51	62	65	66	86
	2008	95,901	45	58	58	69	79	80	93
	2009	124,748	61	73	64	79	93	95	100
	2010	74,817	59	74	61	76	92	94	97
Total	2007	406,172	38	50	60	77	72	56	86
	2008	312,440	45	59	61	83	83	76	93
	2009	466,601	63	76	67	90	94	93	99
	2010	374,134	63	76	64	86	93	92	96

Source: Freddie Mac, Amherst Securities as of May 2011

eligible. (See the bottom section of the top table. Our number will be higher than the QRM percentage of 30.5% for 2009 in Exhibit 1, as we do not have a data source for front-end DTI (aka payment-to-income or PTI ratio). Thus, we screen only by back-end DTI. Moreover, our numbers are based exclusively on Freddie data rather than Fannie and Freddie data.) If the proposed rule allows DTI ≤41%, our number suggest that 45% of Freddie borrowers would have qualified. If the rules also allowed LTVs up to 90 for purchase and rate/term refis, 61% of borrowers would have qualified (DTI≤41, Relaxed LTV).

The bottom section of the table shows the % of loans with individual QRM characteristics—DTI ≤36, DTI≤41, LTV as initially proposed, LTV relaxed, FICO, product type, hybrid. Note that for 2009, 63% of Freddie borrowers had DTIs ≤36, 76% had DTIs ≤41; 67% meet the original LTV rules, 90% meet the relaxed standards.

One more point. Going forward, investors will be a larger part of the market; and we believe it is important to actually do a careful evaluation as to what risk parameters should be required of investor properties to be QRM.

Subjecting these loans to risk retention, regardless of their other characteristics could further cramp credit availability.

Implications

The approach taken by the regulatory authorities is to use a very narrow definition of QRM, expecting that most loans that are originated would require risk retention, and providing sponsors with considerable flexibility in how they meet the risk retention guidelines on non-QRM loans. We believe this approach is anti-competitive, and represents another benefit for the "too big to fail" banks, who have both origination and securitization departments. We would have rather seen regulators go the other direction—set up a broader definition of QRM and use more stringent risk retention rules. (Actually, we don't think the risk retention rules do much, but doing without them was not an option. They are required under Dodd-Frank.)

Let's evaluate this controversial statement more closely. Clearly, non-bank broker dealers will be unable to meet the 5% risk retention provision.

What about money managers—couldn't the largest money managers buy loans, securitize, and start a fund to provide the risk retention? That's unlikely, as the funds would be locked up over the life of the loan, as the retained portion cannot be sold if the funds were withdrawn.

What about smaller banks—couldn't they originate and securitize loans? Perhaps, but most do not have the securitization and distribution capability. *Couldn't smaller banks partner with non-bank broker dealers*? It would be possible to structure the transaction such that the smaller bank provides the loans, while the non-bank broker dealer provides the securitization structure and distribution of the non-retained piece. To make this work the smaller bank would have to assume the risk retention obligation. However, these types of partnerships would be difficult to orchestrate. It is more likely that one would see partnerships between smaller originators and REITs, as REITs could sponsor the securities *and* hold the credit risk. In fact, these are the only partnerships that we believe can be successful. (REITs would have to establish a shelf, as Redwood Trust, the only firm to come to market with a securitization backed with new issue collateral over the last two years, has done.)

Indeed, these rules (as proposed) leave large banks with a securitization capability and REITs to drive new issue activity. It's no wonder that this was the approach favored by some of the largest banks. It eliminates competition from non-bank broker dealers, a sector obviously near and dear to our hearts. If the alternative approach had been selected (a broader definition of QRM), then few non-QRM loans would be originated. Thus, risk retention would apply to only a small fraction of non-Agency securitization. If this was the case, the anti-competitive nature of these guidelines largely disappears.

Qualified Residential Mortgages (QRM) and Qualified Mortgages (QM)

Note that the definition of a QRM can be no more lenient than the definition of a Qualified Mortgage (QM). However, the definition of a qualified mortgage has not yet been finalized. That's quite important, because we believe that due to the liability risks for the originator, we expect that most mortgages that are originated will be qualified mortgages.

Qualified Mortgage?

On April 19, 2011, the Federal Reserve issued a proposed rule that amends Regulation Z in accordance with Dodd-Frank (comments due by July 21st). While the Fed is currently in charge of Reg Z, responsibility for this regulation will move over to the new Consumer Finance Protection Bureau when it is formed in July. The Fed's QM rule grew out of the Dodd-Frank attempt to prohibit lenders from making mortgage loans without regard to a consumer's ability

to repay. Thus, it defines "ability to repay" (well . . . sort of!), and covers circumstances in which a loan is a "qualified mortgage," and hence presumed to meet ability-to-repay (ATR) standards. Note that there was no attempt to sync the definitions of "qualified mortgage" and "qualified residential mortgage." This is a critical point, because as mentioned above, Dodd Frank requires that the definition of a "qualified residential mortgage" can be no broader than the definition of a "qualified mortgage."

The amended Regulation Z requires that mortgage lenders must make a reasonable and good faith determination when a loan is originated, that mortgage borrowers have a reasonable "ability to repay" (ATR) the loan, including any mortgage-related obligations such a property taxes. A creditor can meet the general ability to repay standards by considering and verifying 8 specific underwriting factors: *(1)* current or reasonably expected income or assets; *(2)* current employment status; *(3)* monthly mortgage payment; *(4)* monthly payments on any simultaneous loans; *(5)* monthly payment for mortgage-related obligations; *(6)* current debt obligations; *(7)* debt-to-income ratio; and *(8)* credit history. These factors must be considered and verified based on widely accepted underwriting standards. ATR qualification for an adjustable rate mortgage must be based on the fully indexed rate.[2] Note that there are no hard and fast standards as to what determines if the borrower meets the ATR requirement.

If the loan is a "qualified mortgage," the Dodd Frank Act requires the lender be provided with a protection from liability. However, it was unclear if the Act should be interpreted as a safe harbor, or has a presumption of compliance with the ATR. Consequently, the Federal Reserve Board is seeking comments on 2 alternatives for determining a "qualified mortgage" (QM).

Alternative #1 – QM would operate as a safe harbor. A QM is defined as a loan that does not contain negative amortization payments, interest-only payments, or balloon payments, or a loan term >30 years. In addition, total points and fees cannot be >3% of total loan amount, the income or assets relied upon in making the ATR determination must be considered and verified, the mortgage underwriting is based on maximum interest rate that may apply in the first 5 years, it must use a payment schedule fully amortizing the loans over the loan term, and must take into account any mortgage-related obligations.

Alternative #2 – There is a rebuttal presumption of compliance. A QM is defined using the criteria under Alternative 1, plus additional underwriting requirements from the general ability-to-repay standard. Thus the lender would also have to consider a borrower's employment status, monthly payments on any simultaneous mortgage, current debt obligations, DTI ratios and credit history.

The Federal Reserve proposal notes that the advantage of the safe harbor is its provision to lenders of an incentive to make qualified mortgages. "*That is, in exchange for limiting loan fees and features, the lenders' regulatory burden and exposure to liability would be reduced*." The disadvantage is that the lender could not be challenged "*for failing to underwrite a loan based on the consumer's employment status, simultaneous loans, current debt obligations or credit history, or for generally not making a reasonable and good faith determination of the consumer's ability to repay the loan*." [3]

It is very clear that the first alternative (where there is an absolute safe-harbor) has no teeth whatsoever. However, we believe it is the only real alternative. Some have argued that 3% maximum upfront fees assure that only "good" loans will be made. Moreover, it appears the 3% limit be easily circumvented if the lender charged the borrower a

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[2] The only exception to ATR standards: A creditor can refinance a non-standard mortgage with risky features into a more "standard mortgage" if the monthly payment is reduced and the borrower has never been delinquent on an existing mortgage. In this case the underwriting factors in ATR apply, except for the requirement to consider and verify the consumer's income or assets. This is meant to provide flexibility for streamlined refinancings. [NOTE: The requirements are not waived for fixed-to-fixed refinancing.]

[3] One exception to the above was meant to preserve credit for rural and underserved borrowers. A creditor operating predominantly in rural or underserved areas can make a balloon-payment qualified mortgage for portfolio; these loans must otherwise meet the requirements of a QM (except for allowing the balloon).

higher interest rate.[4] [*NOTE*: The proposed rules will not apply to loans <$75,000; higher permissible fees will be applied on such.] However, the second alternative (which does have bite!) could have a chilling effect on loan origination. While the Fed has not specified a maximum DTI, lenders will be very unwilling to make loans that do not conform to the limits in government programs, for fear of being challenged.

The Interaction Between QM and QRM is Underappreciated

We are very concerned that the Fed uses Alternative #2 to define a QM, and that Federal agencies do not broaden the QRM standard. This is not an unlikely set of circumstances. Our fear is that lenders, in order to be very sure of not being challenged on the "ability to pay" presumption, opt for very strict credit standards (close to QRM), choking off credit availability. *There is insufficient attention being paid to the interaction between these standards.*

As the noose on credit availability tightens, credit is being choked off at a time when the housing market is extremely fragile. If no further actions are taken, Amherst calculations show that approximately 11 million borrowers are in danger of losing their homes. And not one of them would be QRM under the proposed criteria (the derogatory events criteria, which is the alternative to credit scoring, eliminates them). Neither would the investors, who are the largest buyers of distressed homes. We know that 35% of all home sales are for cash, 40% are distressed sales, and 22% are investor purchases. But we don't know the percentage of distressed sales purchased by investors, other than that it is high. Many of such purchases are for cash. *We have repeatedly stressed that expanding credit availability to investors is one of the most valuable actions that can be taken to help alleviate the housing crises*. If the new rules are adopted as proposed, it is possible that lenders will become reluctant to make non-QRM loans (realize that both investor loans and loans to borrowers who have derogatory events on their credit are non-QRM). Thus, already tight lending standards are likely to tighten more if the Federal agencies decide to keep the very narrow definition of QRM.

We believe that a broader definition of QRM will encourage private sector securitization. It is clear that if the government wants to play a smaller role in housing finance, the private markets must step in, and securitization must return. No one is arguing that securitization should return to the levels of 2005-2007, but a securitization outlet is necessary or credit availability will be very limited. Clearly, the increased role of the private markets must start in the jumbo market. With the temporary extension in the FHA and GSE loan limits rolling off at the end of September, the ceiling in high cost areas will decline from $729.75K to $625.5 K, and there will be increased opportunity for the private sector to enter.

The fundamental issue is that credit availability (outside of FHA) is already very tight; we worry that if QRM is not broadened, credit availability will tighten further. This is best seen by looking at the jumbo sector; since the Agencies were unable to participate prior to 2008 (the GSEs entered this market in 2008, when loan limits were extended from $417k nationwide to as high as $729.75K in high cost areas). Exhibit 3 (next page) shows total origination to the jumbo sector, broken down by holder. In 2001, jumbo product origination totaled $450 billion ($300 billion held in bank portfolios and $150 billion in private label securitizations). In 2010, origination of jumbo product totaled $220 billion ($92 billion in bank portfolios, a negligible amount via private label securitization, and $110 billion of GSE product). In fact, for every year 2001-2006, origination was ≥$450 billion. It fell to the $220 billion level in 2009 and 2010. The large drop is due to the absence of private label securitization activity.

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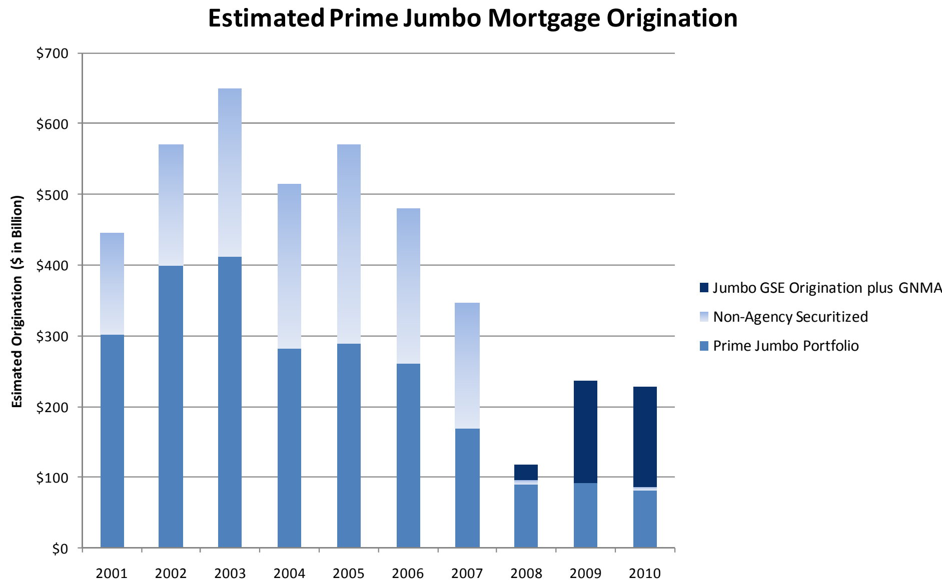
[4] *A loan in which extra fees have been rolled into the rate would likely sell at a premium. If a premium loan is QM, but not QRM, there is no analysis of how the loans would interact with the premium capture reserve fund. It is likely that it would be more difficult to structure these deals to so that a premium capture account would not be required.*

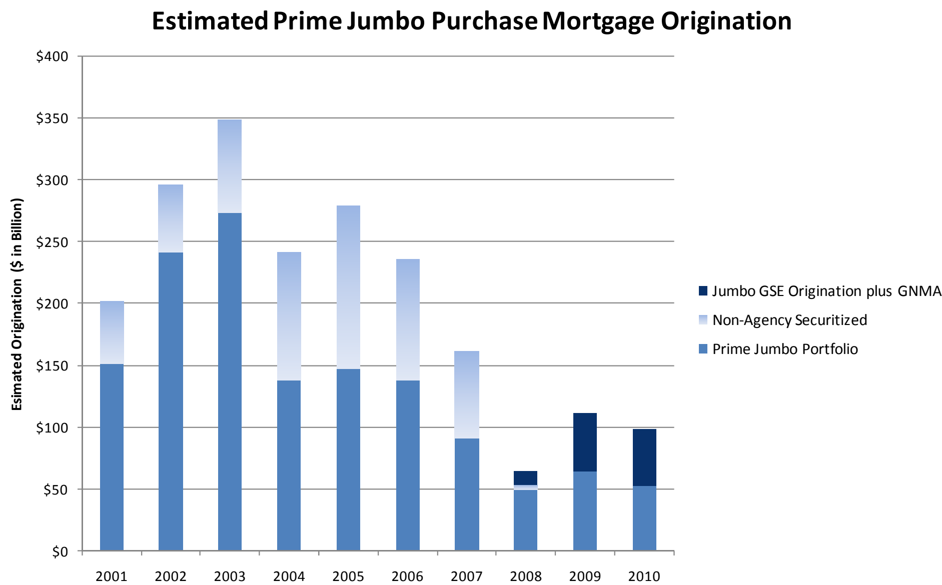
Exhibit 3: Jumbo Origination



Source: CoreLogic, Inside MBS&ABS, Amherst Securities

We want to know how much credit availability has contracted. We can't derive this from the numbers in Exhibit 3. In that exhibit, we have looked at total jumbo origination as a measure of credit availability, but that is inaccurate, as it includes refinancing activity. We crunched the numbers to remove refinance activity, leaving us with purchase origination, as shown in Exhibit 4 (below). And, yes—home prices have fallen, so the proportion of the market that will need a jumbo mortgage is lower than during the 2005-2007 period. Perhaps the best way to compare credit

Exhibit 4: Jumbo Purchase Origination



Source: CoreLogic, Inside MBS&ABS, Amherst Securities

availability is to note that nationwide, prices are approximately what they were in 2003. Moreover, drop in home prices would be consistent with a 2003 GSE loan limit of $322K, in fact, the GSE loan limit was $322,700. Thus, if we look at 2010 jumbo purchase volume, and add to it any purchase loans between $322K and $417K, we can directly compare this to our 2003 prime purchase origination. Approximately $85 billion of GSE and FHA/VA purchase issuance was in this range, bringing 2010 jumbo origination (using the 2003 definition of jumbo) to $185 billion.

We can directly compare this to the 2003 number of $350 billion. Yes, this is the peak year, but $185 billion is considerably lower than surrounding years. Indeed jumbo credit availability, as measured by origination activity, is very low. And, with QRM, credit availability will likely become even more limited. *To increase origination, and hence credit availability, private label securitization must return.*

These risk retention and QRM policies seem to discourage the private markets, rather than encourage them. Nobody wants lending standards to return to what they were during 2005-2007, but QRM rules go overboard in the other direction. Drawing from the lessons of the past few years, investors in new securitization will demand a high loan quality. The definition of QRM should be broadened, and the Fed needs to allow for an absolute safe harbor in QM. If both of these actions are not taken, it will serve to further choke off credit availability.

Re-Securitization Provisions

To be exempt from risk retention, resecuritization transactions need to meet two conditions:

1. The transaction must be collateralized solely by existing ABS issued in a securitization transition for which credit risk was retained as required under the rule, or which was exempted from the credit risk retention requirements of the rule.
2. The transaction must be structured so it involves issuance of only a single class of ABS interests and provides for a pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of the class. The idea is that a resecuritization structured as a single-class pass-through would not alter the level or allocation of credit risk nor interest rate risk on the underlying ABS.

These rules would choke off virtually all re-securitization activity. The idea of a re-securitization is to create a multi-tranche deal that better fits the needs of investors. Stated differently, re-REMIC activity is simply a way to re-divide existing cash flows; no new risk is being created. Dividing existing cash flows into two tranches would trigger risk retention, as the sponsor has issued more than one class of ABS interests.

Moreover, if the goal of risk retention is better-quality loans, it makes no sense to apply risk retention to pre-existing assets.

Re-REMICs have been a very important technical factor, contributing to the run-up in prices over the past 2 years in the non-Agency MBS market. Vast quantities of the universe of RMBS securities (originally purchased with an AAA rating and thought to have little or no credit risk) have been downgraded below investment grade, and will eventually take credit losses. These instruments no longer fit the needs of regulated institutions or total return money managers, many of whom are mandated to manage only higher rated assets. *Providing more credit support to the senior tranche through a re-REMIC structure allows creation of a properly enhanced senior security that better meets the needs of investors*. We believe these securities are priced attractively to alternative investment opportunities. Meanwhile, with prices rising across all asset classes, hedge funds are looking for vehicles to deliver a higher return to their investors. They have increasingly been doing so through leverage. The re-REMIC structure provides internal leverage (*i.e.*, the structure provides essentially permanent financing to the junior bond).

To reiterate, there is no reason for risk retention where there is no risk retention requirement on the underlying security. *The cash flows on the re-REMIC are merely redistributions of the cash flows of the underlying security, in a manner that better fits investor needs.*

Conclusion

We have made the following points:

- The risk retention rules as proposed do not eliminate conflicts of interest, are enormously anti-competitive, and will greatly crimp credit availability.
- The QRM rules are so narrow they will compound credit availability issues. These issues could be further exaggerated if the CFPB adopts QM, using the ability-to-pay presumption, rather than giving lenders an absolute safe harbor. We would much prefer a broader definition of QRM, with less flexibility on risk retention than the current configuration (a narrow definition of QRM and considerable flexibility on risk retention). We believe QM must provide the absolute safe harbor.
- Applying risk retention to re-securitization activity is completely nonsensical, and will largely choke off this activity. There is no reason for risk retention on a security that merely redistributes cash flows that are already outstanding. The stated purpose of risk retention is to encourage production of "good" loans, certainly risk retention on a re-securitization does not do so.

If there is one thing mortgage investors, mortgage originators, mortgage-backed securities dealers and the government can all agree on—it's that we don't want a return of the mortgage underwriting standards that prevailed during the 2005-2007 period. However, we do need to move the vast overhang of housing that has been generated by the crisis. Credit availability outside of the FHA space is already very limited. These rules, as proposed, will compound the problem.

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