October 30, 2013

Robert deV. Frierson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551
Docket No. R-1411

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

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

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Docket No. OCC-2013-0010

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Constitution Center,
(OGC) Eighth Floor, 400 7th Street, SW
Washington, DC 20552
RIN 2590-AA43

Regulations Division
Office of General Counsel
Department of Housing and Urban Development
451 7th Street, SW, Room 10276
Washington, DC 20410-0500
RIN 2501-AD53

Re: Proposed Rules on Credit Risk Retention (Docket, RIN, and File Numbers cited above)

Dear Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") issued jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission, and the Department of Housing and Urban Development (collectively, the "Agencies"). The Proposed Rules are a reproposal of rules originally released for comment in April of 2011. They would implement credit risk retention

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

requirements for securitizers of asset-backed securities ("ABS"), as required by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Unfortunately, the Proposed Rules represent a major step backward, primarily because the Agencies have chosen to dramatically expand the definition of "qualified residential mortgage" ("QRM") by equating it with the definition of "qualified mortgage" ("QM") developed by the Consumer Financial Protection Bureau ("CFPB"). As a result, the exemption from risk retention requirements, which is extended to all QRMs, will gut the Proposed Rules. Risk retention requirements will play essentially no role in securitizations of residential mortgages—where this reform is critical if the risk of another financial crisis is to be reduced.

INTRODUCTION

If properly structured and regulated, the securitization markets can be an important source of affordable credit for households, businesses, and state and local governments. However, when the securitization process is corrupted through reckless or fraudulent origination of the underlying financial assets, coupled with a lack of transparency and disclosure regarding the nature of those assets, then enormous harm can be inflicted on the entire financial system.

It was precisely this type of broken securitization market that contributed so heavily to the financial crisis. In the years leading up to the crisis, the "originate to distribute" model became pervasive in the residential mortgage market. Loans were originated for the express purpose of being sold into securitization pools, allowing lenders to reap lavish fees without bearing the credit risk of borrower default. This widespread practice ultimately led to the accumulation of massive amounts of high-risk mortgage-backed securities in the hands of financial institutions and investors of all types. The situation epitomized the very concept of systemic risk, and when the housing bubble burst, it took a huge toll on markets, investors, and the economy.

Simply put, the securitization process was the conveyor belt that heaped toxic securities upon innumerable financial institutions and investors, crippling the balance sheets of banks and Government-Sponsored Enterprises, and triggering an unprecedented wave of foreclosures.

This horrendous situation was allowed to unfold because the laws and regulations in place before enactment of the Dodd-Frank Act suffered from glaring—and ultimately extremely costly—gaps and deficiencies. To address these problems, and to ensure that the securitization markets would never wreak such havoc again, Congress passed Subtitle D of Title IX of the Dodd-Frank Act. That subtitle institutes a whole series of reforms aimed at improving the asset-backed securitization process, and the risk retention provisions addressed in the Proposed Rules are supposed to be an important element—if not the linchpin—of those reforms.

As argued in more detail below, while many commenters have raised concerns about the impact of risk retention on the **housing** market, the Agencies must not lose sight of the congressional resolve to repair a deeply flawed **securitization** market. The Dodd-Frank Act clearly requires that the provisions in Subtitle D, including Section 941, be implemented as set forth and not diluted, changed, or evaded to achieve other social policy goals, no matter how worthy. Those matters can be and must be addressed through other means.

THE DODD-FRANK ACT

The Dodd-Frank Act includes several important remedies designed to address the flaws in the securitization market leading to the crisis. Section 941, the subject of the Proposed Rules, requires securitizers to retain at least 5 percent of the risk associated with the assets underlying a securitization, subject to exemptions for assets that are by design of high quality and low risk. The rationale for this requirement is that forcing a securitizer to assume some risk exposure will create a strong incentive for that securitizer to monitor and control the quality of the assets in the securitization pool. This incentive helps "align the interests of the securitizer with the interests of investors" in ABS, ultimately resulting in better quality ABS and less systemic risk.[2]

In addition, under the Dodd-Frank Act, securitizers as well as Nationally Recognized Statistical Rating Organizations ("NRSROs") must assume new responsibilities for reviewing assets in a securitization pool, making disclosures regarding those assets, and informing investors about the representations and warranties to which they are entitled in connection with an ABS investment.[3]

OVERVIEW OF PROPOSED RULES

The Proposed Rules have essentially three components. First, they establish the basic credit risk retention requirement by specifying that securitizers of ABS must retain a minimum of 5 percent of the fair value of the securitization. This 5 percent risk retention requirement may be held in any combination of vertical and horizontal interests. The securitizer must make certain disclosures to investors regarding the form and amount of the securitizer's retained interest, and the risk retained is subject to restrictions on hedging and transfer.

Second, the Proposed Rules define the universe of mortgages, known as "qualified residential mortgages" or "QRM," that are not subject to any risk retention requirements. In a significant departure from the prior proposal, the Proposed Rules define QRM as those mortgages meeting the broad definition of "qualified mortgages" or "QM," which was developed by the CFPB.

---

[2] 78 Fed. Reg. 57,932.

[3] Sections 945, 942, and 943, respectively, of the Dodd-Frank Act.

Finally, the Proposed Rules establish the underwriting standards that warrant reduced risk retention requirements for ABS backed by other types of financial assets, including qualifying commercial real estate loans and commercial or automobile loans.

SUMMARY OF COMMENTS

In this comment letter, we incorporate by reference all of our comments submitted in response to the original rule proposal (and a copy of that letter is attached hereto). In addition, we offer the following input:

- With respect to all aspects of the Proposed Rules, the Agencies must adhere to this fundamental guiding principle: The Proposed Rules should be written above all to achieve the risk-mitigation and investor protections goals embodied in Section 941 of the Dodd-Frank Act. To the extent the risk retention requirements and an appropriately narrow QRM exemption create impediments to home ownership or otherwise disrupt the housing or credit markets in undesirable ways, those issues can and should be addressed through separate, targeted legislative or regulatory measures.

- The Agencies have expanded the QRM definition beyond all reasonable boundaries by equating it with the QM definition devised by the CFPB. This approach must be abandoned. It constitutes an impermissible de facto delegation of rulemaking authority to the CFPB; it violates the letter and spirit of Section 941; it will nullify the risk retention regime for residential mortgage-backed securities; and it will even harm the credit markets in precisely the way that the Agencies seek to avoid. The Agencies should restore the originally proposed definition for QRM, or at a minimum adopt the alternative definition referred to in the Release as "QM plus."

- The Proposed Rules must establish specifically tailored risk retention levels at or above the minimum 5 percent rate for different classes of ABS, and must set forth a persuasive rationale for each level. Similarly, the Proposed Rules must correlate risk retention levels with each of the permitted forms of risk retention.

COMMENTS

I. The Proposed Rules should be written first and foremost to reduce systemic risk and to protect investors, in accordance with the Dodd-Frank Act.

The Proposed Rules have drawn a great deal of attention from the securitization industry, lending institutions, public interest groups, and members of Congress. These commenters have focused largely on the exemption from the risk retention requirements for QRMs and the purported impact that the terms of the exemption will have on the housing market.

For example, numerous commenters have argued that a down payment requirement for QRM, such as the 20 percent down payment requirement put forth in the previous proposal, is too restrictive. And, they have made the dire prediction that unless eliminated or at least reduced, such a restriction will raise the cost of mortgages for those who can least afford such an increase, reduce access to home ownership for creditworthy borrowers, and imperil the nation's fragile housing recovery.

While these may be legitimate issues in the context of housing policy, they should not serve as the dominant considerations as the Agencies finalize the Proposed Rules implementing the risk retention requirements. Instead, the **risk mitigation and investor protection goals** that underlie the Dodd-Frank Act should determine the framework for the credit risk retention requirement, including the scope of the exemption for QRMs. To the extent that the Proposed Rules are suggested to have an undesirable impact on the housing market—a matter of understandable concern—the best way to address that impact is through other legislative or regulatory measures in the housing arena that specifically target those potential problems. In short, if there is any conflict between restoring the integrity of the securitization market through risk retention requirements on the one hand, and promoting home ownership or advancing other housing policy objectives on the other, the former must prevail in this context.

This position is warranted on two grounds. First, from a legal standpoint, the Agencies are obligated to adhere to the statutory provisions and the overriding congressional policy at the heart of the Dodd-Frank Act. The statutory language in Section 941 requires the Agencies to establish credit risk retention requirements, and it furthermore sets limits on any exemptions to those requirements. In addition, the guiding policy goal underlying the statute is reducing systemic risk and increasing investor protection to prevent another financial collapse and economic crisis. Both the statutory language and the underlying policy must guide the Agencies as they implement Section 941.

There is no question that Congress's primary aim in enacting the credit risk retention provisions in Section 941 of the Dodd-Frank Act was to mitigate systemic risk and enhance investor protection in the securitization markets, not to promote housing policies. Section 941 ensures that securitizers have "skin in the game" by requiring them to retain an economic interest in the credit risk of the assets they securitize. This in turn creates an incentive to increase the quality of those assets. As observed in the legislative history—

> The provision intends to create incentives that will prevent a recurrence of the excesses and abuses that preceded the crisis, restore investor confidence in asset-backed finance, and permit securitization markets to resume their important role as sources of credit for households and businesses.[4]

[4] S. REP. NO. 111-176, at 128 (2010).

Congress's overriding concern with market stability and investor protection, extending well beyond the housing market, is evident from other provisions in the Dodd-Frank Act. For example, the risk retention measures established in Section 941 are not limited to residential mortgage-backed securities. The definition of "asset-backed security" is extremely broad, encompassing "any type of self-liquidating financial asset . . . that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." This covers securities backed not only by residential real estate, but also by commercial real estate, commercial paper, and automobile loans.

In addition, Subtitle D of Title IX of the Dodd-Frank Act includes a number of provisions unrelated to risk retention, which are aimed at improving the integrity of the securitization process. Those provisions require issuers of ABS to disclose asset-level or loan-level data to investors under the securities laws (§ 942); to review the assets underlying the ABS and disclose the nature of that review (§ 945); and to disclose to investors fulfilled and unfulfilled repurchase requests relating to outstanding ABS offerings (§ 943). Further, the Dodd-Frank Act requires NRSROs to include in their credit rating reports the representations and warranties available to investors in connection with ABS offerings (§ 943).[5]

Thus, Congress's primary concern in passing Subtitle D of Title IX, including Section 941, was protecting investors in all types of securitizations and limiting systemic risk. As a legal matter, these goals must guide the formulation of final rules on risk retention.

This conclusion follows for a second and equally compelling reason. In terms of practical consequences, a weak credit risk retention rule has multiple drawbacks. First, a weak rule is far less likely than a strong rule to restore investor confidence and bring investors back into the securitization market. Even more important, if the securitization markets are not effectively reformed through strong new standards and rules, and they trigger another financial crisis, then the resulting harm to all consumers—**especially** those of modest means who seek mortgage financing—will far outweigh any burdens associated with a narrow QRM exemption in the Proposed Rules. The most cursory review of the devastation that the crisis of 2008 caused in the housing market proves the point.[6]

---

[5] Section 941 notes that any exemptions from the risk retention requirements shall "improve the access of consumers and businesses to credit on reasonable terms." However, this lone reference appears among a litany of other goals, all related to risk mitigation and investor protection, including achieving "high quality underwriting standards," encouraging "appropriate risk management practices," and "the protection of investors."

[6] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION, 36-39 (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf; *see also* Tyler Atkinson et. al, Dallas Fed, *How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis*, Staff Paper No. 20 (Jul. 2013), *available at* http://dallasfed.org/assets/documents/research/staff/staff1301.pdf; U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013), *available at* http://gao.gov/assets/660/651322.pdf.

As one columnist has noted, "[w]hile we are discussing societal costs, let's not forget how minority borrowers and first-time homebuyers were the targets of predatory lenders who lured them into toxic loans loaded with fees."[7] Reinforcing the point are the findings of a study by the Pew Research Center, which pointed to predatory lending as the cause of the widening gap between minorities and whites in America.[8]

Given the magnitude of these and other costs inflicted by the financial crisis, weakening critical protections designed to prevent a recurrence is not an option. The law is clearly intended to make the financial system more stable and to eliminate incentives for fraud, predatory behavior, and outright criminal conduct. And the costs of any failure to achieve these goals are far too high. The Proposed Rules must be finalized with these principles foremost in mind.

II. The credit risk retention exemption for QRM is much too broad and must be substantially narrowed.

In the most significant and misguided departure from the original release, the Proposed Rules would dramatically expand the exemption for QRMs by equating it with the far broader definition of QMs recently promulgated by the CFPB. This de facto delegation of rulemaking responsibility is unacceptable. It violates the clear terms of Section 941, and it undermines the equally clear objectives of the law. In effect, it will gut the credit risk retention framework with respect to residential mortgages—the very securitization market that unquestionably lay at the heart of the financial crisis.

A. Adopting the QM definition as the definition of QRM is an abdication of rulemaking responsibility, in violation of the plain statutory mandate.

By defining QRM simply in terms of the definition of QM devised by the CFPB, the Agencies have violated the plain terms of Section 941 and abdicated their responsibility to fashion a definition that satisfies the unique statutory requirements and goals of the risk retention framework. In Section 941(e), Congress specifically and directly imposed upon **the Agencies** the mandatory duty to "jointly define the term 'qualified residential mortgage' for purposes of this subsection." The CFPB appears nowhere in that rulemaking mandate.

This approach is objectionable on other grounds as well. First, the goals of the CFPB in defining QM are very different from those of the Agencies as they seek to define QRM. Most importantly, as they implement the risk retention regime, the Agencies are concerned principally with reforming the securitization market for the benefit of investors and preventing another buildup of systemic risk of the type that triggered the financial crisis of 2008. And their task in defining QRM is to ensure that any residential mortgage loans

---

[7] Gretchen Morgenson, *Some Bankers Never Learn,* New York Times, July 31, 2011.

[8] Rakash Kochhar, Richard Fry & Paul Taylor, *Wealth Gaps Rise to Record Highs Between Whites, Blacks and Hispanics,* Pew Research Center (July 26, 2011).

exempt from the credit risk retention requirement are only those "of the very highest quality," measured in terms of ability to pay as well as risk of default.

By contrast, the CFPB has a more narrow focus on protecting the integrity of the home mortgage application process for the benefit of borrowers. And its immediate task in defining QM is the more narrow one of providing lenders with a presumption of compliance with the ability-to-pay requirement in mortgage underwriting, not to ensure that banks only make the highest quality loans. Thus, there is no basis for assuming that the QM definition would or could serve as an adequate surrogate for defining QRMs, nor does it appear that the CFPB had any obligation to consider default risk or the implications for risk retention as it formulated the QM definition.

Adopting a definition developed by another agency also surrenders control over that aspect of rule in the future. The Proposed Rules do not merely incorporate the QM definition adopted by the CFPB on a certain date for purposes of convenient reference. While that in itself would be indefensible for the reasons explained in this letter, the Agencies have gone a step further, in the wrong direction. Section .13(a) of the Proposed Rules defines QRM to mean "'qualified mortgage' as defined in section 129C of the Truth in Lending Act (15 U.S.C. § 1639c) and regulations thereunder." And the Release makes clear that the definition incorporates CFPB regulations "**as they may be amended from time to time**."[9] Hence, the CFPB's definition of QM, as it may be amended by the CFPB in its discretion, will control the Agencies' definition of QRM henceforth. The Release removes any doubt by observing that "[t]he external parameters of what may constitute a QRM may continue to evolve as the **CFPB** clarifies, modifies, or adjusts the QM rules."[10]

Thus, the Agencies have yielded control over the definition of QRM to another agency, even though that agency was given no role by Congress in developing the QRM definition or reforming the securitization process through credit risk retention requirements.[11] This is unacceptable. The Agencies must exercise their own independent judgment and apply their own expertise to fashion—and adjust as necessary over time—a QRM definition that satisfies the letter and the spirit of Section 941, not the Truth in Lending Act.

B. <u>Adopting the QM definition as the definition of QRM will gut the risk retention rule for residential mortgage-backed securities.</u>

The broad proposed definition of QRM will eviscerate the risk retention rule. It will enlarge the class of mortgage loans eligible for the exemption so much that risk retention will become the rare exception, rather than the rule. Furthermore, it will severely degrade

---

[9] 78 Fed. Reg. 57,989 (emphasis added).

[10] *Id.* (emphasis added).

[11] It appears that the sole constraint on the CFPB is the admonition in Section 941 that QRM must be "no broader than the definition 'qualified mortgage,'" as that term is defined by the CFPB. It is unclear if, how, or when the Agencies will have to intervene to ensure that changes in the CFPB's QM definition do not breach this limit.

the quality of loans that can be securitized without risk retention, putting the securitization market for residential mortgages back on essentially the same precarious footing that lead to the financial crisis.

The breadth of the QRM definition is astonishing. The Release concedes that "an approach that aligns QRM with QM covers **most of the present mortgage market**, and a significant portion of the historical market."[12] Thus, the exception for QRM mortgages truly will nullify the risk retention rule in that sector.

The Agencies have adopted this extraordinarily expansive QRM definition even while recognizing that Congress intended the standard to be rigorous, and even in the face of their own data showing that the definition should include factors that are key determinants of default risk. For example, the Release acknowledges that because QRMs will be totally exempt from the risk retention requirements, the underwriting standards and product features for QRMs should ensure that such residential mortgages are of "a very high quality."[13] Furthermore, as also acknowledged in the Release, Section 941 requires the Agencies to take into consideration underwriting features, in addition to product features, "that historical loan performance data indicate result in a lower risk of default."[14]

The Agencies have just such data, but they chose to ignore it. According to the SEC's own analysis accompanying the Proposed Rules, "higher FICO scores and lower [combined loan-to-value ("CLTV")] ratios are associated with significantly lower levels of serious delinquency, both statistically and economically."[15] Indeed, analysis in the Release indicates that incorporating a FICO and CLTV restriction would substantially lower the serious delinquency rate of QM loans. For example, QM loans have a high "serious delinquency rate" of 34 percent.[16] In contrast, QM loans that also have a "combined loan-to-value ratio of 70 percent or less and a minimum FICO score of 690 [have] a 12% serious delinquency rate, and when . . . further limited to a combined loan-to-value ratio of 70% or less, [there is] a 6.4% serious delinquency rate."[17] Adopting a QRM definition associated with a 34 percent serious loan delinquency rate simply does not satisfy the standard that Congress intended to impose as a condition of the risk retention exemption.

The original proposal would have included, among other features, a loan-to-value ratio requirement as well as credit history restrictions, both of which would have substantially reduced the delinquency rate for QRM loans and vastly improved their quality. The Proposed Rules must be amended to restore the definition of QRM in the original

[12] 78 Fed. Reg. 57,994 (emphasis added).
[13] 78 Fed. Reg. 57,988.
[14] 78 Fed. Reg. 57,989.
[15] JOSHUA WHITE & SCOTT BAUGUESS, SEC DIVISION OF ECONOMIC AND RISK ANALYSIS, QUALIFIED RESIDENTIAL MORTGAGE: BACKGROUND DATA ANALYSIS ON CREDIT RISK RETENTION, at 17, Aug. 2013. The SEC defines serious delinquency as "a loan having ever been 90 days late, foreclosed, or real estate owned." *Id.* at 6.
[16] 78 Fed. Reg. 57,995.
[17] *Id.*

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

proposal. At a minimum, the QRM definition should be replaced with the variation suggested in the Release, referred to as "QM-plus," which would include a 70 percent CLTV requirement.[18]

C. The broad definition of QRM in the Proposed Rules will also constrict access to credit for many would-be homebuyers.

Ironically, the overly broad definition of QRM in the Proposed Rules will create one of the very drawbacks that the Agencies sought to avoid: constricting the flow of credit or raising borrowing costs for many people seeking home loans. As explained above, the Agencies should be guided primarily by the need to address investor risk and systemic risk in the securitization process. However, to the extent the impact of the Proposed Rules on the cost and availability of credit is to be considered at all, it militates strongly in favor of adopting a **narrow** QRM definition, not the expansive one embodied in the QM definition.

The prior release reflected concern that if the QRM definition is too narrow, and risk retention is too broadly applied, then the "flow or pricing of credit to borrowers and businesses" might be disrupted.[19] The Release accompanying the Proposed Rules similarly expresses concern "about the prospect of imposing further constraints on mortgage credit availability at this time, especially as such constraints might disproportionately affect groups that have historically been disadvantaged in the mortgage market."[20]

At the same time, however the Agencies seem to have recognized that adopting an overly broad or forgiving QRM definition would have just this undesirable effect. For example, the original release observes that if the QRM definition is too lax, then the supply of non-QRM mortgages will become so small that the securitization market for those mortgages will become illiquid, adversely affecting access to credit for many would-be homeowners.[21] The Release accompanying the Proposed Rules also acknowledges this concern, noting that under the proposal, non-QM loans would have higher funding costs,[22] and that "the effect of aligning QRM with QM could ultimately decrease credit availability as lenders, and consequently securitizers, would be very reluctant to transact in non-QM loans."[23]

For reasons that are not adequately explained, the Agencies chose to ignore their own reservations about adopting a very broad QRM definition. In reality, that decision is likely to harm the very borrowers that the Agencies profess a desire to protect. As admitted in the Release, the proposed definition of QRM will exempt virtually the entire mortgage market. By the Agencies' own reckoning, this will shrink the securitization market for non-QRM loans, reduce liquidity, and raise costs to historically disadvantaged borrowers.

---

18 78 Fed. Reg. 57,993-94.
19 Credit Risk Retention; Proposed Rule, 76 Fed. Reg. R 24090, 24,118 (April 29, 2011) ("Original Proposal").
20 78 Fed. Reg. 57,991.
21 Original Proposal at 24,118.
22 78 Fed. Reg. 57,991.
23 78 Fed. Reg. 57,994.

D. <u>The Agencies offer no persuasive justification for adopting such a broad QRM definition.</u>

The Release fails to adequately justify the Agencies' approach to QRM. The direct costs of appropriately narrowing the QRM definition and subjecting the majority of residential mortgage-backed securities to risk retention are too uncertain and most likely too small to be a significant factor. As explained in the Release, the direct costs incurred by a sponsor for funding risk retention under the newly proposed QRM definition will be exceedingly small, on the order of "zero to 30 basis points."[24] Industry estimates of the costs associated with the appropriately narrowed QRM definition are significantly higher, of course.[25] However, as a general matter, industry claims that regulatory reforms will impose heavy costs and burdens tend to be gross exaggerations, often without credible support.[26] Here, the costs associated with the better, more narrow QRM definition must viewed in this light. In addition, much will depend on how a sponsor funds its risk retention obligations. Furthermore, the costs are likely to be mitigated "if investors value the protections associated with risk retention."[27]

The Agencies rely principally upon the supposedly heavy indirect costs of a narrow QRM exemption as the basis for their approach. However, the Agencies have essentially weighed the competing factors and determined, without explanation, that the goal of establishing a meaningful risk retention regime must be subordinated to the vaguely defined and merely potential adverse effects on housing and credit that might flow if the QRM and QM definitions are not aligned.[28] This violates the letter, spirit, and intent of Section 941.

Especially misguided is the wait-and-see approach reflected in the Release. It states that "the agencies intend to review the advantages and disadvantages of aligning the QRM and QM definitions as the market evolves to ensure that the rule best meets the statutory objectives" of Section 941. This approach is backwards. Instead, the agencies should adopt a narrow QRM exemption to achieve the statutory objectives of Section 941, and then monitor the impact of the rule to determine if the feared disruption in the housing or credit markets ever becomes a reality.

III. <u>The Proposed Rules must establish specific risk retention levels for different classes of ABS, and must further establish an economic rationale for each level.</u>

The actual quantum of credit risk retention imposed on securitizers is at the very core of the risk-mitigating protections established by the Dodd-Frank Act. Section 941

---

[24] 78 Fed. Reg. 57,991.

[25] 78 Fed. Reg. 57,994.

[26] *See* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 44-48 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf.

[27] 78 Fed. Reg. 57,991.

[28] *Id.*

requires that, absent an exemption or the presence of certain underwriting standards, the Proposed Rules impose a risk retention requirement of **not less** than 5 percent of the credit risk for any asset that a securitizer conveys through the issuance of an ABS. The statute thus establishes a baseline, and leaves the precise magnitude of risk retention to be set by the Agencies.

However, as a general matter, the Proposed Rules simply incorporate the "not less than 5%" formulation, without regard to the nature of the ABS or the form of the risk retention.[29] Instead, the Proposed Rules must adopt a specific, minimum risk retention requirement for each type or class of ABS. Moreover, the levels set must be derived from objective criteria that reflect the particular risks associated with the various types of ABS. Those criteria may include the terms of the assets underlying the ABS; the form in which the risk is to be retained; expected losses based upon historical data and future scenarios; typical underwriting fees; priority of security interests in or other claims on cash flow from the assets being securitized; and additional metrics such as interest rate spreads relative to benchmark indices.

Such an approach is obviously consistent with Congress's decision to impose a floor, not a ceiling, on the amount of risk retention that is necessary to achieve the statutory goals. It is also consistent with the legislative history of Section 941, which notes that "the implementation of risk retention obligations should recognize the differences in securitization practices for various asset classes."[30] In particular, Congress "expect[ed] that these regulations will recognize the differences in the assets securitized, in existing risk management practices, and in the structure of asset-backed securities, and that regulators will make appropriate adjustments to the amount of risk retention required."[31]

This approach was again recommended by the Federal Reserve Board in its Section 941 Report on credit risk retention. Indeed, that report explicitly stated that:

> Given the degree of heterogeneity in all aspects of securitization, a single approach to credit risk retention could curtail credit availability in certain sectors of the securitization market. A single universal approach would also not adequately take into consideration different forms of credit risk retention, which may differ by asset category. Further, such an approach is unlikely to be effective in achieving the stated aims of the statute across

[29] The Release attempts to justify the 5 percent risk retention requirement, in part, because "[t]he sponsor, originator, or other party to a securitization may retain additional exposure to the credit risk of assets that the sponsor, originator, or other party helps securitize beyond that required by the proposed rule, either on its own initiative or in response to the demands or requirements of private market participants." 78 Fed. Reg. 57,936. This rationale is entirely unpersuasive. If market participants are truly inclined to volunteer or insist on higher risk retention levels, then there is no harm in mandating those levels by rule. On the other hand, if this scenario is as unrealistic as we suspect, then mandating the higher risk retention levels is imperative.

[30] S. REP. NO. 111-176, at 130 (2010).

[31] *Id.*

a broad spectrum of asset categories where securitization practices differ markedly.[32]

Establishing more carefully tailored risk retention levels will certainly enhance the risk mitigation and investor protection functions intended under Section 941. At the same time, such an approach will help ensure that the credit markets are not unnecessarily burdened by the risk retention requirements. More precisely quantified and rationally-based risk retention percentages will serve both goals.

The only justification offered in the Release for the flat 5 percent approach is that correlating the level of risk retention with the level of risk in the underlying loans might be too complex and burdensome from an industry compliance standpoint.[33] This is not an acceptable justification, as it improperly subordinates the goals of the statute to the alleged concerns of the regulated industry.

IV. The Proposed Rules must correlate risk retention levels with each of the permitted forms of risk retention.

The Proposed Rules would allow sponsors to retain risk in a wide variety of forms, including an eligible vertical interest, an eligible horizontal interest, and any combination of the two. As explained in the Release, having a menu of options, as in the prior proposal, is "designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the Proposed Rules to negatively affect the availability and costs of credit to consumers and businesses."[34] Moreover, permitting sponsors to choose any combination of eligible horizontal and vertical interests, in a departure from the more narrow prior proposal,[35] will "increase flexibility and facilitate different circumstances that may accompany various securitization transactions."[36]

This accommodation to market practices **might** be reasonable, but only if the required risk mitigation and investor protection rationale in Section 941 of the Dodd-Frank Act does not suffer. It is not at all clear that this test has been met. For example, the Proposed Rules do not differentiate among the various forms with respect to the required level of credit risk retention: they are each subject to the "not less than 5%" standard. However, it is exceedingly unlikely that each form of risk retention will prove equally effective in achieving the risk mitigation and investor protection goals underlying Section 941.

Indeed, significant debate has centered around which form of risk retention—vertical, horizontal, or some combination of the two—actually imposes more effective risk

---

[32] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, REPORT TO CONGRESS ON RISK RETENTION at 83-84 (Oct. 2010), *available at* http://federalreserve.gov/boarddocs/rptcongress/securitization/riskretention.pdf.

[33] 78 Fed. Reg. 68,016.

[34] 78 Fed. Reg. 57,936.

[35] The prior proposal limited a sponsor's interest to either a vertical interest, a horizontal interest, or an "L-shaped" interest, in which half of the interest was horizontal and half was vertical.

[36] 78 Fed. Reg. 57,936.

retention on a securitizer.[37] What seems beyond dispute is that not all forms are equal. To account for these differences, the Agencies should evaluate the risk profile for each form of risk retention, and adjust the minimum level of required risk retention accordingly.

CONCLUSION

We hope these comments are helpful as you finalize the Proposed Rules.

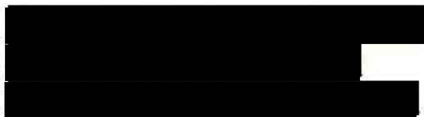
Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Securities Specialist

Katelynn O. Bradley
Attorney

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464



www.bettermarkets.com

---

37 *Compare* 78 Fed. Reg. 57,940 (observing that horizontal risk retention "generally would impose the most economic risk on a sponsor) *with* Comment Letter on Proposed Credit Risk Retention submitted by Sen. Carl Levin, Chairman, Permanent Subcommittee on Investigations, June 28, 2011, at 5 (cautioning against allowing securitizers to meet their risk retention obligations by retaining a horizontal first-loss residual interest).

August 1, 2011

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

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551
Docket No. R-1411

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

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

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552
RIN 2590-AA43

Regulations Division
Office of General Counsel
Department of Housing and Urban Development
451 7th Street, NW
Washington, DC 20410-0500
FR-5504-P-01

Re: Credit Risk Retention

Dear Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") issued jointly by the Office of the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission, and the Department of Housing and Urban Development (collectively, the "Agencies"). The Proposed Rules would implement credit risk retention requirements for securitizers of asset-backed securities ("ABS"), as required by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Proposed Rules also would establish exemptions from the risk retention requirements for ABS comprised of certain types of qualifying loans.

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

INTRODUCTION

If properly structured and regulated, the securitization markets can be an important source of affordable credit for households, businesses, and state and local governments. However, when the securitization process is corrupted through reckless or fraudulent origination of the underlying financial assets, coupled with a lack of transparency and disclosure regarding the nature of those assets, then enormous harm can be inflicted on the entire financial system.

It was precisely this type of broken securitization market that contributed so heavily to the financial crisis. In the years leading up to the crisis, the "originate to distribute" model became pervasive in the residential mortgage market. Loans were originated for the express purpose of being sold into securitization pools, allowing lenders to reap abundant fees without bearing the credit risk of borrower default.[2] This widespread practice ultimately led to the accumulation of massive amounts of high-risk mortgage-backed securities in the hands of financial institutions and investors of all stripes. The situation epitomized the very concept of systemic risk, and when the housing bubble burst, it took a huge toll on markets, investors, and the economy.

Simply put, the securitization process was the conveyor belt that loaded financial institutions and investors up and down the line with toxic securities that continue to cripple the balance sheets of banks (and Government-Sponsored Enterprises) as foreclosures continue at historically high levels.

This horrendous situation was allowed to unfold because the laws and regulations in place before enactment of the Dodd-Frank Act suffered from glaring—and ultimately extremely costly—gaps and deficiencies. To address these problems, and to ensure that the securitization markets would never wreck such havoc again, Congress passed Subtitle D of Title IX of the Dodd-Frank Act, including the risk retention provisions.

Although many commenters have raised legitimate concerns about the impact of risk retention on the ***housing*** market, the Agencies must not lose sight of the Congressional resolve to repair a deeply flawed ***securitization*** market. The Dodd-Frank Act clearly requires that the provisions in Subtitle D, including Section 941, be implemented as set forth and not diluted, changed, or evaded to achieve other social policy goals, no matter how worthy. Those matters can be and must be addressed through other means.

This position is warranted on two grounds. First, legally, the Agencies must adhere to the overriding Congressional policy underlying Title IX of the Dodd-Frank Act, and that policy is reducing systemic risk and increasing investor protection. Second, the same conclusion is compelled by a cost-benefit analysis. If the securitization markets are not repaired properly, and they trigger another financial meltdown, then the resulting harm to all consumers—especially those of modest means who seek mortgage financing—will far outweigh any burdens associated with a narrow qualified residential mortgages exemption in the Proposed Rules.

[2] Release at 24095.

As a highly respected columnist, Gretchen Morgenson, noted recently, "[w]hile we are discussing societal costs, let's not forget how minority borrowers and first-time homebuyers were the targets of predatory lenders who lured them into toxic loans loaded with fees."[3] Making the devastating impact of the financial crisis on families clear, Ms. Morgenson also discussed a recent Pew Research Center study:

> "A study issued last week on the widening wealth gap between minorities and white Americans points to the costs of predatory lending. Conducted by the Pew Research Center, a nonpartisan organization, the study notes that housing woes were the principal cause of precipitous declines in household net worth among both Hispanics and blacks from 2005 through 2009. The organization found that, adjusted for inflation, the median wealth of Hispanic households fell by two-thirds during that period. The wealth of black households declined 53 percent. The net worth of white households fell only 16 percent."[4]

Given the magnitude of these and other costs inflicted by the financial crisis, weakening critical protections designed to prevent a recurrence is not an option. The law is clearly intended to make the financial system more stable and to eliminate incentives for fraud, predatory behavior, and outright criminal conduct. It must be implemented with these ends foremost in mind.

THE DODD-FRANK ACT

The Dodd-Frank Act includes several important remedies designed to address the current flaws in the securitization market. Subtitle D of Title IX establishes a framework under which securitizers must retain at least 5% of the risk associated with the assets underlying a securitization, subject to exemptions for assets that are by design of high quality and low risk. In addition, securitizers as well as Nationally Recognized Statistical Rating Organizations ("NRSROs") must assume new responsibilities for reviewing assets in a securitization pool, making disclosures regarding those assets, and informing investors about the representations and warranties to which they are entitled in connection with an ABS investment.[5]

The focus of the Proposed Rules is specifically on the risk retention requirement established in the Dodd-Frank Act. The rationale for this requirement is that forcing a securitizer to assume risk exposure will create a strong incentive for that securitizer to monitor and control the quality of the assets being brought into the securitization pool. This incentive helps "align the interests of the sponsor with those of investors in ABS," ultimately resulting in better quality ABS and less systemic risk.[6]

---

[3] Gretchen Morgenson, *Some Bankers Never Learn,* New York Times, July 31, 2011.

[4] *Id.* (citing Rakash Kochhar, Richard Fry & Paul Taylor, *Wealth Gaps Rise to Record Highs Between Whites, Blacks and Hispanics,* Pew Research Center (July 26, 2011)).

[5] Sections 945, 942, and 943, respectively, of the Dodd-Frank Act.

[6] Release at 24100.

OVERVIEW OF PROPOSED RULES

The Proposed Rules have essentially three components. First, they establish the basic risk retention requirements by specifying that securitizers must retain a minimum of 5% of the risk associated with the assets underlying an ABS. The risk may be retained in one of several forms, including vertical, horizontal, and other configurations. The securitizer must make certain disclosures to investors regarding the form and amount of the securitizer's retained interest, and the risk retained is subject to restrictions on hedging and transfer.

Second, the Proposed Rules define the universe of mortgages, known as "qualified residential mortgages" or "QRM," that are not subject to any risk retention requirements. To define QRM, the Proposed Rules establish a comprehensive set of criteria relating to the nature of the residential property, the borrower's credit history, the mortgage payment terms, and down payment amounts.

Finally, the Proposed Rules establish the underwriting standards that warrant reduced risk retention requirements for ABS backed by other types of financial assets, including qualifying commercial real estate loans and commercial or automobile loans.

The Release acknowledges the potentially disruptive effects that the risk retention requirements may have on securitization markets and on the "flow or pricing of credit to borrowers and businesses."[7] However, the Release also reflects a belief that a relatively narrow exemption for QRMs is nevertheless appropriate. The Release explains that because QRMs will be totally exempt from the risk retention requirements, the underwriting standards and product features for QRMs should ensure that such residential mortgages are of "a very high quality."[8] In addition, the Release observes that if the QRM definition is too broad, then the supply of non-QRM mortgages will become so small that the securitization market for those mortgages will become illiquid, adversely affecting access to credit for many would-be homeowners.[9]

SUMMARY OF COMMENTS

We offer two types of comments on the Proposed Rules. First, the Proposed Rules need to be strengthened to ensure that the basic risk retention framework achieves its intended purposes. Specifically—

- The Proposed Rules must establish specifically tailored risk retention levels at or above the minimum 5% rate for different classes of ABS, and must further establish an economic rationale for each level.

- Similarly, the Proposed Rules must correlate risk retention levels with each of the permitted forms of risk retention.

---

[7] Release at 24118.
[8] Release at 24117.
[9] Release at 24118.

- The Proposed Rules must close or narrow the exceptions to the prohibitions against the transfer or hedging of any risks retained, so that those exceptions do not eviscerate the statutory requirements.

- The Proposed Rules must more clearly allocate the risk retention obligations among multiple sponsors.

Second, rather than address the specific provisions dealing with the exemptions from the risk retention requirements, including the definition of QRM, we urge the Agencies to adhere to this **fundamental guiding principle**: The Proposed Rules should be written above all to achieve the risk-mitigation and investor protections goals embodied in the Section 941 of the Dodd-Frank Act, rather than to advance any particular housing policy objectives. To the extent the risk retention requirements and the QRM exemption create impediments to home ownership or otherwise disrupt the housing market in undesirable ways, those issues can and should be addressed through separate, targeted legislative or regulatory measures.

COMMENTS

The Proposed Rules Must Establish Specific Risk Retention Levels at or Above the Minimum 5% Rate for Different Classes of ABS, and Must Further Establish an Economic Rationale for Each Level.

The actual quantum of risk retention imposed on securitizers is at the very core of the risk-mitigating protections that the Dodd-Frank Act establishes. Section 941 requires that the Proposed Rules impose a risk retention requirement of ***not less*** than 5% of the credit risk for any asset that a securitizer conveys through the issuance of an ABS, absent an exemption. The statute thus establishes a floor, and leaves the precise magnitude of risk retention to be set by the Agencies.

However, as a general matter, the Proposed Rules simply incorporate the "not less than 5%" formulation, without regard to the nature of the ABS or the form of the risk retention. Moreover, the Proposed Rules do not offer an economic rationale for the decision to adopt the statutory 5% minimum as the uniform benchmark in the rules. This approach is arbitrary and fails to implement the statute as intended.

The Proposed Rules must adopt a specific, minimum risk retention requirement for each type or class of ABS. Moreover, the levels set must be derived from objective criteria that reflect the particular risks associated with the various types of ABS. Those criteria may include the terms of the assets underlying the ABS; the form in which the risk is to be retained; expected losses based upon historical data and future scenarios; typical underwriting fees; priority of security interests in or other claims on cash flow from the assets being securitized; and additional metrics such as interest rate spreads relative to benchmark indices.

Establishing more carefully tailored risk retention levels will certainly enhance the risk mitigation and investor protection functions intended under Section 941. At the same time, such an approach will help ensure that the credit markets are not *unnecessarily*

burdened by the risk retention requirements. More precisely quantified and rationally-based risk retention percentages will serve both goals.

The Proposed Rules Must Correlate Risk Retention Levels with Each of the Permitted Forms of Risk Retention.

The Proposed Rules would allow sponsors to retain risk in a wide variety of forms, including vertical, horizontal, and "L-shaped" (i.e. hybrid) risk retention. As explained in the Release, these options are "designed to take into account the heterogeneity of securitization markets and practices, and to reduce the potential for the Proposed Rules to negatively affect the availability and costs of credit to consumers and businesses." [10]

This accommodation to market practices may be reasonable, but only if the required risk mitigation and investor protection rationale in Section 941 of the Dodd-Frank Act does not suffer. It is not at all clear that this test has been met. For example, the Proposed Rules do not differentiate among the various forms with respect to the required level of risk retention: they are each subject to the "not less than 5%" standard. However, it is exceedingly unlikely that each form of risk retention will prove equally effective in achieving the risk mitigation and investor protection goals underlying Section 941.

For instance, horizontal risk retention is presumptively more effective than the vertical form, since it exposes the securitizer to greater risk, yet the Proposed Rules do not compensate for this disparity by establishing a ***higher*** risk retention requirement for those who elect the vertical form. To account for these differences, the Proposed Rules should set a higher minimum risk retention level where a sponsor elects to retain risk in the vertical form. More generally, the Proposed Rules should carefully evaluate the risk profile for each form of risk retention, and adjust the minimum level of required risk retention accordingly.

The Proposed Rules Must Strengthen the Prohibitions Against the Transfer or Hedging of Any Risks Retained.

The Dodd-Frank Act clearly prohibits a securitizer from "directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain with respect to an asset."[11] This is a profoundly important element of the new risk retention framework and key to making the entire system safer as well as less prone to failure and bailouts. Unless this prohibition is implemented in a robust way, the risk retention requirement will become essentially meaningless, as any securitizer could hedge its retained risk and thereby shed any incentive to ensure that the assets underlying a securitization transaction were of high quality.

The result would be a reversion to the disgraced "originate to distribute" model, which inundated the financial system with toxic time bombs that would inevitably explode but only after the originators had reaped their profits and washed their hands of their originations. That must not be allowed to happen again.

The Proposed Rules do not fully implement this prohibition against the transfer or hedging of retained risk, because they allow too much partial or indirect hedging. For

[10] Release at 24101.
[11] Section 941 of the Dodd-Frank Act.

example, the Proposed Rules would allow a sponsor in a securitization to purchase or sell a related financial instrument, provided that the payments on the financial instrument were not "**materially** related" to the credit risk of one or more particular securitized assets.[12] Therefore, if the relationship between the hedge and the securitized asset is something less than "material"—but potentially still significant—the hedge would be permitted. Moreover, the term "material" is ambiguous, inviting questions that are not addressed in the Proposed Rules. For example, how would "materiality" be measured, by whom, and over what time frame?

The Release itself increases the concerns surrounding this type of weak or partial hedge by describing examples of permitted transactions. They would include "hedges related to overall market movements, such as movements of market interest rates . . . , currency exchange rates, home prices, or of the overall value of a particular broad category of asset-backed security."[13] In addition, and even more troubling, "hedges tied to securities that are backed by similar assets originated and securitized by other sponsors, also would ***not*** be prohibited."[14]

The Proposed Rules include yet another type of permitted hedge that undermines the risk retention requirements. As explained in the Release, the Proposed Rules would allow a sponsor to purchase instruments that are based on an index, even where the index is comprised of a certain percentage of ABS from transactions in which the sponsor is involved.[15] Such hedges would be permitted as long as no single class of ABS from the sponsor's transaction comprised more than 10% of the index, and as long as all classes of ABS from the sponsor's transaction did not comprise more than 20% of the index.

The hedges described above would clearly enable a securitizer to reduce to some degree the risks that it would otherwise be forced to retain under Section 941. They constitute partial or indirect hedges **in direct conflict** with the statutory prohibition. Moreover, techniques could undoubtedly be devised to use the hedging increments allowed under the Proposed Rules to, in effect, negate the entire risk retention exposure.

The law in Section 941 flatly prohibits a securitizer from "directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain."[16] This plain and clear language encompasses any form of hedge, whether full or partial, material or immaterial, or strong or weak. The Proposed Rules must be amended to conform fully to the law and preclude such transactions. Otherwise, the risk retention requirements will be gutted.

---

[12] Release at 24116. The Proposed Rules are at least ambiguous on this point. The provision on hedging appears to provide in a separate paragraph that any hedge is prohibited if it "in any way reduces or limits the financial exposure of the sponsor" to its credit risk. Release at 24164. However, this language conflicts with the prohibition against a "material" relationship between retained risk and any hedge, since the materiality test clearly implies that hedges involving non-material but still meaningful relationships would be permitted. Moreover, none of this language negates what are essentially unacceptable loopholes for certain specific types of hedges, as described above in the text, which certainly would reduce the required risk exposure to some degree.

[13] *Id.*

[14] *Id.* (Emphasis added.)

[15] *Id.*

[16] Dodd-Frank Act § 941(b).

The Proposed Rules Must More Clearly Allocate the Risk Retention Obligations Among Multiple Sponsors.

In situations where two or more entities each meet the definition of "sponsor" in connection with a single securitization transaction, the Proposed Rules would simply require that one of the sponsors retain the necessary credit risk, without specifying any standards that would determine which sponsor should bear the risk.[17]

This provision affords too much discretion to the sponsors in a given transaction, which increases the risk of evasion. For example, this approach fails to account for the possibility that a shell entity or an entity with little or no involvement in the securitization process might be designated as the risk-retaining entity. This scenario would undermine the goals of the Dodd-Frank Act, since a sponsor that is in fact controlling the assembly of assets for a securitization might entirely evade the risk retention requirement through the designation mechanism. This in turn would destroy the incentives for ensuring that high quality assets are involved in the securitization, thus undermining the alignment between the interests of securitizers and investors that the Dodd-Frank Act intended to establish.

The Proposed Rules must stipulate how the risk retention obligations will be allocated between or among multiple sponsors. The formula should be designed to maximize the risk-mitigating impact of the risk retention requirements. The most obvious solution is to insist that *each* sponsor be subject to an appropriate risk retention amount (no less than 5%) as to all assets that it contributes to the trust or pool. Alternatively, the rules could require the entity exercising the most control over the securitization to retain the full amount of appropriate risk (again, not less than 5%), subject to controls that would prevent the use of shell entities without significant assets to manage the securitization.

The Proposed Rules Should Be Written to Reduce Systemic Risk and Protect Investors, in Accordance With the Dodd-Frank Act, Not to Achieve Housing or Other Policy Goals.

The Proposed Rules have drawn a great deal of attention from public interest groups, lending institutions, and members of Congress. These commenters have focused largely on the exemption from the risk retention requirements for QRMs and the impact that the terms of the exemption—most notably the 20% down payment requirement—will have on the housing market.

For example, numerous commenters have argued that the down payment requirement for QRM in the Proposed Rules is too restrictive, and unless reduced, will raise the cost of mortgages for those who can least afford such an increase, reduce access to home ownership for creditworthy borrowers, and imperil the nation's fragile housing recovery.

While these are legitimate issues in the context of housing policy, they should not serve as the dominant considerations as the Agencies finalize the Proposed Rules implementing the risk retention requirements. Instead, the ***risk mitigation and investor protection goals*** that underlie the Dodd-Frank Act should determine the framework for risk retention, including the scope of the exemption for QRMs. To the extent that the

[17] Release at 24098-99.

Proposed Rules are suggested to have an unavoidable and undesirable impact on the housing market—a matter of understandable concern—the best way to address that impact is through other legislative or regulatory measures in the housing arena that specifically target those potential problems.

There is no question that Congress's primary aim in enacting the risk retention provisions in Section 941 of the Dodd-Frank Act was to mitigate systemic risk in the securitization markets, not to promote specific housing policies. Section 941 ensures that securitizers retain an economic interest in the credit risk of the assets they securitize. This in turn creates an incentive to increase the quality of those assets. As observed in the legislative history—

> When securitizers retain a material amount of risk, they have "skin in the game," aligning their economic interest with those of investors in asset-backed securities.[18]

Congress's overriding concern with market stability and investor protection, extending well beyond the housing market, is evident from other provisions in the Dodd-Frank Act. For example, the risk retention measures established in Section 941 are not limited to residential mortgage-backed securities. The definition of "asset-backed security" is extremely broad, encompassing "any type of self-liquidating financial asset . . . that allows the holder of the security to receive payments that depend primarily on cash flow from the asset." This covers securities backed not only by residential real estate, but also by commercial real estate, commercial paper, and automobile loans.

In addition, Subtitle D of Title IX of the Dodd-Frank Act includes a number of provisions unrelated to risk retention, which are aimed at improving the integrity of the securitization process. Once implemented in Agency rules, those provisions will require issuers of ABS to disclose asset-level or loan-level data to investors under the securities laws (§ 942); to review the assets underlying the ABS and disclose the nature of that review (§ 945); and to disclose to investors fulfilled and unfulfilled repurchase requests relating to outstanding ABS offerings (§ 943). Further, the Dodd-Frank Act requires NRSROs to include in their credit rating reports the representations and warranties available to investors in connection with ABS offerings (§ 943).[19]

Hence, to the extent there is any conflict between restoring the integrity of the securitization market through risk retention requirements on the one hand, and promoting home ownership or advancing other housing policy objectives on the other, the former must prevail. This was the intent of Congress as reflected in the provisions of Subtitle D of Title IX of the Dodd-Frank Act, and it must be implemented as the Proposed Rules are finalized.

---

[18] Release at 24096 (quoting S. Rep. No. 111-176, at 128 (2010)).

[19] Section 941 notes that any exemptions from the risk retention requirements must "improve the access of consumers and businesses to credit on reasonable terms." However, this lone reference appears among a litany of other goals, all related to risk mitigation and investor protection, including achieving "high quality underwriting standards," encouraging "appropriate risk management practices," and "the protection of investors."

CONCLUSION

We hope these comments are helpful as you finalize the Proposed Rules.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com

www.bettermarkets.com