Massachusetts Housing Partnership

COMMENTS ON THE PROPOSED INTERAGENCY RULE ON CREDIT RISK RETENTION

August 1, 2011

We appreciate the opportunity to provide comments on the proposed interagency rule on Credit Risk Retention (Federal Reserve Docket No. 2011–1411) and particularly to comment on the proposed definition of Qualified Residential Mortgages (QRM). The Massachusetts Housing Partnership (MHP) is a public, nonprofit organization that provides financing for affordable housing across the Commonwealth. Though our own multifamily loan programs and through a residential mortgage program offered by participating banks, we have provided more than $3.2 billion in long-term financing supporting more than 17,000 rental units and more than 15,000 home purchases by low-income, first-time buyers.

In our view, the risk retention requirements of Dodd-Frank Wall Street Reform and Consumer Protection Act were a necessary and appropriate response to the 2008 financial crisis. The Financial Crisis Inquiry Commission reached the following conclusion based upon extensive hearings and investigation:

> …no one in this pipeline of toxic mortgages had enough skin in the game. They all believed they could off-load their risks on a moment's notice to the next person in line. They were wrong. When borrowers stopped making mortgage payments, the losses—amplified by derivatives—rushed through the pipeline. As it turned out, these losses were concentrated in a set of systemically important financial institutions.

Many critics of QRM fail to recognize that critical nexus with the financial crisis. The legislative intent was to make risk-retention the <u>norm</u> for securitized mortgage transactions with only a small number of exceptionally strong mortgages exempt from that requirement. If anything it could be argued that the retained risk requirements in Dodd-Frank and the proposed credit risk retention rules did not go far enough to address the underlying problem.

The following comments on QRM are informed by MHP's experience over the last 20 years administering the SoftSecond mortgage program, which provides below-market mortgage financing to low-income, first-time homebuyers through participating banks. The program has financed 15,586 home purchases representing $2.5 billion in mortgage financing. The design of the program requires lenders to retain 20 percent top loss risk for the life of the mortgage, backed by a publicly-funded top loss reserve. MHP has commissioned static pool analyses which allow us to evaluate loan losses and the costs of lender-retained risk over the entire life of the program, including loan losses resulting from the collapse of housing prices that began in our local market in 2005. We have also engage detailed analysis of defaults and delinquencies and run our borrower and loan data through national pricing and risk assessment models.

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Two strong conclusions emerge from that data. First, SoftSecond loan performance has compared very favorably to prime mortgage benchmarks and there are strong indications that the performance is tied to lenders retaining risk in the loans they originate. When SoftSecond borrower and loan data is run through national models, defaults and losses are grossly overestimated relative to our actual experience. The reason, we believe, is that lenders with skin in the game are highly motivated to prevent losses. Most other loans with comparable credit scores, loan-to-value ratios, household incomes and other borrower characteristics contained in national datasets are originated by lenders without any retained risk and they significantly underperform compared to our loans as a result. Second, even with a population skewed to lower-income home buyers the cost to lenders of retaining credit risk on SoftSecond mortgages does not impose an unreasonable cost. Cumulative losses on the 20 percent top-loss retained risk are 0.21% of total loan originations, so the cost of covering that risk through loan pricing is in the range of 5 basis points.

MHP urges the agencies to be skeptical of arguments that risk retention would impose excessive costs on mortgage origination, particularly for loans serving low and moderate-income homebuyers, and to subject those claims to critical analysis. Risk retention by itself should impose little or no additional cost on borrowers because the underlying mortgage risk is unchanged. Risk retention simply shifts a portion of credit risk and reserves against future losses upstream from investors, insurers and guarantors of mortgage-backed securities to the entities that create the securities and originate the underlying mortgage loans. Without risk retention borrowers are still being charged to cover underlying credit risk through loan pricing used to pay mortgage insurance premiums, guarantee fees, and the spread to bond investors. While the originator may need to charge additional fees to cover retained risks under the proposed rule, that cost is offset because other parties are bearing <u>less</u> risk and should price accordingly. Once the credit risks in any particularly mortgage pool are quantified this is close to a zero-sum game, with credit risks simply reallocated among parties to the transaction. There are unquestionably some transaction and collection costs associated with retained risk (e.g., creating a workable mechanism for repurchase, limited recourse, or letters of credit), but we have seen no convincing evidence that these transaction costs would be excessive or would impose unreasonable new burdens on end loan pricing.

We also disagree with the suggestion that conformity with the proposed interagency ability to pay/qualified mortgage rules (which we'll collectively describe as QM) is an acceptable definition of a Qualified Residential Mortgage for purposes of Dodd-Frank risk retention. The proposed QM rule was created for an entirely different purpose and leaves significant discretion to lenders, as it should. Two mortgage loans might be identical with respect to QM compliance and yet have a significantly different risk of default. As we have seen from analysis of MHP's own mortgage loan portfolio, lenders with skin in the game make mortgage loans with substantially less risk than those of other loans with seemingly identical underwriting characteristics.

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MHP does strongly support the exemption of federally-guaranteed mortgage loans (including loans guaranteed by Fannie Mae and Freddie Mac during conservatorship) from risk retention. It is important, in our view, to restore an appropriate federal role in standard-setting for mortgage finance and to create a safe harbor for responsible loan origination for sale into the secondary market, particularly for smaller banks. While it may be impossible to predict the future of the government-sponsored enterprises, it would be helpful if the final rule created a presumption that Fannie/Freddie and their successors would continue to be exempt from risk-retention beyond the term of their conservatorship provided there continues to be a substantial degree of federal oversight over their underwriting standards.

Much of the housing industry outcry about risk retention and QRM is not based on the effect of the proposed regulations themselves, but on a fear that future bank regulators will view non-QRM mortgages as unsafe and unsound or impose unreasonable capital requirements for non-QRM mortgages. That is not the legal effect of the proposed risk retention regulations and in our view it is not a sufficient rationale to weaken them. It would be very constructive if federal banking regulators made a public statement that QRM status will not be used as a measure of safety and soundness and also provided some anticipatory guidance on how loan loss reserves will be evaluated and risk-based capital requirements will be established for non-QRM mortgage loans where banks have retained risk.

Thank you for your consideration of these comments. MHP would be pleased to provide any additional information that would be useful to the agencies in finalizing the proposed rule.

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