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Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
Docket No. OCC-2011-0002 /
RIN 1557-AD40

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1411 / RIN 7100-AD70

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN: 3064-AD74

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
File No. S7-14-11 / RIN 3235-AK96

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Regulations Division
Office of General Counsel
Department of Housing and Urban Development
451 7th Street, SW, Room 10276
Washington, DC 20410-0500
Docket No. FR-5504-P-01 /
RIN 2501-AD53

Re: Credit Risk Retention Proposed Rule

Dear Sir or Madam:

The PMI Group, Inc., and its wholly-owned subsidiary, the PMI Mortgage Insurance Co. (PMI), are submitting this letter in response to your request for comments on the above referenced notice of proposed rulemaking.

PMI provides residential mortgage insurance (MI) in the United States. Mortgage insurance provides first loss protection to mortgage lenders and investors in the event of a borrower's default. By protecting lenders and investors from credit losses, PMI helps to ensure that mortgages are available to creditworthy U.S. homebuyers, and in particular first-time homebuyers.

As an insurer in the first-loss position, PMI strongly supports the goal of improved underwriting standards for residential mortgages and supports appropriate incentives to encourage lending practices that are responsible and will serve to keep borrowers in their homes for the long term. Our comments will focus predominantly on the definition of a Qualified Residential Mortgage (QRM)[1].

PMI's comment letter will make four major points:

1. The proposed narrow definition of a QRM loan runs counter to Congressional intent and we urge the agencies to revise the definition based on a thorough review of the legislative history. The legislative history makes it absolutely certain that the QRM was intended by Congress to be a broad exemption from the risk retention requirement for mortgage loans that were underwritten to pre-bubble standards. Furthermore, an objective reading of the statute and its legislative history demonstrates that the agencies have at least three independent grounds to exempt lower down payment loans from the risk retention requirements in the Dodd-Frank Act.

2. The definition of QRM should be expanded in a way that captures more qualified borrowers while not sacrificing prudential underwriting and loans with MI should be included in the definition of QRM. As proposed, the narrow QRM approach will adversely affect the housing finance market, increase costs and reduce credit availability to qualified borrowers. The proposed regulation would exclude from the QRM safe and sound mortgage loans that comply with the requirements traditionally used for decades prior to the housing bubble. There is no policy basis for excluding these loans from the QRM definition, especially in light of the fact that such an approach will have a disproportionate adverse impact on first-time homebuyers, including many minorities and low- and moderate-income borrowers.

3. The public's need for non-QRM mortgage products will lead to the growth of government mortgage insurance programs. These programs are exempt from the risk retention requirement, at the expense of private mortgage insurance that puts private capital at risk. We urge the agencies to thoroughly evaluate the consequences of a policy that will unnecessarily shift more risk to the taxpayers. Public policy, as expressed by both the Administration and Congress, dictates that mortgage risks should be borne as much as possible by the private sector, and not through government guarantees.

4. Mortgage insurance should be a permissible form of risk retention for residential mortgages. The Dodd-Frank Act provides the option for the agencies to permit the risk retention requirements for commercial real estate transactions to be in the form of a third-party holding a first loss position. Mortgage insurance is economically equivalent to holding a first-loss position on residential real estate loans. MI absorbs the first-loss in the event of a default on insured residential mortgages, and thus has the same economic interest as a third party purchaser of a first loss position in a commercial real estate securitization. Alternatively, under the Dodd-Frank Act regulators can exempt loans with mortgage insurance. Government insured residential mortgages were exempt

[1] See Appendix A for responses to specific questions.

in the law because the federal insurance protects the lender and investor from loss in the event of a borrower default. Private mortgage insurance provides the same protection to lenders and investors.

Introduction

A. Background on PMI and Its Role In Mortgage Finance

PMI Mortgage Insurance Co. was established as an Arizona insurance corporation in 1972. PMI is licensed to transact mortgage guaranty insurance in all 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Guam. As an Arizona insurance corporation, PMI's principal regulator is the Arizona Department of Insurance, but PMI is subject to the insurance laws and regulations of every jurisdiction in which it is licensed. The Company primarily provides mortgage insurance for mortgage loans originated in the United States.

As of December 31, 2010, the PMI Group had total consolidated assets of $4.2 billion, including an investment portfolio of $2.8 billion. On that date, the Company had approximately $24.9 billion of risk-in-force (the company's insurance exposure). Since 2007, PMI has paid approximately $4.0 billion in claims, primarily to Fannie Mae and Freddie Mac (the Government Sponsored Enterprises, or GSEs). As part of its efforts to mitigate claims paid, PMI has in place a proactive loan modification program which seeks to prevent foreclosure where possible, and thereby keeping borrowers in their homes and reducing the cost of claims to the Company.

B. MI Places Private Capital at Risk

The private mortgage insurance industry places private capital at risk, not taxpayer dollars. There is no perception that mortgage insurance companies are too big to fail, or that the government will provide financial aid to a troubled MI company. Thus it is private capital, and only private capital, that is placed at risk when mortgage insurance is issued. Moreover, the private capital markets have shown that they are willing to invest in the MI industry. Since the mortgage crisis began, the mortgage insurance industry has raised $8.8 billion through new capital and asset sales. In 2010, The PMI Group, Inc. alone successfully raised a total $765 million in new capital.

C. MI Capital Regime is based on Counter-Cyclical Capital

Under Arizona law (as well as the laws of several other states), PMI is obligated to contribute *fifty percent* of all earned premiums each year to a special contingency reserve ("CR") which generally cannot be touched for a 10 year period. The purpose of contingency reserves is to provide an additional source of capital upon which PMI may draw to pay claims during downturns in the economy. Contingency reserves, which are exclusive of, and in addition to, the loss reserves that PMI is obligated to establish in respect of delinquent loans, served its purpose well during the current economic crisis as

PMI has been able to draw down in excess of $1.5 billion in CRs to pay claims since 2008.

The other two reserves that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for losses on individual policies when the insurer is notified of defaults. Premiums received for the term of a policy are placed in unearned premium reserves. Each state establishes the method by which premiums are earned to match premiums with loss and exposure.

In addition to CRs, Arizona law requires PMI to maintain its risk-to-capital ratio below 25:1 or to obtain a temporary waiver of this requirement upon a demonstration that its capital is reasonable in relation to its insured risk and adequate to its financial needs. Finally, Arizona, as well as most other states, has enacted all or part of the NAIC Model Regulation on Hazardous Financial Condition. Under these laws, insurers are subjected to a number of financial standards, the failure of one or more of which may indicate a hazardous financial condition. Regulators have a number of options at their disposal should they determine that an insurer is in a hazardous financial condition, including orders to reduce or suspend new business, increase capital or obtain reinsurance. These regulations thus act as an early warning system to detect and impose appropriate remedial actions on insurers well before they are threatened with insolvency.

Due to the robust regulatory framework under which PMI operates, PMI has been able to meet all of its contractual obligations during these difficult economic times and, indeed, has even been able to raise additional funds in the capital markets.

D. MI Companies Provide a Check on the Underwriting Standards and Practices of Loan Originators

Because private MI assumes a first loss position with respect to insured mortgages, it is critically important to PMI and the other mortgage insurance companies that prudent underwriting standards are used when mortgages are originated, and that necessary policies, procedures and internal controls are present.

Because MI companies hold risk for a longer term than loan originators who sell loans into the secondary market, it is critical that mortgage insurers mitigate risk by establishing guidelines and parameters for loan eligibility and aggressively manage loan performance. PMI carefully monitors the performance of "like loans" from different originators to test the efficacy of different origination practices against expectations based on geographic location and representative loan risk. PMI tracks loan performance, conducts quality control audits of files, and reviews origination practices to ensure the lenders are complying with our high standards. Our reviews include compensation structures for loan officers and underwriters, training requirements, fraud prevention procedures, as well as a lender's quality assessment and quality control processes. Strong oversight of loan originators provides assurances that inferior loan origination practices can be detected and addressed in an efficient and timely manner.

Additionally, certain defaulted loans are reviewed to determine whether inadequate procedures were followed, i.e. inappropriate underwriting, inadequate appraisal quality, inaccurate documentation, which might have led to default. In cases where PMI finds that origination standards were sacrificed PMI follows up with the appropriate action. Our policy exclusions provide us the right to rescind coverage for negligence, misrepresentation or fraud. Additionally, if the lender's underwriting is determined to have been in error, coverage can be rescinded.

During the run up to the housing crisis there was a breakdown of the normal checks and balances in the mortgage finance system and a dangerous relaxation of more traditional underwriting standards. The MI underwriting mechanisms did not always function as MI firms desired in large part because of the almost absolute reliance on the GSEs' automated-underwriting (AU) systems. As a result of this experience, starting in 2007, PMI has re-imposed its traditional, more conservative underwriting requirements on all loans that PMI insures. Private MI companies cannot permit originators to engage in unsustainable underwriting practices while transferring the risk to the insurance company. PMI will only insure mortgages that are in compliance with its own standards, and has instituted processes and procedures to ensure that originators comply with these requirements.

E. The Interests of MI are Aligned with the Interests of Investors and Borrowers

When an MI company provides mortgage insurance, its economic interest is directly tied to the performance of that mortgage over time. As an insurer in first loss position, an MI company's economic interest is the same as the interest of an investor in a mortgage-backed security – to have the mortgage perform as expected over the long run. Further, the interests of an MI company also are aligned with the borrower. A loan that is poorly structured, poorly underwritten, or that contains hidden and unaffordable jumps in interest rates or large prepayment penalties are risky both for the borrower and for an MI company. MI companies do not reap any benefits from loans that contain product features that increase risk. Finally, if a mortgage does run into trouble, MI companies have a very strong incentive to help the consumer avoid foreclosure, and even in this situation the interests of an MI company remain aligned with the consumer.[2]

PMI is acutely focused on loss mitigation, particularly activities which minimize the frequency of home forfeiture. PMI actively pursues loss mitigation activity in three primary areas. First, PMI proactively works with investors, servicers, regulators and other agencies to craft mortgage modification and home retention solutions which meet the needs of all parties. Our commitment in this area is exemplified by our close work with other MI industry members and the Department of Treasury in crafting the Home Affordable Modification Program and also with our founding membership in the Hope Now Alliance. PMI also works closely with the servicers who service the loans that we insure. In this effort, we measure and monitor servicer performance and help to guide and

[2] From 2008 through year-end 2010 mortgage insurers have completed almost 645,000 workouts covering $130 billion in mortgage loans

facilitate improvements in servicer performance in order to maximize the level of home retention and reduce the incidence of default. Finally, PMI performs extensive borrower outreach to identify borrowers who have been otherwise unable to work with their servicer on a loan modification and recruit those borrowers back into a modification discussion, if appropriate. In such cases, PMI helps to facilitate information collection, document preparation and servicer evaluation of the potential loan modification. Importantly, pursuant to a loan modification, PMI subsidizes credit counseling for borrowers in order to help them reduce potentially unsupportable debt so that the loan modification can be as sustainable as possible.

For the three year period of 2008 – 2010, PMI helped over 82,000 borrowers retain their homes through loan modifications or payment plans. Over this same period, PMI also helped over 20,000 borrowers avoid foreclosure through liquidation workouts, which include pre-foreclosure sales or deeds-in-lieu.

Part I

The proposed, narrow definition of a QRM loan runs counter to Congressional intent, and if not revised, could raise significant concerns regarding the legality of the regulation. The legislative history makes it absolutely certain that the QRM was intended by Congress to be a broad exemption from the risk retention requirement for mortgage loans that were underwritten to pre-bubble standards. Furthermore, an objective reading of the statute and its legislative history demonstrates that the agencies have at least three independent grounds to exempt lower down payment loans from the risk retention requirements in the Dodd-Frank Act.

A. Statutory Authority to Make Exemptions from Risk Retention

The Dodd-Frank Act contains at least three different provisions authorizing the responsible agencies to make exemptions from the risk retention requirement. The agencies are not limited to the QRM section for this purpose, and can also exclude mortgages when in the public interest, or in order to improve access to credit under reasonable terms. The agencies should use their discretionary authority under these provisions to effectuate public policy by exempting loans protected by MI from risk retention requirements.

Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA),[3] adds a new section 15G to the Securities Exchange Act of 1934. This section directs the responsible agencies[4] to jointly prescribe regulations to require a securitizer to

[3] Public Law No. 111-203.
[4] The Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision (until July 21, 2011 when it was absorbed by the Comptroller of the Currency), the FDIC, the

retain an economic interest in the credit risk of asset backed securities sold to third parties.

The statute gives the responsible agencies broad discretion with respect to the amount of credit risk that must be retained, the manner in which the credit risk is held and the length of time the credit risk must be retained.[5] The statute also has several different and independent authorities for exemptions.

1. Exemption When In the Public Interest

One statutory provision authorizes the responsible agencies to create a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors.[6] Public policy is strongly in favor of the recovery of our housing markets and one way this can be accomplished is to ensure that well qualified first-time homebuyers are able to gain access to mortgage financing through MI protected, low down payment loans. The agencies should use the authority provided by this section to exempt such loans from the risk retention requirement, and thereby make homeownership available to more first-time buyers. The exemption permitted under this section does not require the agencies to find a correlation between MI and the risk of default.

2. General Exemption Authority

Another section[7] provides that the responsible agencies may make exemptions and exceptions from the credit risk requirements, including exemptions and exceptions for classes of institutions or assets. The statute states that such exemptions shall (i) help ensure high quality underwriting standards; and (ii) encourage appropriate risk management practices by securitizers and originators, improve the access of consumer and business to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors. As discussed above, not only does mortgage insurance ensure a higher standard of underwriting, it assists institutions in managing their risk by providing a reliable form of risk transfer. Additionally, mortgage insurance allows borrowers, particularly first-time homebuyers, greater opportunity to access the mortgage markets. Accordingly, this section provides another independent authority under which the agencies should exempt higher loan-to-value (LTV) loans covered by mortgage insurance in order to improve the access of mortgage credit to first-time home buyers and to low- and moderate-income families. Again, there would be no need to find a correlation between mortgage insurance and the risk of default.

Securities and Exchange Commission, and with respect to residential mortgages, the Federal Housing Finance Agency, and the Department of Housing and Urban Affairs.

[5] 15 U.S.C. 78o-11(c)(1).

[6] 15 U.S.C. 78o-11(c)(1)(G).

[7] 15 U.S.C. 78o-11(e)(1) and (2).

3. Qualified Residential Mortgage Exemption

A third independent basis for exemption from the risk retention requirement was added to the legislation during Senate floor consideration through an amendment offered by Senators Landrieu and Isakson, among others. This amendment excludes from risk retention mortgages that meet the definition of a "Qualified Residential Mortgage" or "QRM."[8]

The term QRM is to be defined through a joint regulation issued by the responsible agencies.[9] In defining the QRM, these agencies are to consider "underwriting and product features that historical loan performance data indicate result in a lower risk of default."[10] The legislation also lists examples of such features, including full loan documentation, debt-to-income ratios, loan terms that present payment shock, mortgage insurance and other credit enhancement to the extent such insurance or credit enhancement reduces the risk of default, and restricting the use of balloon payments, negative amortization, interest-only loans, and similar features.[11] It does not mention down payment requirements.

Thus, the statutory language provides several avenues for the regulatory agencies to create exemptions and exceptions to the risk retention requirement. These exemptions can be based on such general factors as "in the public interest," the need to ensure credit availability to first-time homebuyers, or the fact that the loans meet the QRM standard. These various provisions clearly indicate Congressional concern with the risk retention section and the potential for adverse impacts on credit availability and first-time home buyers, among others. The agencies should use one or more of these provisions to exempt loans protected by MI from risk retention, and thereby advance the important public policy objectives that are discussed in this letter.

B. Proposed Rule is Inconsistent with Congressional Intent

The legislative history of the QRM amendment clearly demonstrates the Congressional intent for a broad definition that would include all mortgages that are safely and soundly underwritten pursuant to the traditional standards in effect before the housing bubble. The agencies are not free to ignore legislative intent when promulgating implementing regulations.

1. Legislative History

i. Original Treasury Proposal and Senate Bill

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[8] 15 U.S.C. 78o-11(c)(1)(B) and (e)(4).
[9] 15 U.S.C. 78o-11(e)(4)(B).
[10] Id.
[11] Id.

The risk retention provisions in the DFA may be traced to the Administration's financial regulatory reform report issued on June 17, 2009.[12] The report stated that loan originators or sponsors should be required to retain five percent of the credit risk of securitized exposures, with exceptions that are consistent with safety and soundness.[13] The accompanying legislative language included authority for exemptions from risk retention in two different situations: (i) as may be appropriate in the public interest or for the protection of investors, and (ii) to help ensure high quality underwriting and to facilitate appropriate risk management, improve access of consumers to credit on reasonable terms, or otherwise serve the public interest.[14] The House passed this legislation on December 11, 2009, essentially adopting the Treasury language.[15]

The following year the Senate Banking Committee reported out its version of the legislation. The reported bill included a new and additional third ground pursuant to which the responsible agencies could lower or eliminate the risk retention requirement for classes of loans that meet underwriting standards that "indicate a *reduced* credit risk."[16] Note that the reported legislative language did not limit the exception to near perfect loans, or to loans that had "substantially" less risk, but simply to loans that have "reduced" risk.

The Senate Banking Committee explained that the reported bill authorizes the regulators to provide a total or partial exemption from risk retention as may be appropriate in the public interest and for the protection of investors.[17] In addition, the report states that the bill <u>also</u> authorizes exceptions, exemptions and adjustments that will "help ensure high underwriting standards, encourage appropriate risk management practices, improve access to credit on reasonable terms, <u>or</u> are otherwise in the public interest."[18] Thus, the report contemplated that an exception can be given based on any one of a number of factors, including the need to improve access to credit on reasonable terms. Exempting low down payment mortgages that are covered by MI would be consistent with this goal, and thus is an authorized ground for providing an exception from risk retention.

In short, prior to Senate floor consideration, neither the House passed bill nor the Senate reported bill contained an exception for QRM loans. However, both bills did contain authority for the agencies to provide exceptions for various reasons, including as may be necessary to "improve access to credit on reasonable terms or… otherwise in the public interest." There was no indication that Congress favored only narrow exceptions. The legislative history shows considerable Congressional apprehension that the risk retention requirement could have negative consequences on credit availability, and

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[12] U.S. Department of the Treasury, "Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation," (June 17, 2009).
[13] <u>Id</u>. at 44.
[14] U.S. Department of the Treasury, Draft Legislation, §951.
[15] H.R. 4173, as passed by the House of Representatives on December 11, 2009.
[16] Section 941 of S.3217, as reported by the Senate Banking Committee on April 30, 2010.
[17] Senate Report No. 111-176 at 130.
[18] <u>Id</u>. at 130-131.

included several "escape" clauses to allow the agencies to take action to prevent this unintended consequence.

ii. The Senate Specifically Rejected a Mandatory Down Payment Standard

During the Senate floor debate, despite the existence of the "escape" clauses noted above, it became clear that many Senators, both Republicans and Democrats, were still very concerned that risk retention would "shut down the securitization process and make less credit available."[19] One remedy came in the form of an amendment offered by Senator Corker. His amendment would have replaced the risk retention requirements with a mandatory 5 percent down payment requirement, and mandated a study by the Federal Reserve Board on the asset-backed securitization process.[20] The Corker Amendment failed, in *large part because of concern that a 5 percent down payment requirement was viewed as too restrictive*. Speaking against the amendment, Senate Banking Committee Chairman Dodd stated:

> …(T)he [Corker] amendment puts in government-dictated, hard-wired underwriting standards that would have very serious consequences … for first-time homebuyers, minority home buyers, and others who are seeking to attain the American dream of home ownership…. (I)t does this at a time, as we all know, that the housing markets are just starting to recover, potentially putting that recovery at risk.
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> * * *
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> Many insured depositors (sic), of course, have mortgage programs that require less than 5 percent down payment. They are performing well, and have done so in the past. And we want low- and moderate-income families to go to banks and get loans, qualified low- and moderate-income people …. We do not want to simply shut them off to nonprofits. We want to get them into the financial mainstream.
>
> The Corker amendment would create a new barrier to accomplishing that goal….[21]

Senator Merkley also argued strenuously against a mandatory 5 percent down payment requirement. He urged that the Senate adopt an amendment offered by himself and Senator Klobuchar in lieu of the Corker amendment.[22] The Merkley-Klobuchar amendment contained more flexible mortgage underwriting standards, as well as a requirement to verify income and assets, but no minimum down payment requirement. As explained by Senator Merkley:

> I think it is important to recognize that the bulk of what Senator Corker has addressed [in his amendment] goes right to the heart of [my]

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[19] See, e.g. Statements of Senator Corker and Senator Isakson at 156 Cong. Rec. S3514 (May 11, 2010)
[20] Amendment No. 3955, 156 Cong. Rec. S3551 (May 11, 2010)
[21] 156 Cong. Rec. S3518 and S3520 (May 11, 2010).
[22] Amendment no. 3962, 156 Cong. Rec. S3552 (May 11, 2010).

> amendment as well. There is a point of distinction between the two amendments, a critical point of distinction; that is, the 5 percent underwriting absolute line. That line is a line of great concern for those of us who have had experience with first-time home buyers, those who have had experience with families who are at the bottom on the income spectrum…. So the inflexibility of that standard is a great concern….[23]

Later in the debate, Senator Merkley elaborated further:[24]

> Many families, when they are buying a modest home, have a significant expenditure in all kinds of closing costs, independent of their down payment. They may well have thousands of dollars, $5,000, $8,000 of skin in the game before they ever get to the down payment. So we want to create the flexibility for first-time home buyers and for families on the lower end of the income spectrum to be able to get home ownership.

Following this debate, the Corker amendment was defeated by a vote of 42-57, and the Merkley-Klobuchar amendment was adopted by a vote of 63-36.[25] Thus, when faced with the clear choice between a mandatory down payment requirement and more flexible underwriting, the Senate voted for the more flexible approach.

The debate on the Corker amendment shows that the concept of a mandatory down payment requirement was specifically rejected, and that such leaders as Chairman Dodd of the Senate Banking Committee argued strongly against imposing such a requirement. His views prevailed when the amendment was defeated. As will be discussed shortly, the Senate authors of the QRM provision were convinced that risk retention would play havoc with credit availability, and that the availability of mortgage credit would be shut down. Therefore, they authored QRM legislation as a broad standard intended to capture all mortgage loans that are underwritten under the "good-old-day" standards, which were the standards in effect prior to the housing bubble. <u>These standards allowed for higher LTV lending so long as the loan was covered by mortgage insurance</u>. This concept was specifically mentioned in the debate as an example of "good-old-day" lending.

iii. <u>The QRM Was Never Intended to be a Narrow Standard</u>

Following consideration of the Corker amendment, the Senate turned to an amendment offered by Senators Landrieu and Isakson, among others.[26] This is the amendment that created an exemption for Qualified Residential Mortgages, and can be found, with minor changes, as section 941 of the Dodd-Frank Act.

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[23] 156 Congressional Record S3516 (May 11, 2010).
[24] 156 Cong. Rec. S3521 (May 11, 2010).
[25] 156 Cong. Rec. S3574 (May 12, 2010); incorporated into sections 1411 and 1412 of DFA.
[26] Amendment no. 3956, 156 Cong. Rec. S3575 (May 12, 2010). The amendment was co-sponsored by Senators Hagan, Warner, Menendez, Tester, Lincoln, Levin, Burr and Hutchison.

Senator Isakson, one of the co-sponsors of the amendment, explained that it was necessary to exempt qualified residential mortgage loans because he believed that the 5 percent risk requirement simply would not work in practice, and therefore without a QRM there "would be no loans."[27] Obviously, this view is not consistent with the position that the QRM was intended to be a narrow carve out for only the very strongest loans. Rather, since the concern behind the amendment was that no loans would be made subject to a risk retention requirement, then QRM loans should encompass the vast majority of loans that meet traditional underwriting standards.

The concept was made clear by Senator Isakson, who stated that the amendment would force lenders to go back to "good-old-day" loans where the borrower is qualified to borrow the money. As a result, "the only risk retention that will be required is when someone is making a bad loan, which means people will stop making bad loans."[28]

Senator Isakson explained what he considered to be a "good-old-day" loan as one in which the borrower's income is verified, the borrower has ratios that meet the tolerance levels for a qualified loan, there is equity of 20 percent in every loan, either through a down payment or if the down payment is less than 20 percent, having mortgage insurance. In other words, by returning to "*the way things used to work*."[29]

The Landrieu-Isakson amendment was not opposed by any Senator, and was agreed to by consent without a roll call vote.[30] In approving the final bill, the Conference Committee retained the Landrieu-Isakson amendment with minor changes.[31] One change was to specifically cross reference the standard for a "qualified mortgage" in Title XIV of the DFA, which relates to underwriting standards applicable to all mortgage originations. The cross reference provides that the QRM may be no broader than the standard for a qualified mortgage in Title XIV.[32] Another change directs the agencies to consider MI and other types of insurance or credit enhancements, "to the extent that such insurance or credit enhancement reduces the risk of default." This statutory language is not clear. The direction to consider the extent to which "such insurance" reduces the risk of default could be read as referring only to "other types of insurance," but not MI. This makes logical sense as well, since "other types of insurance" could be referring to property insurance, credit insurance or even life insurance on the borrower. Limiting the consideration of "other types of insurance" to those types that reduce the risk of default would therefore be a reasonable interpretation of the phrase. However, the NPR takes the position that the phrase applies to both MI and "other types of insurance, "and we therefore proceed to discuss how we believe the term "risk of default" should be applied.

The concept of "risk of default" is not further defined in the statute or in the legislative history of the QRM amendment. However, since a default, in and of itself, does not create a *risk* unless there is a resulting financial loss, the most logical

[27] 156 Cong. Rec. S3576 (May 12, 2010).
[28] Id.
[29] Id.
[30] 156 Cong. Rec. S3625 (May 12, 2010).
[31] House Report No. 111-517, (June 29, 2010).
[32] 15 U.S.C. 78o-11(e)(4)(C).

interpretation is that the term "risk of default" means the risk of financial loss that results from a default. If Congress sought to link mortgage insurance to the frequency of default, or to the rate of default, it would have used those words ("frequency" or "rate"), instead of "risk" of default. Since mortgage insurance is in a first loss position, a loan that is covered by MI reduces the risk of default by reducing the financial consequences of a default.

The conclusion that risk of default includes protection against loss is supported by the explanation of the amendment by Senator Isakson on the floor of the Senate on December 17, 2010.[33] Senator Isakson stated that "It was our clear legislative intent that, underwriting and product features that data indicate a lower risk of default must be considered… for loans with lower down payments that have combined loan-to-value ratios greater than 80 percent, the protections provided by mortgage insurance result in lower losses for lenders and investors and fewer foreclosures for borrowers than similar loans that lack insurance. The mortgage insurance provision ensures that the qualified residential mortgage exemption can serve those consumers that cannot afford a 20 percent down payment while putting substantial private capital at risk to drive underwriting discipline."

In summary, the legislative history of the QRM provision demonstrates that the sponsors of the amendment were of the belief that the 5 percent risk retention requirement would inhibit mortgage securitization to such an extent that virtually no mortgages would be securitized. The QRM was intended to prevent this result by exempting "good-old-day" loans from risk retention. A "good-old-day" mortgage was conceived as a loan that was underwritten "the way things used to work," i.e. fully documented, appropriate debt to income ratios, down payment requirements that consider private mortgage insurance, and the other traditional underwriting criteria.

As noted, the Conference Committee essentially adopted the Senate amendment. There is no legislative history or other indication that the Committee sought to change the basic goal of the amendment: to create a QRM that encompasses all of the "good-old-day" mortgage loans that are underwritten under the traditional standards used prior to the housing boom of the mid-2000s. The QRM exemption was never intended to only include a narrow class of super-high quality loans, and it was never intended to impose high down payment requirements that would adversely affect first-time homebuyers and economically disadvantaged groups. In fact, an amendment that would have imposed a hard wired minimum down payment was specifically rejected.

This conclusion is directly supported by a statement by Senator Isakson made on the Senate floor following final passage. In this statement, Senator Isakson explained the intent behind the amendment as follows:

> Earlier this year, I began working with Senators *Landrieu* and *Hagan* to develop the concept of a qualified residential mortgage, QRM or, as I call it, a "new gold standard" for residential mortgages, which ultimately was

[33] 156 Cong. Rec. S10442 (Dec. 17, 2010).

> included in the credit risk retention title of 941(b) in the financial reform bill. While risk retention can serve as a strong deterrent to excessive risk taken by lenders, it also imposes the potential of a constriction of credit in the mortgage market.
>
> I want to make this point clear. The risk retention provision of the Dodd-Frank bill would require an originator of a mortgage to retain 5 percent of that mortgage as risk retention…. What is going to happen is that very few mortgages will be made, and those that will be made will be only the most pristine ones, not necessarily the ones that meet the needs of middle America. * * *
>
> But in terms of mainstream America, we need to go back to the good old days of the 1960s, 1970s, and 1980s… (T)he easy underwriting that started in 2006, and then accelerated, caused us lots of problems. That is what we are here to try to stop today. I am optimistic that our amendment will be the first step to correct the lending practices of the past and will set on a better path in the future. * * *
>
> It is my hope that these regulators will follow the intent of the legislation, by ensuring a broad spectrum of qualified borrowers will fit under the umbrella of protection under the qualified residential mortgage safety and soundness provisions. [34]

This statement by Senator Isakson was followed up by correspondence on February 16, 2011[35] and May 3, 2011 to the regulators reinforcing legislative intent with regard to their desire to create a broad exemption from risk retention for "historically safe mortgage products" and their expectation that the statute "contemplates the inclusion of low-down payment loans, provided they have mortgage insurance…."

2. <u>The Proposed Regulation Conflicts with Congressional Intent</u>

The proposed regulation applies a very narrow definition of a QRM, and even the alternative approach described in the preamble, while a tad broader, is still very limited. For many potential homebuyers, the most restrictive requirement relates to a mandated cash down payment. The proposed regulation would mandate a cash down payment of at least 20 percent of the amount of the loan. Since closing costs would also have to be paid in cash, the combined amount of funds that a home buyer would actually need would exceed 20 percent. Private mortgage insurance would not be allowed to step in for any portion of the down payment – a practice that has, and continues to be, commonplace in the mortgage market, particularly for loans that are sold to Fannie Mae and Freddie Mac. The alternative suggested in the proposal would require a 10 percent cash down payment (plus cash payment of closing costs), provided that the loan has private mortgage

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[34] 156 Congressional Record S10441 (Dec. 17, 2010).
[35] See Appendix B for correspondence dated February 16, 2011.

insurance or similar credit enhancement. Based on Federal Housing Finance Agency data,[36]only abut 20 percent of all loans originated in the period of 1997 through 2002 (a period before the relaxation of underwriting standards that characterized the housing boom) that were acquired by Fannie Mae or Freddie Mac would have meet the proposed requirements for the QRM. Put another way, 80 percent of the loans that qualified under more "traditional" underwriting criteria would not be included within the QRM as defined in the proposal.[37] Lowering the mandatory down payment to 10 percent would increase the percentage of "good-old-day" to approximately 27 percent, but would still leave out 73 percent of these solidly underwritten mortgages.[38]

All four of the banking agencies have uniform guidelines on prudential mortgage underwriting. These guidelines state that mortgages are being prudently made if they have a loan-to-value ratio of 90 percent or less, or if above 90%, are supported by mortgage insurance or other forms of credit enhancement.[39] This is a significantly more liberal standard than the proposed QRM, again demonstrating that many prudent loans will not be within the QRM definition.

The preamble to the proposed regulation explains the agencies' rationale for proposing a very narrow QRM. First, the regulators assumed that Congress intended the QRM to be narrow because a securitization sponsor would not be required to retain credit risk when securitizing QRM loans, and therefore "the underwriting standards and product features for QRMs should help ensure that such residential mortgages are of *very high* credit quality."[40] Elsewhere in the preamble the agencies state that "to ensure that QRMs have low default risk consistent with their complete exemption from risk retention requirements, the agencies are proposing that the QRM definition require a sizable equity contribution."[41] The agencies also acknowledged that under the proposed standard "many prudently underwritten residential mortgage loans will not meet the proposed definition of a QRM."[42]

The basic assumption made by the agencies – that Congress intended a narrow QRM definition – is not found anywhere in the statutory language and is totally inconsistent with the legislative history. Further, the agencies acknowledge that their proposed definition would have the effect of excluding prudently underwritten loans from the QRM basket. This is the direct opposite of Congressional intent.

The Senators who authored the QRM amendment believed that credit would be highly constrained, if not eliminated, for loans that would be subject to the risk retention

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[36] FHFA Mortgage Market Note 11-2 (April 11, 2011).
[37] See also *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention Before the H. Comm. On Fin. Serv.*, 112th Cong. (April 14, 2011) (statement of Patrick Lawler, Chief Economist, FHFA) (hereinafter "Lawler testimony").
[38] FHFA Mortgage Market Note 11-2, p 17.
[39] See, e.g. 12 C.F.R. part 34, subpart D – Real Estate Lending Standards.
[40] 76 Fed. Reg. 24090, 24117 (April 29, 2011).
[41] Id. at 24123.
[42] Id. at 24118. The FHFA admitted at a recent House Financial Services Committee hearing that there could be "many loans made to creditworthy borrowers that fall outside of the QRM standards." Lawler testimony at page 7.

requirement. In order to prevent this result, they authored the QRM provision, and specifically wanted all prudently underwritten loans to be included in the QRM. By prudently underwritten, they were referring to loans underwritten under traditional "good-old-days" standards, i.e., the standards that applied before the housing bubble.

It is irrelevant whether or not the agencies agree with the Senators' view that credit for non-QRM loans will be constricted, since it is Congressional intent that must be carried out. If the agencies believe that the authors of the amendment were acting under mistaken assumptions, the remedy is to suggest a statutory amendment. The remedy is not to simply ignore the very clear and demonstrable statements made by the authors of the QRM provision. As stated by the Supreme Court: the "deference owed to an [administrative agency] … cannot be allowed to slip into a judicial inertia which results in the unauthorized assumption by an agency of major policy decisions properly made by Congress." [43] Accordingly, reviewing courts must not "rubber-stamp . . . administrative decisions that they deem inconsistent with a statutory mandate or that frustrate the congressional policy underlying a statute."[44]

Another reason given by the agencies for a narrow QRM standard is to ensure the origination of a large number of prudently made but non-QRM loans in order to ensure a broad liquid market for securities backed by such loans.[45] In other words, the agencies are saying that in order to establish a private secondary market, they are intentionally limiting the loans that are protected by the QRM, to ensure that there are a large number of well underwritten, but non-QRM, loans to support a securitization market. This was made clear in recent Congressional hearings where the agencies repeatedly emphasized the need to have a large number of well underwritten, non-QRM, loans to provide for a "vibrant and liquid market for non-QRM loans."[46]

There is no statutory foundation to support the consideration of this issue. Encouraging the creation of a secondary market for non-QRM loans is simply not a legally permissible factor when implementing this section. There appears to be no question that non-QRM loans will impose higher costs on the homebuyer. Congress, not the agencies should decide if creation of a secondary market is in the best interests of the country, especially since the method chosen by the regulators to achieve this policy objective is inconsistent with legislative intent and would result in higher costs for consumers.

Another problem with the proposed rule is that it is based on data for loans were originated between 2005 and 2008.[47] This was during the height of the housing bubble, and the loans that were made during this period did not reflect "good-old-day" lending. Rather, many of these loans had multiple risk defects, including poor product design,

[43] *American Ship Building Co* v. *NLRB*, 380 U.S. 300, 318 (1965).
[44] *Bureau of Alcohol, Tobacco and Firearms v. Federal Labor Relations Authority*, 464 U.S. 89, 97 (1983).
[45] 76 Fed. Reg. 24118.
[46] *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention Before the H. Comm. On Fin. Serv.*, 112th Cong. (April 14, 2011) (statement of Michael Krimminger, General Counsel, FDIC, p 8).
[47] 76 Fed. Reg. 24118.

low- or no-documentation, and highly inflated collateral factors (among other problems). The data from loans made in this period do not provide a sound basis for determining the requirements for a QRM that is intended to restore pre-bubble lending standards. For example, the fact that a low loan-to-value ratio (LTV) reduces defaults on poorly designed and underwritten loans made in the 2005-2008 time period cannot be used to support the conclusion that LTV should play a significant role when defining a QRM for loans that will be similar to the loans made in the 1990s.

The legislation contemplated returning to the underwriting standards that were in place prior to the bubble, and the agencies should have looked at pre-bubble underwriting standards and the resulting delinquency/default metrics. Loans purchased by Fannie Mae and Freddie Mac in the pre-bubble period of 2000 through 2003 had a 90-day delinquency rate that averaged only 1.5 percent.[48] A return to the underwriting standards used in this era would return our system to the appropriate balance between safety and credit availability, without imposing undo risk on creditors or the markets.

Nevertheless, the agencies evaluated each suggested QRM factor with regard to how that factor would have affected loans originated in the bubble period. It is clear that the agencies wanted to develop a tight QRM loan definition so that there would not be significant defaults of QRM loans even in a housing collapse similar to what we experienced in 2008.[49] This approach is not consistent with legislative history, which instructs that the QRM was to return us to pre-bubble lending, and was not intended to design a loan that could withstand an unprecedented economic collapse.

Under long standing Supreme Court guidance, agency rules will be considered arbitrary and capricious if the agency fails to consider the relevant factors, or makes a determination based on factors Congress did not intend.[50] Under the Supreme Court's *Chevron* doctrine, the courts are required to defer to an agency's *reasonable* interpretation of a statute it is charged with administering.[51] However, *Chevron* deference may not apply because more than one agency is charged with implementing the statute. As recently explained by the Court of Appeals for the District of Columbia:

> We review the OCC's interpretation of FIRREA and * * * related statutory provisions *de novo* because multiple agencies besides the Comptroller administer the act, including the Board of Governors of the

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[48] Fannie Mae Credit Supplement Q1 2011, p 9 (May 6, 2011) and Freddie Mac Credit Supplement Q1 2011, p 26 (May 4, 2011).

[49] 76 Fed. Reg. 24117. OCC testified before the House Financial Services Committee that "the proposed rule generally would prohibit QRMs from having product features that contributed significantly to the high levels of delinquencies and foreclosures since 2007—such as failure to document income, "teaser" rates, or terms permitting negative amortization or interest-only payments—and also would establish conservative underwriting standards designed to ensure that QRMs are of high credit quality." *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention Before the H. Comm. On Fin. Serv.*, 112th Cong. (April 14, 2011) (statement of Julie Williams, Chief Counsel, OCC, p 12).

[50] See, e.g. *Motor Vehicle Manufacturers' Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

[51] *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

> Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift . . .and thus deference under *Chevron*… is inappropriate. [52]

Even assuming that the courts will apply *Chevron* deference, the courts will not allow the regulation to stand "if it is inconsistent with the intent of Congress, or would defeat the purpose" of the relevant statute.[53] Deference to an agency's interpretation "is unwarranted when the administering agency's interpretation would cripple a statutory scheme in its inception." As instructed by the Supreme Court, "reviewing courts must not rubber stamp administrative decisions that frustrate the congressional policy underlying the pertinent * * * legislation."[54] A recent example of this principle may be found in *Cuomo v. Clearinghouse Association*, where the Supreme Court struck down part of an OCC regulation that the Court determined was not a "reasonable interpretation" of the National Bank Act.[55]

With respect to this proposed rule, the agencies decided to issue a narrow definition of a QRM based on factors and considerations that are not found in the statute or legislative history. Further, the agencies based the proposal on data that was not relevant, e.g. loan characteristics made during the housing bubble, rather than the loans made prior to the bubble.

In light of these issues, we recommend that the agencies revise the NPR to provide for a broad QRM that is consistent with Congressional intent and the legislative history of the QRM amendment. This revised NPR should recognize the role of MI in supporting low down payment mortgage loans in the same manner that MI was recognized as supporting such loans under pre-bubble underwriting.

PART II

The definition of QRM should be expanded in a way that captures more qualified borrowers while not sacrificing prudential underwriting and loans with mortgage insurance should be included in the QRM definition. As proposed, the narrow QRM approach will adversely affect the housing finance market, increase costs and reduce credit availability to qualified borrowers. The proposed regulation would exclude from the QRM safe and sound mortgage loans that comply with the requirements traditionally used for decades prior to the housing bubble. There is no policy basis for excluding these loans from the QRM definition, especially in light of the fact that such an approach will have a disproportionate adverse impact on first-time

[52] *Grant Thornton, LLP v. Office of Comptroller of the Currency*, 514 F.3d 1328, 1331 (D.C. Cir. 2008).
[53] *New York v. Schweiker*, 557 F. Supp. 354, 360 (S.D.N.Y. 1983); accord *Montres Rolex, S.A. v. Snyder*, 718 F.2d 524, 533 (2d Cir. 1983), cert. denied sub nom. *Grand Jewels, Inc. v. Montres Rolex*, S.A., 465 U.S. 1100 (1984).
[54] See *Bureau of Alcohol, Tobacco and Firearms v. Federal Labor Rel. Auth.*, 464 U.S. 89 (1983).
[55] 129 S.Ct. 2710 (2009).

homebuyers, including many minorities and low- and moderate-income borrowers.

A. Non-QRM Loans Will be More Expensive

While it may be hard to quantify the size of the disturbance in the pricing and availability of prudently underwritten non-QRM mortgages, there is no question that such mortgages will be more expensive and less available. According to Congressional testimony given by the American Securitization Forum, "the highly conservative nature of the QRM definition will likely limit the availability, and increase the cost, of mortgage credit to consumers, particularly to those with low to moderate incomes … these loans will certainly feature higher interest rates, more points and fees and more onerous terms than QRM loans."[56] The FHFA testified at that same hearing that "Loans that do not achieve QRM status …would subject securitizers to the higher costs associated with risk retention, and those costs might well be passed on to borrowers.[57] Noted economist Mark Zandi warned that a too narrow QRM, limited to loans with a high down payment, could significantly raise the cost of mortgage credit and reduce its availability for a large number of potential borrowers.[58]

B. Proposed Rule Will Have a Disproportionate Negative Impact on First Time Homebuyers and Low- and Moderate-Income Families

FHFA data shows that during the pre-bubble years, approximately 50 percent of all mortgage loans originated in underserved areas had loan-to-value ratios in excess of 80 percent. In order to be purchased by Freddie Mac or Fannie Mae, these low-down payment loans were required to have mortgage insurance. According to the 2009 Home Mortgage Disclosure Act (HMDA) data, 37% of the borrowers who received mortgages insured by private mortgage insurance to purchase homes made less than area median income and 23% made less than 80% of median income. These numbers clearly demonstrate the importance of MI to lower-income borrowers. Furthermore, data shows that low income and minority first-time homebuyers have consistently turned to high LTV loans in greater proportions. The 2009 data from the American Housing Survey indicates that 72 percent of African-American buyers and 63 percent of Hispanic buyers took out mortgages that were above 90 percent LTV. This compares to 45 percent for all households. For the typical U.S. family, it would take almost 9 years to save enough money for a 10 percent down payment, and fully 14 years to save for a 20 percent down payment.[59]

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[56] *Understanding the Implications and Consequences of the Proposed Rule on Risk Retention Before the H. Comm. On Fin. Serv.*, 112th Cong. (April 14, 2011) (statement of Tom Deutsch, Executive Director, ASF, p 36) (hereinafter "Deutsch testimony").
[57] Lawler testimony at page 6.
[58] Zandi, Mark, *The Skinny on Skin in the Game,* Moody's Analytics Special Report (March 11, 2011).
[59] Based on NAR's 2009 median home price of $172,100, and median family income of $49,777. At $3000 per year, the savings rate in the example is 6%, equal to the current savings rate, which is at the highest levels since the early 1990s.

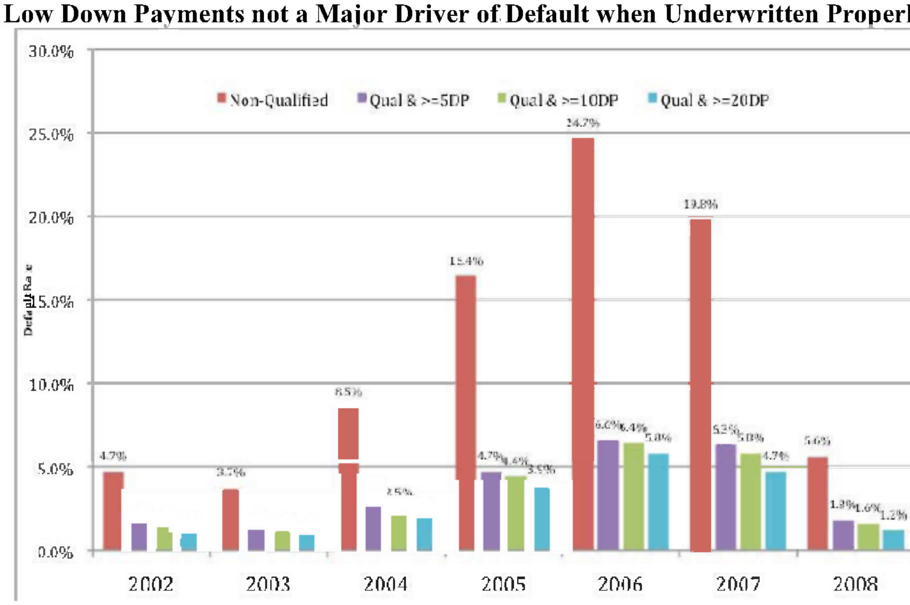
C. Down Payment and LTV Have Minimal Impact on Default Rates

The QRM proposal ignores compelling data that demonstrate that sound underwriting and product features, such as fully documenting the income of the borrower, and avoiding exotic or non-traditional mortgage products, have a much larger impact on reducing default rates than larger down payments. According to an analysis using mortgage data from CoreLogic, for otherwise high quality loans originated between 2002 and 2008 boosting down payments in 5 percentage point increments has only a negligible impact on default rates. As expected, loans with strong standards and at least 20 percent down payment performed best. However, the chart also shows clearly that lower down payment loans can be included in a strong QRM framework, and also have strong performance.

TABLE 1

IMPACT OF INCREASING MINIMUM DOWN PAYMENT ON DEFAULT RATES FOR LOANS THAT MEET QRM STANDARDS

Low Down Payments not a Major Driver of Default when Underwritten Properly



Source: Vertical Capital Solutions of New York, an independent valuation and advisory firm conducted this analysis using loan performance data maintained by First American CoreLogic, Inc. on over 30 million mortgages originated between 2002 and 2008. Note: Default rates are by origination year, through the end of 2009. Default means 90 or more days delinquent, plus in process of foreclosure, plus loans foreclosed. The sample QRM in this analysis is based on fully documented income and assets; fixed-rate or 7-year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41% total debt-to-income ratio; mortgage insurance on loans with 80% or greater loan-to-value ratios; and maturities no greater than 30 years.

We believe that the agencies should take this evidence into account and that a revised NPR should be issued that modifies the proposed QRM to include low-down payment loans that are covered by mortgage insurance or other forms of credit enhancement.

D. Mortgage Insurance Reduces the Frequency of Default and Should be Included in QRM

Third party data and independent analysis makes clear that MI is associated with lower frequency of default and therefore should be included in the QRM definition. A study conducted by Genworth and based on the CoreLogic Servicing Database shows that, of 4.9 million low down payment mortgage loans originated between 2003 and 2007, insured loans became seriously delinquent 32 percent less often than low down payment mortgages supported by piggyback loans. And with respect to loans that became delinquent, insured loans became current 54 percent more often than uninsured loans with piggyback seconds. As a follow-up to this analysis, and at Genworth's request, Promontory Financial Group conducted study analyzing 5.4 million low down payment loans. Promontory assessed the relative performance of insured loans and loans with piggyback seconds over time, and controlled for loan characteristics that correlate to delinquency risk, including documentation level, loan purpose, owner-occupied status, cumulative LTV and FICO score. This analysis found that loans with MI consistently experience lower severe delinquency rates than comparable uninsured loans supported by piggy back mortgages.[60] Again, based on these empirical studies, it is clear that MI is associated with lower frequency of default, and therefore should be included in the QRM definition. (Please see Question 111(a) in Appendix A for a further explanation)

E. Proposed QRM Standard Will Harm the Economic Expansion

The current economic expansion has been significantly sub-par in large part because the housing market has lagged the rest of the economy in recovery, and policies that would hinder a housing recovery will likely also keep economic growth disappointing. Prior to the housing bubble, approximately 40 percent of all home mortgages purchased by the Fannie Mae and Freddie Mac had loan-to-value ratios in excess of 80 percent.[61] Under the proposal, these potential homebuyers would not qualify for QRM mortgages, and thus would be forced to take out higher cost, non-QRM loans. As a result, a significant number of potential homebuyers, who would meet the traditional underwriting standards used in the 1990s and early 2000s, would be priced out of the market. By relegating these consumers to the more expensive non-QRM sector, housing demand will be reduced, with a corresponding adverse impact on house values and economic growth.

In addition to reducing the number of eligible first-time homebuyers, the narrow QRM standard will have a pernicious impact on current homeowners who have little or no equity left in their home due to the sharp declines in house prices in the aftermath of the housing boom. Consumers who must sell in today's market due to job changes or other life events (divorce, death, etc.) will find a reduced market for their home. Many existing home owners who want to refinance in order to take advantage of lower interest rates or mortgages with better terms will be hurt by the proposal, since they will not have sufficient equity to qualify for a QRM loan. For refinancing transactions, the proposed

[60] Both studies have been included in the Genworth submission to the NPR. In addition, the Promontory study may be accessed at the following web link http://promontory.com/
[61] FHFA Data for mortgage purchases in 1999 and 2000.

QRM definition would limit acceptable loan-to-value ratios to no more than 75 percent when the transaction only changes the rate or term of the existing mortgage, and no more than 70 percent when the transaction includes a distribution of cash to the borrower. This impact is of particular concern in those markets that have been hardest hit by the housing crisis. In the five hardest hit states, fully two-thirds of all homeowners have less than 25 percent equity in their homes.

These concerns are shared by many experts in housing finance. For example, the American Securitization Forum noted that "even highly creditworthy borrowers" are having trouble in today's market in obtaining mortgages, but that under the proposed QRM standard this problem will be "substantially exacerbated" and the availability of mortgage credit to consumers will suffer.[62] The ASF concluded that "a wide availability of low-down payment loans is necessary for the housing market to recover."

PART III

The public's need for non-QRM mortgage products will lead to the growth of government mortgage insurance programs. These programs are exempt from the risk retention requirement, at the expense of private mortgage insurance that puts private capital at risk. We urge the agencies to thoroughly evaluate the consequences of a policy that will unnecessarily shift more risk to the taxpayers. Public policy, as expressed by both the Administration and Congress, dictates that mortgage risks should be borne by the private sector, and not through government guarantees.

Requiring a 20% minimum down payment for all loans, unless they are insured by a federal agency such as the FHA, will seriously undermine efforts to bring private sector capital back into the housing market and may expose taxpayers to significant new risk. Because of the added costs imposed on the securitization of non-QRM loans, market forces will drive low down payment homebuyers to federal mortgage insurance programs, especially FHA insured loans.

A fundamental principal of effective risk management for residential mortgage loans is the provision of co-insurance between the insurer and insured. The FHA program with 100% default protection at the loan level violates this basic insurance principle. Additionally, the FHA's default coverage is backed by the U.S. Government which further removes the incentive to originate higher quality, lower risk residential mortgage loans. By contrast, private mortgage insurance is designed to align the interests of the mortgage originator, insurer, and investor. Private mortgage insurance typically provides coverage of 25% to 35% of the loan amount. Investors know that in certain severe stress scenarios they may experience a loss in excess of this coverage and are more likely to conduct the due diligence that is necessary to ensure they are purchasing high quality mortgages from loan originators.

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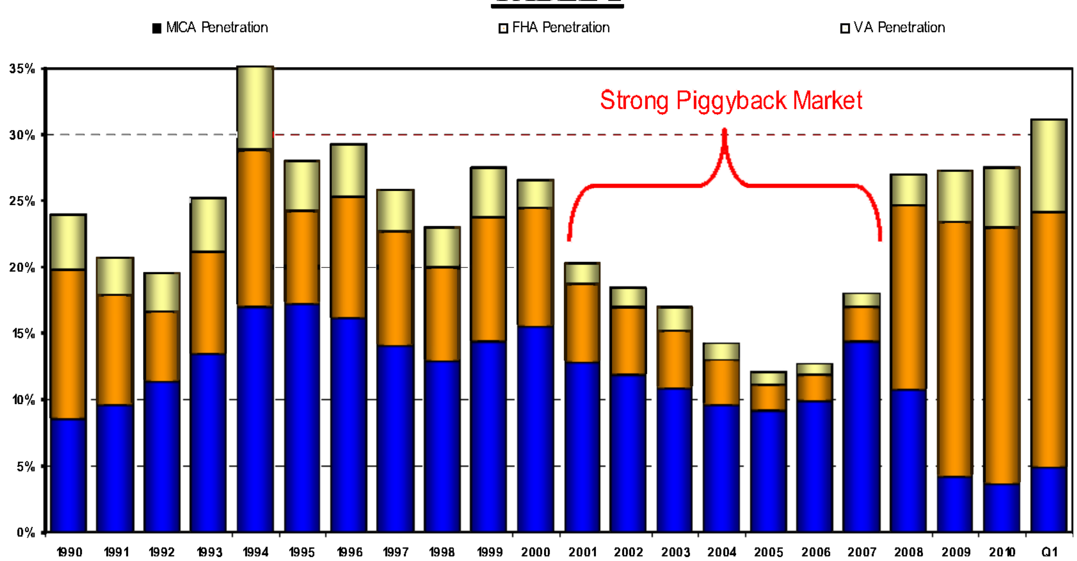
[62] Deutsch testimony.

As most policymakers will agree, the FHA already is exposing taxpayers to significant potential liability. The fiscal year 2012 Administration budget projects that the FHA's insurance-in-force will increase by 28% in this fiscal year (2011) and by 10% in the next fiscal year. Taxpayer exposure for FHA mortgages will be $1.253 trillion by September 30, 2012. Explicitly exempting government insured loans from the QRM, while failing to recognize private mortgage insurance as a criterion for the QRM will significantly increase the taxpayer's potential exposure and block the return of private capital into the mortgage market.

Further, relying on FHA and similar programs to meet the credit needs of first-time homebuyers would be a mistake for other reasons. The government mortgage insurance programs do not have unlimited capacity. The market share of FHA insured loans for the purchase of single family houses has already increased dramatically, from 14 percent in 2001 to 38.9 percent as of the end of the third quarter, 2010.[63] At some point the volume of mortgages seeking FHA type insurance will overwhelm the ability of the agency to review and provide coverage.

The chart below illustrates the dramatic growth in market share for the FHA and VA government insurance programs. The trend in the FHA/VA market share will be exacerbated if the proposed definition of QRM is put into effect.

TABLE 2



To put in place a policy that so clearly favors a government program runs counter to the stated goals of the Administration, which has expressed significant concerns about the FHA market share. A recently issued white paper co-authored by the Department of the Treasury and the Department of Housing and Urban Development stated the Administration's objective of reducing reliance on the FHA program, and instead bringing in private capital.[64] Former FHA Commissioner David Stevens elaborated on

[63] FHA, FHA-Insured Single Family Mortgage Originations and Market Share Report, 2010-Q3 at Table 2.
[64] *Reforming America's Housing Finance Market: A Report to Congress,* Treasury and HUD (Feb. 2011).

the report's findings when he testified before the House Financial Services Committee in February 2011. He stated that the Administration does not want the FHA program to have such a large role in supporting housing finance:

> (W)e do not want FHA to have such a substantial share of the market – and we are very aware of the risks this elevated role poses. While the FHA's countercyclical role has been essential to providing liquidity to the housing market to prevent further disruptions in the broader economy, the Obama Administration believes that meeting the diverse housing homeownership and rental needs of the country requires a strong, safe, and healthy market for private capital. [65]

In order to decrease its market share, the Administration and Commissioner Stevens proposed steps for both the FHA and Congress to take that were designed to reduce the FHA's "footprint." These steps include reducing the maximum loan size that would qualify for FHA insurance, increasing the premiums for this insurance, and tightening the underwriting standards for eligibility.[66]

The QRM proposal would impair these important policy objectives by making FHA and other government programs *more attractive* than private insurance by completely exempting these programs from risk retention but not providing similar treatment for loans insured by private MI companies.

In order to effectuate this important public policy goal, the agencies should issue a new NPR that places private mortgage insurance companies on a level playing field with government programs.

PART IV

> **Mortgage insurance should be a permissible form of risk retention for residential mortgages. The Dodd-Frank Act provides the option for the agencies to permit the risk retention requirements for commercial real estate transactions to be in the form of a third-party holding a first loss position. Mortgage insurance is economically equivalent to holding a first-loss position on residential real estate loans. MI absorbs the first-loss in the event of a default on insured residential mortgages, and thus has the same economic interest as a third party purchaser of a first loss position in a commercial real estate securitization. Alternatively, under the Dodd-Frank Act regulators can exempt loans with mortgage insurance. Government insured residential mortgages were exempt in the law because the federal insurance protects the lender and investor from loss in the event of a borrower default. Private mortgage insurance provides the same protection to lenders and investors.**

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[65] *Are There Government Barriers to the Housing Market Recovery? Before the H. Comm. On Fin. Serv.*, 112th Cong. (Feb. 16, 2011) (statement of David Stevens, FHA Commissioner, HUD, pp 3-4).
[66] Id.

A. MI as a Permissible Form of Risk Retention

The Dodd-Frank Act provides that the Federal banking agencies and the SEC are to establish the permissible types, forms and amount of risk retention required to be held by a sponsor of a securitization of commercial real estate loans.[67] The statute goes on to state that, for commercial real estate transactions, these regulations may "include … retention of the first-loss position by a third-party purchaser" that meets certain specified standards.[68] The NPR provides that a sponsor of a commercial real estate securitization satisfies the risk retention requirement if a third-party purchaser acquires an eligible horizontal residual interest in the securitization, in the same form, amount and manner as the sponsor would otherwise have been required to hold under regulation.[69] The NPR requires that certain other conditions must be met, such as requiring the third-party to review the assets collateralizing the securities, and not controlling the securitization.[70]

An eligible "horizontal risk residual interest" is defined in the proposal as a first-loss interest equal to at least 5 percent of the par value of all of the asset-backed securities that are issued as part of the transaction.[71]

Mortgage insurance is economically equivalent to holding a first-loss position on residential real estate loans. MI absorbs the first-loss in the event of default on insured residential mortgages, and thus has the same economic interest as a third-party purchaser for a first-loss position in a commercial real estate securitization. There is no public policy reason to provide different treatment for commercial real estate than for residential mortgages with respect to the risk retention requirement. MI companies have the same motivation to ensure proper underwriting of the residential mortgage loan as a company taking the first-loss position in a commercial real estate securitization.

We understand that the Dodd-Frank Act specifically provides the option for the responsible agencies to permit the risk retention requirement for commercial real estate transactions to be in the form of a third-party holding a first-loss position. However, the fact that a similar provision is not provided in the Dodd-Frank Act for residential mortgages does not preclude the agencies from establishing a similar rule for residential mortgages under their broad regulatory authority to create exceptions, exemptions and adjustments from the risk retention requirement,[72] and to establish the form for holding the retained risk.[73] These statutory provisions give the agency sufficient authority to effectuate important public policy goals by providing equivalent treatment for commercial and residential real estate securitizations.

[67] 15 U.S.C. 78o-11(c)(1)(E).
[68] 15 U.S.C. 78o-11(c)(1)(E)(ii).
[69] 76 Fed. Reg. 24109.
[70] See 76 Fed. Reg. 24161-2 for a complete description of the third-party purchaser qualifications.
[71] 76 Fed. Reg. 24102.
[72] 15 U.S.C. 78o-11(c)(1)(G), (e)(1) and (2).
[73] 15 U.S.C. 78o-11(c)(1)(C)(i).

B. Loans with MI Should Be Exempt from Risk Retention

The Dodd-Frank Act provides that loans insured by the Federal Housing Administration, the Farm Credit Administration, and other U.S. Government agencies are exempt from the risk retention requirement.[74] The NPR explains that federal insurance protects the lender from some or all of the credit loss in the event of a borrower default, and that the federal insurance protects investors against default by the issuer.[75]

Private mortgage insurance provides the very same protection to lenders and investors. As explained elsewhere in this letter, private MI is subject to rigorous regulatory standards designed to ensure that MI companies will be able to meet all of their obligations. Private mortgage insurance companies hold more capital against their insurance commitments than required under comparable bank and securities regulation. Thus, private mortgage insurance provides a similar backstop for both lenders and investors as government insurance programs. Further, public policy clearly dictates that, to the extent possible, private capital, not the U.S. Treasury, should stand behind our mortgage finance system. Providing an exemption for government insurance programs, but requiring risk retention for loans insured by private companies, works against this public policy and is not the in the long-term interests of our country.

Conclusion

The MI industry has been a structurally important part of the mortgage finance industry for over 50 years. Our industry has been critical in facilitating safe, affordable housing to qualified borrowers who do not have the resources to put 20 percent down towards the purchase of a home. Furthermore, MI protects investors by reducing the frequency and severity of defaults and foreclosures.

As stated earlier, PMI supports the goal of improved underwriting standards for residential mortgages as well as the concept of risk retention. However, we strongly urge the regulators to issue a new NPR that takes into account the relevant legislative history of the QRM amendment, and the substantial public policy advantages of a broad QRM definition that will not unfairly harm low- and moderate-income families and first-time home buyers. We urge the agencies to include within the definition of QRM loans with CLTV's of up to 95 percent, provided that loans above 80 percent LTV have mortgage insurance (or other comparable insurance or credit enhancement). Such a modification of the QRM definition will provide important societal benefits without material risks to the housing finance system. Unless the definition of QRM is modified along these lines, we believe that the rule will negatively impact consumers, restrict the availability of credit, increase taxpayer risk and impede the already weak housing recovery.

Additionally, the regulators must seriously consider the consequences of putting in place a policy that so clearly favors government insurance programs. This runs

[74] 15 U.S.C. 78o-11(c)(3).
[75] 76 Fed. Reg. 24137.

counter to Administration policy, will shift significant amounts of risk to the taxpayers and is unnecessary given the ability of the private sector to fulfill this role and do so in a way that aligns the interest of the lender, the consumer and the investor.

PMI appreciates the opportunity to comment on the agencies' proposal. If you have any questions or would like to discuss our commentary further, please feel free to contact me.

Regards,

David H. Katkov

APPENDIX A

I. <u>QRM Specific Questions</u>

Q. 2. Are there other terms, beyond those defined in §.2 of the proposed rules, that the Agencies should define?

We believe that the following changes in the definition section would be very helpful:

1. The term "credit risk" should be refined to mean the actuarially determined expected losses inherent in an asset. The definition should make it clear that credit risk is reduced when an asset is supported by guarantees, such as mortgage insurance. And that credit risk increases when an asset includes one or more features that have historically resulted in higher losses, such as introductory teaser rates, no/low documentation, simultaneous second liens and negative amortization.
2. The term "risk of default" is used in both the statute and the regulation, but not defined. We believe that the phrase "risk of default" was intended to include both the risk that an obligor would not meet his or her obligations and the effect that would have on the creditor or security holder.

Q. 12(a). Would the minimum five percent risk retention requirement, as proposed to be implemented, have a significant adverse effect on liquidity or pricing in the securitization markets for certain types of assets (such as, for example, prudently underwritten residential mortgage loans that do not satisfy all of the requirements to be a QRM)?

We believe the answer is unquestionably yes. While it may be hard to quantify the size of the disturbance in the pricing of prudently underwritten non-QRM mortgages, there appears to be no question that such mortgages will be less available and classified into a higher than necessary credit risk category (non-prime) which in addition to carrying the incremental originator expense of risk retention are likely to incur elevated costs to securitize due to the requisite increased levels of overcollateralization and subordination often required in pools with perceived elevated credit risk. Studies prepared by independent third parties indicate that mortgage rates could increase in the range of 75 to 100 basis point or even as high as 185 basis points for non-QRM loans, depending upon private market conditions (see response to question 108).

Q. 69(a). Should a third-party purchaser option be available to other asset classes besides CMBS? Would expanding this option to other asset classes fulfill the purposes of section 15G?

The Dodd-Frank Act provides that the Federal banking agencies and the SEC are to establish the permissible types, forms and amount of risk retention required to be held by a sponsor of a securitization of commercial real estate loans.[1] The statute goes on to state that, for commercial real estate transactions, these regulations may "include … retention of the first-loss position by a third-party purchaser" that meets certain specified

[1] Section 15G(c) (1) (E).

standards.[2] The NPR provides that a sponsor of a commercial real estate securitization satisfies the risk retention requirement if a third-party purchaser acquires an eligible horizontal residual interest in the securitization, in the same form, amount and manner as the sponsor would otherwise have been required to hold under regulation.[3] The NPR requires that certain other conditions must be met, such as requiring the third-party to review the assets collateralizing the securities, and not controlling the securitization.[4]

An eligible "horizontal risk residual interest" is defined in the proposal as a first-loss interest equal to at least 5 percent of the par value of all of the asset-backed securities that are issued as part of the transaction.[5]

Mortgage insurance is economically equivalent to holding a first-loss position on residential real estate loans. MI absorbs the first-loss in the event of default on insured residential mortgages, and thus has the same economic interest as a third-party purchaser for a first-loss position in a commercial real estate securitization. There is no public policy reason to provide different treatment for commercial real estate than for residential mortgages with respect to the risk retention requirement. MI companies have the same motivation to ensure proper underwriting of the residential mortgage loan as a company taking the first-loss position in a commercial real estate securitization.

We understand that the Dodd-Frank Act specifically provides the option for the responsible agencies to permit the risk retention requirement for commercial real estate transactions to be in the form of a third-party holding a first-loss position. However, the fact that a similar provision is not provided in the Dodd-Frank Act for residential mortgages does not preclude the agencies from establishing a similar rule for residential mortgages under their broad regulatory authority to create exceptions, exemptions and adjustments from the risk retention requirement,[6] and to establish the form for holding the retained risk.[7] These statutory provisions give the agency sufficient authority to effectuate important public policy goals by providing equivalent treatment for commercial and residential real estate securitizations.

Q. 79. Is our proposal regarding the treatment of the Enterprises appropriate?

Yes. PMI supports the provisions in the NPR that make a guarantee by Fannie Mae or Freddie Mac a permissible form of risk retention. The risk retained by the GSEs under their guarantees to investors is consistent with the incentive alignment objectives and requirements of section 941.

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[2] Section 15G(c) (1(E) (ii).
[3] 76 Fed. Reg. 24109 (2011).
[4] See 76 Fed. Reg. 24161-2 for a complete description of the third-party purchaser qualifications.
[5] 76 Fed. Reg. 24102 (2011).
[6] Section 15G(c) (1) (G) and Section 15G (e) (1), (2).
[7] Section 15G(c) (1) (C) (i).

Q. 90. Should the rules permit sponsors to allocate risk to a third party, and if so, how to ensure that incentives between the sponsor and investors are aligned in a manner that promotes quality underwriting standards?

See response to question 69(a) above.

Q. 106. Is the overall approach taken by the Agencies in defining a QRM appropriate?

No, as discussed in detail on pages 6 – 18 of PMI's comment letter, the legislative history demonstrates that the QRM was intended as a broad standard that would encompass all loans that were underwritten to pre-bubble standards. The narrow approach taken by the agencies is inconsistent with legislative intent. Also as discussed in the comment letter, the narrow approach taken by the agencies will have a significant adverse impact on the housing markets, will unnecessarily increase the cost of mortgage finance for creditworthy borrowers, and will have a disproportionate impact on first-time homebuyers, minorities, and other underserved populations.

Q. 107. What impact might the proposed rules have on the market for securitizations backed by QRM and non-QRM residential mortgage loans?

The securitization of non-QRM loans would be adversely impacted. Not only will the costs of such securitizations increase due to the increased capital and other requirements (e.g. premium capture) resulting from the proposal, but only a few private entities will have the capital resources necessary to securitize and retain 5 percent of the credit risk on non-QRM loans. These few institutions will have the market power to raise the costs of mortgage finance, and could easily become institutions that are "too big to fail." The only alternative to these few companies will be government programs, such as the FHA and VA, and the continued growth of these programs will expose the U.S. taxpayer, rather than the private sector, to credit risks.

In hearings before the House Financial Services Committee on April 14, 2011, the American Securitization Forum testified on this very point. The ASF concluded, among other things, that the proposal: (i) will impose increased costs that will make many securitizations economically unfeasible, given a prohibitively low return on capital for securitizers; and (ii) the proposals worsen the existing non-level playing field between the GSEs and private securitizers by increasing the relative execution advantages of the GSEs as to non-QRM loans, thus impeding the bipartisan policy goal of winding down the GSEs over an appropriate timeline. We share these concerns.

We also note that the Amherst Securities Group, in a letter dated June 2, agrees with our view that the narrow QRM approach will have anti-competitive effects. Their letter states that *"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."*

Q. 108. What impact, if any, might the proposed QRM standards have on pricing, terms, and availability of non-QRM residential mortgages, including to low and moderate income borrowers?

Our data indicates that low- and moderate-income home purchasers rely heavily on programs, such as private MI and government backed mortgage insurance, in order to obtain a mortgage without meeting a downpayment requirement of even 10 percent. A survey by the National Association of Realtors estimates that last year, 50% of homebuyers were first-time homebuyers and that 86% of these buyers made down payments below 20%. Any regulation that would classify such loans as non-QRM would disproportionately increase the costs of housing finance for minorities and for low- and moderate-income consumers, and reduce the availability of mortgage credit even further for these populations.

Based on 2009 income and home price data, it would take almost 9 years for the typical American family to save enough money for a 10 percent down payment, and fully 14 years to save for a 20 percent down payment.[8] For the typical African-American family, it would take over 13 years for a 10 percent down payment, and 22 years to saving for a 20 percent downpayment, and this is assuming a record high 6 percent savings rate.

A 20 percent or even a 10 percent down payment requirement for the QRM means that even the most creditworthy and diligent first-time homebuyer cannot qualify for the lowest rates and safest products in the market. This will impact minorities and other underserved populations even more significantly, or limit these communities to government guaranteed loan programs. The alternative, financing through the non-QRM market, with higher interest rates and riskier product features, does not serve any public purpose. Increased borrower costs related to the QRM proposed rule have been estimated by Mark Zandi of Economy.com in the range of 75 to 100 basis points[9] and by the National Association of Realtors to range from 85 to 185 basis points[10]; please see chart below.

It is for these reasons that the Center for Responsible Lending recently appeared before the House Financial Services Committee and testified that the proposed rule would "reinforce an unfair, separate and unequal housing finance system that would relegate underserved families to FHA or to higher cost, less desirable lending channels – or even exclude them entirely from homeownership they could otherwise sustain."

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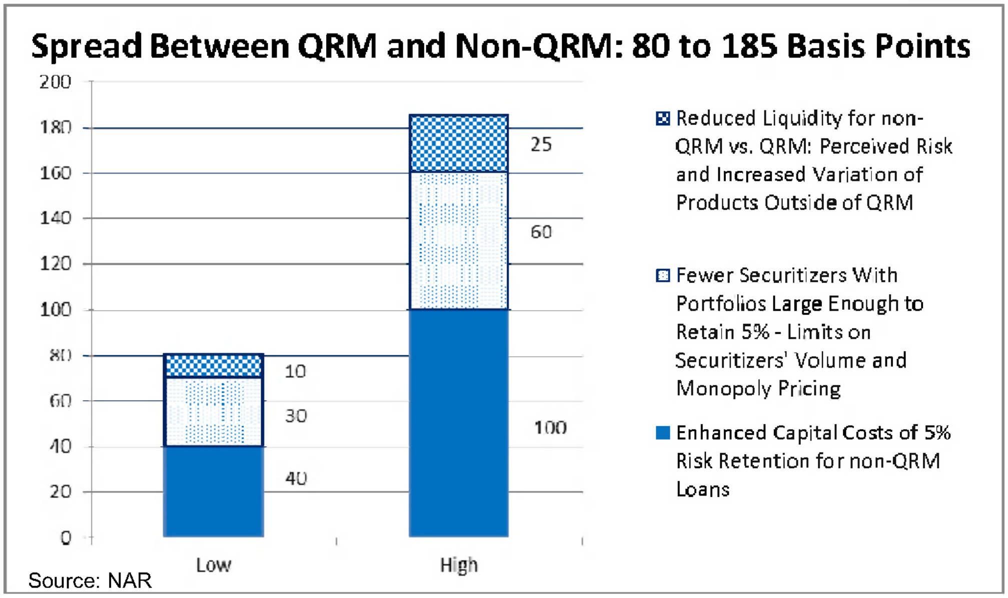
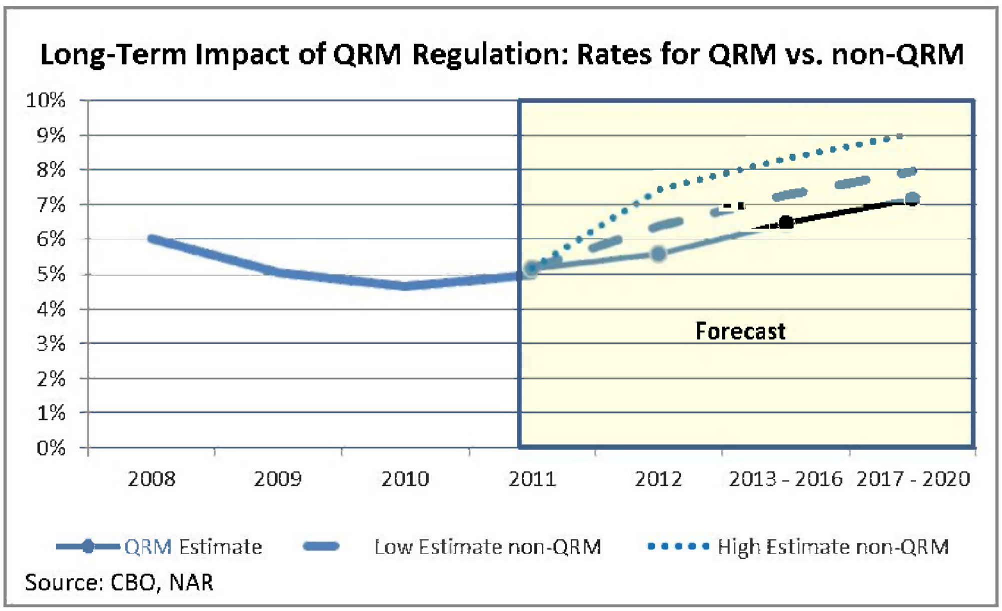
[8] Based on NAR's 2009 median home price of $172,100, and median family income of $49,777. At $3000 per year, the savings rate in the example is 6%, equal to the current savings rate, which is at the highest levels since the early 1990s.

[9] Zandi, Mark. *Reworking Risk Retention*, p 2. Moody's Analytics Special Report (June 20, 2011).

[10] Fears, Ken. *QRM: Higher Mortgage Rates on the Horizon*. National Association of Realtors (June 17, 2011).





Source: QRM: Higher Mortgage Rates on the Horizon. June 17, 2011. Ken Fears, National Association of Realtors

Q. 110. The Agencies seek comment on all aspects of the proposed definition of a QRM, including the specific terms and conditions.

PMI is primarily concerned about the excessively high down payment requirements in the QRM. We recognize that LTV is a factor in default, however the QRM rule simply does not take into consideration data that demonstrates that sound underwriting and product features, like documentation of income and type of mortgage, have a larger impact on reducing default rates than high down payments.

An analysis of data from CoreLogic Inc. on high quality loans[11] originated between 2001 and 2008 shows that increasing down payments in 5 percent increments has a negligible impact on default rates, but significantly reduces the number of borrowers that would qualify under the QRM definition. Specifically, as shown in the chart below, on loans that already meet strong underwriting and product standards, moving from a 5 percent to a 10 percent down payment reduces the default experience by an average of only two- or three-tenths on one percent. Importantly, however, that increase in down payment would eliminate up from 4 to 7 percent of borrowers from qualifying for QRM loan. Further increasing the minimum down payment to 20 percent as proposed in the QRM rule would amplify this disparity – knocking 15 to 20 percent of borrowers out of the QRM market with only a small improvement in default performance of about eight-tenths of one percent.

Impact of Raising Down Payments Requirements on Default Rates and Borrower Eligibility

Origination Year	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Reduction in default rate* by increasing QRM down payment **from 5% to 10%**	0.2%	0.1%	0.3%	0.3%	0.2%	0.5%	0.2%
Proportion of borrowers **not eligible** for QRM by moving from 5% to 10% Down	5.2%	4.3%	5.5%	4.6%	4.8%	6.7%	5.7%
Reduction in default rate* by increasing QRM down payment **from 5% to 20%**	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%
Proportion of borrowers **not eligible** for QRM by moving from 5% to 20% Down	16.9%	14.5%	19.4%	19.2%	19.1%	20.1%	18.0%

* Default = 90 or more days delinquent, plus in process of foreclosure, plus loans foreclosed.
Source: Data from CoreLogic, Inc. Analysis by Vertical Capital Solutions for Genworth Financial and the Community Mortgage Banking Project.

In conjunction with the down payment requirements, the proposed rule requires stringent front-end and back-end debt to income ratios (DTIs). PMI recognizes that DTIs were envisioned under the Dodd-Frank Act, however the DTIs in the proposed rule are unduly restrictive and allow no flexibility for compensating factors. We would urge the regulators to further evaluate the impact of the DTI requirements and propose that the

[11] Loan attributes: Fully documented income and assets; fixed-rate or 7 year or greater ARMs; no negative amortization; no interest only loans; no balloon payments; 41 percent total debt-to-income ratio; mortgage insurance on loans with 80 percent or greater LTV; and no maturities greater than 30 years.

ratios put forth in the Alternative Option in the preamble of the QRM might be more appropriate as they provide for more flexibility.

If not revised, PMI believes that the combination of the restrictive DTIs and the high down payment requirement would result in closing the door on many qualified borrowers.

Q. 111(a). The Agencies seek comment on whether mortgage guarantee insurance or other types of insurance or credit enhancements obtained at the time of origination would or would not reduce the risk of default of a residential mortgage that meets the proposed QRM criteria but for a higher adjusted LTV ratio. Commenters are requested to provide historical loan performance support for their views if possible, particularly if they control for loan underwriting or other factors known to influence credit performance.

As an initial matter, we believe that this question misapplies the statutory language in the Dodd-Frank Act. The statute states that one of the factors that the agencies should consider in developing the QRM standard, is "mortgage guarantee insurance or other types of insurance or credit enhancement obtained at the time of origination, to the extent such insurance credit enhancement reduces the risk of default."[12] The statutory language does not mandate a comparison of loans with and without MI in which underwriting and other factors known to influence credit performance (other than LTV) are held constant. Rather, the plain reading of the statute simply asks for an analysis of whether MI reduces the risk of default for high LTV loans. Thus, the required finding can be made if the reduction in the risk of default results from higher underwriting standards imposed by MI companies. The question, on the other hand requires all underwriting factors, other than LTV, to be the same. While this type of regression analysis may be appropriate for certain statistical purposes, it is not the standard imposed by the statute, and therefore question 111(a) requires an analysis that is inconsistent with the legislation.

Secondly, we believe that the term "risk of default" relates to the financial losses that result from a default. Otherwise the statute would have referred to the "rate" of default or to the "frequency" of default. Private MI reduces the risk of default by reducing the losses associated with defaults. Since 2007, mortgage insurers have paid over $24 billion in claims. Over the course of the current mortgage crisis, the MI industry estimates that it will pay around $30 billion in claims in front of the taxpayer to Fannie Mae and Freddie Mac. Since 2007 PMI has paid $3.9 billion in claims and claim adjusted expenses and anticipate paying another $5.2 billion, on past vintages. These paid claims represent a significant reduction in loss given default. Based on this information, it is clear that MI reduces the loss given a default, and therefore reduces the economic risk of default.

Furthermore, third party data and independent analysis makes clear that MI is associated with lower frequency of default and therefore should be included in the QRM

[12] 15 U.S.C. 78o-11(e)(4)(B).

definition. A study conducted by Genworth and based on the CoreLogic Servicing Database shows that, of 4.9 million low down payment mortgage loans originated between 2003 and 2007, insured loans became seriously delinquent 32 percent less often than low down payment mortgages supported by piggyback loans. And with respect to loans that became delinquent, insured loans became current 54 percent more often than uninsured loans with piggyback seconds. As a follow-up to this analysis, and at Genworth's request, Promontory Financial Group conducted study analyzing 5.4 million low down payment loans. Promontory assessed the relative performance of insured loans and loans with piggyback seconds over time, and controlled for loan characteristics that correlate to delinquency risk, including documentation level, loan purpose, owner-occupied status, cumulative LTV and FICO score. This analysis found that loans with MI consistently experience lower severe delinquency rates than comparable uninsured loans supported by piggy back mortgages.[13] Again, based on these empirical studies, it is clear that MI is associated with lower frequency of default, and therefore should be included in the QRM definition.

Finally, for purposes of discussion, even if the narrow interpretation of "risk of default" is maintained, it should be noted that the agencies clearly have the discretion to recognize the benefits of mortgage insurance under two other sections of the law authorizing exceptions to the risk retention provisions, regardless of the relationship between mortgage insurance and the risk of default. One of these provisions directs the agencies to consider exemptions that would "improve the access of consumers … to credit on reasonable terms"[14] The other provision authorizes exemptions when in the public interest.[15] Credit risk is different than risk of default, and clearly includes the concept of loss in the event of a default. Either of these statutory provisions could be used to provide an exemption for loans that are covered by mortgage insurance, without the need to correlate the insurance and risk of default.

Q. 111(b). If the information indicates that such products would reduce the risk of default, should the LTV ratio limits be increased to account for the insurance or credit enhancement?

The obvious intent in the statute is to allow mortgage insurance or credit enhancement to be used when LTV ratios would not otherwise meet minimum LTV standards. Simply put, there would be no reason to mention mortgage insurance and credit enhancement at all unless Congress was intending that this product could be used to increase mortgage availability through a relaxation of down payment requirements.

Q. 111(c). If so, by how much?

Mortgage guidelines issued by all four of the banking agencies state that a prudently underwritten mortgage may have an LTV <u>in excess</u> of 90 percent for loans

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[13] Both studies have been included in the Genworth submission to the NPR. In addition, the Promontory study may be accessed at the following web link http://promontory.com/

[14] Section 15G(e)(2).

[15] Section 15G(c)(1).

protected by mortgage insurance.[16] In other words, there is no LTV cap if the loan has MI coverage.

The banking agencies' capital rules likewise provides for beneficial capital treatment for high LTV loans protected by mortgage insurance.[17] A recent study completed earlier this year by the International Monetary Fund stated that "absolute LTV limits might be a blunt instrument that excludes potentially creditworthy first-time buyers/borrowers." The IMF study recommends that loans that do not meet a strict LTV limit could be made available to borrowers who "agree to purchase adequate mortgage insurance."[18] These factors support a flexible approach in which LTV can be 95 percent if adequate mortgage insurance is required.

Moreover, Congress was well aware that MI has been used successfully for over 50 years prior to the recent housing bubble to lower down payment requirements without significant adverse impact on loan performance.

We recommend that the QRM standard allow for loans up to 95 percent LTV, so long as the loan is protected by mortgage insurance.

Q. 112(a). If the proposed QRM criteria were adjusted for the inclusion of mortgage guarantee insurance or other types of insurance or credit enhancements, what financial eligibility standards should be incorporated for mortgage insurance or financial product providers and how might those standards be monitored and enforced?

The countercyclical capital requirement imposed by state insurance authorities has functioned as it was designed, with adequate resources set aside in reserves to pay all claims while the companies are also supporting the recovery of the housing sector by continuing to write new business.

The primary framework for state regulation of MI is the Mortgage Guaranty Insurance Model Act (the "Act") promulgated by the National Association of Insurance Commissioners (NAIC). Using PMI as an example through the provisions of the Act, we are subject to a comprehensive and robust set of financial regulations and oversight activities by the Arizona Department of Insurance ("AZ DOI"), our domestic regulator,

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[16] The Interagency Guidance on High LTV Residential Real Estate Lending, issued by the four Federal Banking Agencies in 1999, requires that mortgage loans that have an LTV in excess of 90 percent must be supported by mortgage insurance or other credit enhancements. Loans that do not comply with the MI or credit enhancement requirement are subject to enhanced regulatory scrutiny, are limited to a special basket of loans that in the aggregate cannot 100 percent of the institutions' capital, must be reviewed and monitored closely by the institution, and must be reported quarterly to the institution's board of directors..See, e.g. OCC Issuance 199-38.

[17] Under the risk-based capital rules, residential mortgage loans that are "prudently underwritten" are assigned to the 50 percent risk weight category. Prudently underwritten mortgages must be supported by MI or other credit enhancements if the LTV is more than 90 percent. See, e.g. 12 C.F.R. Appendix A.

[18] International Monetary Fund, "Global Financial Stability Report: Durable Financial Stability - Getting There From Here," at page 143 (April 2011).

that address capital and investments,[19] loss reserving,[20] financial condition and product rates and restrictions.[21] (Other mortgage insurers are subject to substantially similar regulatory requirements in their respective states of domicile.) Together, the insurance laws/regulations and the mandated supervisory activities of our domestic regulator, provide a strong financial oversight process to ensure that the company operates in a stable and secure manner for the benefit of its policyholders. These laws and regulations have been developed for the unique challenges posed by a type of insurance that provides long term default loss protection on residential mortgages. Specifically, the loss reserving requirements provide an extra capital cushion which increases the ability of the MIs to withstand boom and bust cycles that are typical in the real estate market.

Additionally, like numerous other states, Arizona has adopted Hazardous Financial Condition regulations based on the Model Regulation promulgated by the NAIC.[22] Under these regulations, insurers, including MIs, are subject to 18 criteria which singly or in combination may indicate that the MI is in a financially hazardous condition. A number of actions are prescribed if it is determined that an insurer is in a hazardous financial condition, including orders to reduce or suspend new business, increase capital and surplus, or obtain reinsurance. These regulations act as an early warning system to detect and impose remedial actions on insurers well before they are threatened by insolvency.

In summary, MI is a well regulated, counter-cyclical source of loan level protection provided for residential mortgage loans. Our view is that the financial eligibility standards imposed on mortgage guaranty insurers under state law, and as monitored and enforced by state regulators such as the AZ DOI, are appropriate and sufficient for eligibility to insure QRM loans. Non-MI credit enhancement providers should be subject to the same or substantially equivalent financial standards, as well as rigorous regulatory monitoring and enforcement, to be deemed eligible to insure QRM loans. This ensures an even playing field for mortgage insurers and alternative credit enhancement providers, and reduces the likelihood that alternative credit enhancement providers will be unable to meet their claims obligations under stressful economic conditions.

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[19] *Arizona law sets minimum capital and surplus requirements (A.R.S. § 20-1542) and minimum policyholder position ("MPP") requirements to ensure a sufficient capital position to be permitted to continue transacting insurance (A.R.S. § 20-1550). MI investments are limited (A.R.S. § 20-1545; 20-531). Dividends are subject to regulatory review and approval (A.R.S. § 20-155).*

[20] *Arizona law requires MI loss reserves (A.R.S. § 20-1555) and contingency reserves ("CRs") equal to fifty percent (50%) of net unearned premium for a period of ten (10) years or until approved for release by the Arizona Department of Insurance (A.R.S. § 20-1556). CRs provide an extra capital cushion, which greatly increases the ability of MIs to withstand periods of increased claims due to stress in the general economy and/or housing markets. Finally, Arizona requires premium deficiency reserves (A.R.S. § 20-1556.01).*

[21] *Mortgage guaranty insurance is required to be written on a monoline basis in Arizona (A.R.S. § 20-1547) to ensure the clear financial stability of the mortgage insurance business written. Mortgage insurers are limited in the geographic concentration of the risks they write (A.R.S. § 20-1543) and the insurer can cover no more than twenty-five percent (25%) of the entire indebtedness of the insured on any loan (A.R.S. § 20-1546). Policy forms and premium rates are subject to regulatory review and approval.*

[22] Ariz. Admin. Code § R20-6-308.

Q. 120. The Agencies seek comment on the appropriateness of the proposed LTV and combined LTV ratios for the different types of mortgage transactions.

PMI believes that any standard relating to loan-to-value should include all loans collateralized by the same property at origination, and thus supports the CLTV approach. Only the combined CLTV provides a true picture of the credit risk of the mortgage, and the ability of the consumer to repay. We recommend that the QRM standard allow for origination and rate and term refinance loans up to 95 percent LTV, so long as the loan is protected by mortgage insurance.

Q. 143. The Agencies seek comment on the potential benefits and costs of the alternative approach, with a broader QRM exemption combined with a stricter set of risk retention requirements for non-QRM mortgages.

The proposal contains various alternative approaches. One approach would permit an LTV of 90 percent, with no restriction on the use of subordinated liens. Another alternative would permit the cash downpayment to be reduced to 10 percent. A third alternative would allow a cash downpayment of 10 percent, but only if the loan was covered by mortgage insurance.

Our data demonstrates that permitting any type of LTV or down payment standard to be satisfied in connection with a purchase mortgage transaction should not be satisfied through the use of subordinate or "piggy back" loans. Piggyback loans are loans where borrowers have little or no equity in their mortgages. Instead, borrowers get an 80% first mortgage loan and simultaneously get up to a 20% second mortgage. Therefore, the borrowers have little or no equity in their mortgage, but many of the first loans were purchased by the GSEs because those loans met their 80 percent LTV standard.

Data prepared by Genworth and replicated and validated by Promontory Financial Group indicates that delinquencies and defaults for mortgages that met the 80 percent LTV test through the use of piggy back loans was approximately 1.65 times more frequent than insured loans with the same characteristics including LTV, borrower credit scores, origination year, geographic location, loan purpose and borrower documentation levels. This analysis demonstrates that not all low down payment loans are the same. MI significantly mitigates the risk that a high LTV loan will become delinquent and go to default. The data makes it clear that with proper underwriting and mortgage insurance, low down payment lending can be done without exposing the borrower, lender or investor to excessive risk.

Allowing a down payment of 10 percent without a mortgage insurance requirement would be an experiment with potentially unfortunate results. As explained previously, PMI requires loan originations to comply with independently derived underwriting standards, and has controls and processes to ensure compliance with this requirement. This is an important safeguard for all loans, but especially important when the LTV is in excess of 80 percent. Additionally, in the event of default, investors benefit from reduced loss severity when loans are covered by mortgage insurance.

The third alternative, a 10 percent down payment coupled with mortgage insurance, should be expanded. Our data indicates that loans with even less than 5 percent down payment underwritten with mortgage insurance are sustainable loans that perform well and support the achievement of homeownership for first-time homebuyers and underserved groups in the community. As illustrated in the table below, expanding the QRM definition to include lower levels of down payment improves access to QRM loans, with little incremental impact to overall rates of default.

Impact of Raising Down Payments Requirements on Default Rates and Borrower Eligibility

Origination Year	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
Reduction in default rate* by increasing QRM down payment **from 5% to 10%**	0.2%	0.1%	0.3%	0.3%	0.2%	0.5%	0.2%
Proportion of borrowers **not eligible** for QRM by moving from 5% to 10% Down	5.2%	4.3%	5.5%	4.6%	4.8%	6.7%	5.7%
Reduction in default rate* by increasing QRM down payment **from 5% to 20%**	0.6%	0.3%	0.7%	0.8%	0.8%	1.6%	0.6%
Proportion of borrowers **not eligible** for QRM by moving from 5% to 20% Down	16.9%	14.5%	19.4%	19.2%	19.1%	20.1%	18.0%

* Default = 90 or more days delinquent, plus in process of foreclosure, plus loans foreclosed.
Source: Data from CoreLogic, Inc. Analysis by Vertical Capital Solutions for Genworth Financial and the Community Mortgage Banking Project.

Q. 145. How would this approach help to ensure high quality loan underwriting standards and align the interests of investors?

Requiring mortgage insurance ensures high underwriting standards and helps align the interests of securitizers and investors. Mortgage insurance companies have the exact same interests as investors – that the mortgages are high quality loans with as little credit risk as possible. Mortgage insurers can ensure that high underwriting standards are met by imposing independent underwriting criteria, and by using appropriate controls and testing to make sure that these independent standards are met when loans are made.

A fundamental principal of effective risk management for residential mortgage loans is the provision of co-insurance between the insurer and insured. The FHA program with 100% default protection at the loan level violates this basic insurance principle. Additionally, the FHA's default coverage is backed by the U.S. Government which further removes the incentive to originate higher quality, lower risk residential mortgage loans. By contrast, private mortgage insurance is designed to align the interests of the mortgage originator, insurer, and investor (in QRM terms, "sponsor.") Private mortgage insurance typically provides coverage of 25% to 35% of the loan amount. Investors know that in certain severe stress scenarios they may experience a loss in excess of this coverage and are more likely to conduct the due diligence that is necessary to ensure they are purchasing higher quality mortgages from loan originators.

Q. 146(a). Would this approach have the practical effect of exempting the securitization of most residential loans from the risk retention requirement?

No, based on FHFA research, 50% to 70% of loans would not be exempt from the QRM definition. As explained by the FHFA[23], the impact of removing the LTV requirement entirely would result in approximately 71% of loans being classified as non-QRM loans. This compares to 81% of loans being classified as non-QRM loans as a result of implementing the definition in the proposed rule. Separately, no DTI requirement would result in approximately 64% non QRM loans in the 2000 to 2010 period. And when taken together, 54% of mortgages would be non-QRM and would not be exempt from QRM.

Secondly, we believe that the legislative intent behind the QRM provision was to exempt all mortgages underwritten pursuant to the traditional, pre-bubble underwriting practices from the additional costs and burden of risk retention. If these underwriting practices are used for the overwhelming number of new mortgages, and thus exempt from risk retention, the goals of the amendment will have been met. The imposition of risk retention on traditionally underwritten mortgage loans should not be a goal of the agencies, would not serve any public purpose, would unnecessarily raise the cost of home ownership, and would not be consistent with the legislation.

Q. 148. Would the lower QRM standards under the alternative approach be consistent with the requirement that QRMs be fully exempted from section 15G's risk retention requirements?

Yes. The statutory language and legislative history demonstrate that the QRM standard was intended to encourage the use of traditional underwriting standards, not the "super standards" in the proposal. Congress wanted a broad exemption to avoid the potential of unnecessarily raising mortgage costs and restricting credit for the majority of mortgage loans, rather than the high-risk loans for which it had intended for risk retention to apply.

[23] FHFA Mortgage Market Note 11-2, p 11, 15. (April 11, 2011).

Q. 149. How could this type of alternative approach be designed to limit the likelihood that loans with significant credit risk are included in the pool and thus not subject to risk retention?

Credit risk is a fact of life when making any loan. Attempting to limit risk to zero or near zero is not the purpose of the QRM provisions, and is not in the public interest. Congress clearly wanted the mortgage industry to return to traditional underwriting standards. The agencies should review the standards that were used in the era before the housing bubble, and use those standards as the basis for the QRM.

The agencies have taken the correct steps to ensure the QRM standard limits credit risk in QRM pools. The most critical step taken by the agencies is that of removing high-risk lending products that were the foundation for layered risk. The high-risk products that weighed heavily on recent vintages of mortgage lending included:

- The expansion of subprime credit beyond historical levels where FICO scores down to 580 were accepted in combination with no and low documentation loans
- Interest Only and Option Arm loans where borrowers were qualified at the minimum rate/payment
- Deeply discounted teaser rates used to qualify borrowers
- No down payment loans, including loans with closed simultaneously on floating rate subordinate financing (80 first lien, 20 second lien)
- Multiple layers of risk such as investor loans with no down payment and interest only

United States Senate

COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP

WASHINGTON, DC 20510-6350

February 16, 2011

The Honorable Shaun Donovan
Secretary of Housing and Urban Development
Department of Housing and Urban Development
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Washington, DC 20410

The Honorable Sheila Bair
Chairman, Federal Deposit Insurance U.S. Corporation
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The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
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The Honorable Mary Schapiro
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Acting Director
Federal Housing Finance Agency
1700 G Street NW
4th Floor
Washington, DC 20552

The Honorable John Walsh
Acting Comptroller
Office of the Comptroller of the Currency
1775 Duke Street
Alexandria, VA 22314

Dear Secretary Donovan, Chairman Bair, Chairman Bernanke, Chairman Schapiro, and Messrs. DeMarco and Walsh,

We are writing regarding the current rulemaking to implement the risk retention provisions of Section 941of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. We recognize the complexity of the issues involved in writing the risk retention rules. However, we are concerned that a number of issues outside of the legislative scope and intent might unnecessarily slow the rulemaking process. We would like to take this opportunity to clarify our legislative intent. Most importantly, we directed the Federal banking agencies, the Secretary of Housing and Urban Development, and the Director of the Federal Housing Finance Agency to jointly define Qualified Residential Mortgage (QRM) by "taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default" (PL 111-203, Sec. 941(b)).

We are concerned that efforts to impose a high down payment requirement for any mortgage to meet the QRM exemption standard would be inconsistent with our legislative intent. As the authors of the QRM provision, we can assure you that, although there was discussion about whether the QRM should have a minimum down payment, in negotiations during the drafting of our provision we intentionally omitted such a requirement.

The purpose of the QRM is to support a housing recovery by creating a robust underwriting framework that will attract private capital to support responsible lending and borrowing. In developing the QRM framework, we recognized the importance of establishing a framework that would allow creditworthy first-time homebuyers to have access to the benefits of loans meeting the QRM standard. We also recognized that homeowners in the hardest hit housing markets have lost extraordinary amounts of equity as result of plummeting home prices. For all of these families, a high down payment is simply out of reach. A QRM with a high down payment requirement would force them to postpone buying or refinancing a home for years, or to take on mortgages at much higher interest rates. Either outcome undermines efforts to restore our shaky housing market.

Consequently, the QRM framework set forth in the statute specifically contemplates the inclusion of low-down payment loans, provided they have mortgage insurance or other forms of credit enhancement, to the extent such insurance or credit enhancement reduces the risk of default. We strongly urge your agencies to adopt a QRM framework that follows the statutory framework and supports a housing recovery by ensuring that all financially responsible families will have access to the lower interest rates and borrower protections afforded by the QRM.

The risk retention rules are challenging enough to write without the inclusion of extraneous issues. The QRM provisions of Section 941 are clear in their intent and provide the regulators with an explicit framework to follow. We strongly urge you to adhere to that framework. It is important that these rules be issued soon so that the lenders, investors, housing groups and consumers have ample time to provide extensive comment.

We look forward to reviewing the proposed rule for risk retention and the QRM. These rules can have a significant impact on the future of our housing finance system for years to come.

Sincerely,

Mary L. Landrieu

Senator Mary L. Landrieu

Kay R. Hagan

Senator Kay R. Hagan

Senator Johnny Isakson

cc: The Honorable Timothy Geithner
Secretary
Department of the Treasury
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