Statement of Henry V. Cunningham Jr., CMB

On Behalf of the
Mortgage Bankers Association

House Financial Services Committee
Subcommittee on Capital Markets and Government Sponsored Enterprises

"Understanding the Implications and Consequences of the Proposed Rule on Risk Retention"

April 14, 2011

1717 Rhode Island Ave., NW | Washington, DC 20036 | www.mortgagebankers.org |
(202) 557-2700

Chairman Garrett, Ranking Member Waters and members of the subcommittee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA).[1] My name is Hank Cunningham, and I am President of Cunningham and Company, an independent mortgage banking firm with offices throughout North Carolina. I have more than 37 years of professional mortgage experience and currently serve as Chairman of the MBA's Residential Board of Governors, and I also serve on MBA's Board of Directors. Thank you for holding this hearing on the important subject of the proposed regulations to implement the credit risk retention provisions of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The Dodd-Frank Act instructs regulators to establish risk retention requirements specific to the type of asset being securitized. Furthermore, the act mandates specific and separate frameworks for residential mortgage-backed securities (MBS) and commercial MBS. Because the proposal's risk retention requirements for residential MBS are dramatically different from its commercial MBS requirements, MBA has arranged its testimony accordingly to provide the unique perspectives of the commercial and residential real estate finance markets.

Residential Mortgage Market Perspectives on Risk Retention

Risk retention under the Dodd-Frank Act was intended to align the interests of borrowers, lenders and investors in the long-term performance of loans. This "skin in the game" requirement, however, is not a cost-free policy option.

Implementing this regulation will result in much higher costs for consumers where loans are subject to risk retention requirements, while cutting off access to credit to other consumers. Congress determined that this was an appropriate tradeoff to lower the level of risk to the financial system, and we understand the intent of the legislation.

Recognizing these costs, the Dodd-Frank Act allows an exemption from risk retention requirements for "qualified residential mortgages" (QRM). The congressional intent in providing this exemption was so the QRM definition would bound well-underwritten loans with full documentation and other sound underwriting requirements while excluding loans with riskier features such as negative amortization.

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

Regrettably, as we will explain, MBA believes the regulators' approach to the QRM, characterized by high down payment requirements and unduly restrictive qualifying ratios, is contrary to the explicit intent of Congress. For example, MBA believes the regulators have made the proposed QRM definition far too narrow. In fact, the QRM definition is so restricted that **80 percent** of loans sold to Fannie Mae or Freddie Mac over the past decade would not meet these requirements.

Additionally, the proposal raises several other major concerns addressed in this testimony including:

- What impact the proposal could have on the Federal Housing Administration (FHA) programs;
- The effect of the proposed government sponsored enterprise (GSE) exemption; and
- The economic impact of the proposal.

It is no exaggeration to say that both the risk retention requirements and the structure of the QRM exemption will affect who can and cannot buy a home for years to come. Considering the gravity of this rule and the many concerns it raises, MBA believes the comment period and discussion on the rule should be both extended and broadened as necessary to ensure there is ample opportunity for the public to present its views on the rule's profound implications before it is finalized.

We also would like to clearly state that while a move to a uniform national servicing standard may benefit the housing finance industry, servicing standards have no place in this proposal. While servicing standards may be germane to the risks of foreclosure, they are not relevant to a regulation intended to address underwriting criteria. Moreover, national servicing standards currently are being pursued through a separate regulatory action and they will include requirements beyond those in the proposal.

Including servicing requirements in the risk retention regulations will only cause confusion for consumers and lenders. For these and other reasons, we strongly request that Congress direct the regulators to exclude servicing provisions from any final risk retention regulations.

Preliminary Assessment

MBA recognizes the implementation of the risk retention requirements of the Dodd-Frank Act is a massive undertaking from both a procedural and substantive perspective. Procedurally, implementing these provisions requires the cooperation of an unusually large number of regulatory agencies. Moreover, the Dodd-Frank Act provides an unrealistically short timeframe for this work, evidenced by the fact that the regulators

have already missed the statutory deadline for issuing final risk retention regulations. Substantively, the task includes development of risk retention provisions for every single type of asset class and security structure. Considering the breadth of the work and these constraints, we appreciate the efforts of the agencies to develop this proposal.

Also, while we are still in the midst of our review, we are pleased with the flexibility that the proposal provides to securitizers in structuring the risk retention requirements. The various proposed structures represent a thoughtful effort to tailor risk retention obligations to a wide range of securitization vehicles.

We are disappointed, however, that this degree of flexibility is absent from the proposed QRM exemption.

QRM Aspects of the Proposed Regulations

Congress' intent in crafting the risk retention legislation was to address errant securitizer and originator behavior inherent in the originate-to-sell model. At the same time, Congress has repeatedly expressed in statements and letters to regulators its belief that the QRM should be broadly defined.

The QRM exemption from the risk retention requirements was intended to recognize that traditional mortgage loans – standard products, properly underwritten and with full documentation – were not the cause of this recent crisis, and securitization of these loans should remain unimpeded in order to return the MBS market to being among the most liquid in the world. By requiring a QRM exemption, the statute would keep consumer costs lower for QRMs, with higher costs for non-QRM loans. Accordingly, the Dodd-Frank Act requires the regulators to base the QRM definition on "underwriting and product features that historical loan performance data indicate result in a lower risk of default such as":

- Documentation of income and assets;
- Debt-to-income ratios and residual income standards;
- Product features that mitigate payment shock;
- Restrictions or prohibitions on non-traditional features like negative amortization, balloon payments, and prepayment penalties; and
- Mortgage insurance or other types of credit enhancement obtained at the time of origination on low down payment loans to the extent they reduce the risk of default.

This statutory framework is important for two reasons. First, it ensures that the definition is based on objective, empirical data rather than subjective presumptions. Second, it requires consideration of a multifactor approach to establishing the

parameters of the QRM in order to promote sound underwriting practices without arbitrarily restricting the availability of credit. While Congress did not quantitatively define "high quality" or "lower risk," it is clear the intent was to exclude certain higher risk loans, not to restrict QRM to a small subset of the market.

While Congress expected regulators to consider a range of factors to define QRM, these factors did not include either servicing standards or high down payments. Strong documentation, income to support the monthly payment for the life of the loan, reasonable debt loads, protections against payment shock, prohibitions on high-risk loan features like negative amortization and balloon payments, and inclusion of mortgage insurance or comparable credit enhancement for low down payment loans are the core factors that were identified because they lower the risk of default without unduly restraining credit.

MBA believes the regulators' approach to the QRM goes beyond and is contrary to the explicit intent of Congress. To qualify for a QRM under the proposal, the borrower must make a 20 percent down payment and have a maximum loan-to-value (LTV) ratio of 80 percent for purchase loans and a 75 percent combined LTV for refinance transactions, reduced to 70 percent for cash-out refinances. In addition to a 20 percent down payment, the borrower must have cash to pay closing costs. Additionally, a borrower's debt load must not exceed front-end and back-end debt-to-income (DTI) ratios of 28 percent and 36 percent, respectively.

In the analysis used to justify the QRM definition, the Federal Housing Finance Agency (FHFA) found that less than one third of loans purchased in 2009 by the GSEs, Fannie Mae and Freddie Mac, would have met these QRM requirements. This is notable because 2009 was, by most accounts, the most cautiously underwritten, liquidity-constrained market in generations. For example, the average LTV and credit score on Fannie Mae acquisitions in 2007 was 75 and 716, respectively. By 2010 the average LTV had fallen to 66 and the average credit score had risen to 760. Similarly, the average credit score on FHA loans has risen from 650 to above 700. And the few private-label deals that have been completed have had LTVs near 60 and average credit scores near 800. Individual lender decisions and market forces have pushed underwriting standards significantly tighter.

It is questionable why regulators would want to define QRM even narrower than the underwriting practices that prevail in today's much tighter credit market, such that two out of every three borrowers either will not qualify for a loan, or will have higher payments because of the loan's non-QRM status.

As noted by FHFA's analysis of GSE data, "for the 2005-2007 origination years, the requirement for product-type (no non-traditional and low documentation loans, or loans

for houses not occupied by the owner) was the QRM risk factor that most reduced delinquency rates." The intent of the risk retention requirement is to make it more difficult to originate and securitize the types of loans that caused the worst problems during the downturn. The QRM definition should, and does, explicitly target these riskier attributes. We see no reason to further cut off credit to borrowers by layering on other more onerous restrictions that were not implicated in the downturn.

The emphasis of the proposed regulations should be on creating a liquid securities market for QRMs, which are by definition more homogeneous. Homogeneous securities, such as those issued by the GSEs, trade in huge volume because investors can quickly assess their values. Heterogeneous securities, like those that were privately issued, tend to appeal to "buy and hold" investors, given the cost and difficulty of modeling the heterogeneity, and hence are bound to be less liquid. This also clearly necessitates that the QRM sector needs to be large enough to maintain liquidity over time. Even if QRMs are homogeneous with respect to credit, over time they will diverge with respect to coupon, with a resulting loss of liquidity.

MBA believes the QRM's 20 percent down payment requirement alone would provide a nearly insurmountable barrier to most first-time and low- and moderate-income borrowers achieving homeownership, notwithstanding that they otherwise may qualify for a mortgage. The QRM's DTI ratios also are considerably lower than the market has seen in recent years. In conjunction with the LTV requirements, the ratios will bar the door to even more borrowers who may have offsetting resources and payment behavior that under the proposal cannot be considered. Higher LTV loans may pose higher risks. However, these risks can be mitigated by compensating factors such as strong credit and full documentation.

While a reasonable and affordable cash investment or LTV requirement may be warranted – although they are not suggested by the statute – the rules should permit offsetting factors in the context of prudent underwriting. While reasonable DTI ratios were to be considered under the law, the ratios should not be unduly restrictive.

Historically, the reason underwriters focused on DTI ratios was to ensure that households had sufficient resources for necessities such as food, household utilities and transportation. For lower income households this is particularly important. However, for middle and higher income households the same DTI ratio may not be as burdensome. For example, consider a borrower whose monthly income is $4,000 or $48,000 annually. A $1,600 monthly mortgage payment, resulting in a 40 percent DTI would clearly be a burden, as it would leave only $2,400 for all other monthly expenses. Now consider a borrower who makes $144,000 annually, or $12,000 a month. A 40 percent DTI is equivalent to a $4,800 mortgage payment which may well be feasible for a strong credit borrower as it leaves $7,200 for other expenses. Underwriters are

carefully trained to consider compensating factors in determining whether to approve a prospective borrower. Making DTI ratios unduly restrictive, as clearly shown in FHFA's analysis of the data, will prevent many borrowers from getting lower cost financing.

Regulators' Inconsistent Application of Statutory Criteria

MBA also is concerned that the regulators appear to have applied a double standard with respect to the statutory requirement for empirical data. For example, the regulators chose not to include mortgage insurance or other credit enhancements as a factor for QRM eligibility because of the lack of supportive historical loan performance data. Conversely, the regulators included provisions regarding written appraisals, mortgage servicing and mortgage assumability without providing empirical evidence on how any of these factors lessen the risk of default. MBA's concern about the regulators' selective use of data is intensified by the fact that the regulators explain that empirical evidence must be used to substantiate any request to change the proposal. Ironically, while assumptions were made in the proposal without facts, facts are required to refute the assumptions.

QRM Servicing Provisions

As indicated, in order to be considered a QRM and exempt from the risk retention requirements, the proposal would require compliance with certain servicing standards. Specifically, the QRM's "transaction documents" must obligate the creditor to have servicing policies and procedures to mitigate the risk of default (within 90 days of delinquency) and to take loss mitigation action, such as engaging in loan modifications, when loss mitigation is "net present value positive." The creditor must disclose its default mitigation policies and procedures to the borrower at or prior to closing. Creditors also would be prohibited from transferring QRM servicing unless the transferee abides by "the same kind of default mitigation as the creditor."

MBA is extremely concerned with the inclusion of servicing standards in a QRM definition that was very clearly intended under the Dodd-Frank Act to comprise a set of loan origination standards only. The specific language of the act directs regulators to define the QRM by taking into consideration "underwriting and product features that historical loan performance data indicate lower the risk of default." Servicing standards are neither "underwriting" nor "product features" and while they may bear on the incidence of foreclosure they have little if any bearing on default. Accordingly, MBA strongly believes they have no place in this proposal.

Another very serious concern with incorporating servicing requirements into origination-related regulations is the fact that servicing processes and procedures begin after the loan's consummation and continue for the life of the loan – as long as 30 years. It is

problematic to combine into a single regulation origination standards that terminate at the loan's closing and servicing standards that commence at closing and continue for decades. As proposed, the QRM requirements are an attempt to regulate not only two different functions, but also two different timeframes.

Embedding servicing standards within the proposed QRM regulations will have unintended consequences that could actually harm borrowers. The proposal requires loss mitigation policies and procedures to be included in transaction documents and disclosed to borrowers prior to closing. Such a requirement codifies at the time of origination the servicer's loss mitigation responsibilities for up to 30 years. While servicers today have loss mitigation policies to address financially distressed borrowers, these policies continue to evolve as regulators' concerns, borrowers' needs, loan products, technology and economic conditions evolve. One need only look at the variety of recent efforts that have emerged such as the Home Affordable Modification Program (HAMP), Home Affordable Foreclosure Alternatives, FHA HAMP, VA HAMP, and proprietary modifications. A further example is the different set of loss mitigation efforts necessitated by Hurricane Katrina. In both situations, inflexible loss mitigation standards would not have been in the best interest of the public or investors.

The QRM proposal also is likely to make servicing illiquid by combining "static" loss mitigation provisions in legal contracts and borrower disclosures with the inability to transfer servicing unless the transferee abides by those provisions, even if more borrower-friendly servicing options become available.

The proposal also calls for servicers to disclose to investors prior to sale of the MBS the policies and procedures for modifying a QRM first mortgage when the same servicer holds the second mortgage on the property. This adds another level of complexity to the concerns raised above, notwithstanding the irrelevance of these provisions to underwriting, origination, and statutory intent.

Economic Impact on Availability and Affordability of Housing Finance

Mortgage underwriting is subject to the classic statistical problem of Type 1 and Type 2 errors. Type 1 error is the approval of a mortgage for a borrower who subsequently defaults. This error imposes large costs on the borrower and the lender. Type 2 error is the failure to approve a mortgage for a borrower who would have repaid the loan as scheduled. Committing this error causes both the lender and the borrower to miss out on the opportunity for a mutually beneficial transaction.

Before the financial crisis, policy makers encouraged the lending community to provide more financing for underserved market segments such as low-income, minority and first-time home buyers. Implicitly, policy makers sought to avert Type 2 errors. These

efforts to actively promote homeownership resulted in higher default rates. On the other hand, after the crisis, legislation was proposed to forbid mortgage lenders from making loans to borrowers who could not repay, in effect trying to ban Type 1 errors.

It is unrealistic to expect that either type of error can be eliminated completely. The practice of underwriting is an effort to try to cut down on both types of errors as much as possible. Tightening standards through a very narrow QRM definition will result in an increase in Type 2 error, but a reduction in Type 1 error. In other words, too many well-qualified borrowers will either not get credit, or will pay a very high price for it.

The Board of Governors of the Federal Reserve System (Federal Reserve) recently issued a report showing that nearly a quarter of loan applications are rejected. However, the denial rates tell only half the story. Many potential buyers have stopped applying for loans because they assume they cannot get one – even with good credit. Another factor keeping people out of the mortgage market is high down payment requirements. Approximately 20 percent of home buyers currently put down less than 20 percent on their homes, and half of that population puts down 10 percent or less. Given this reality, the proposed 20 percent requirement as part of the QRM framework would increase costs or potentially cut off access to credit for hundreds of thousands of creditworthy households.

Another issue that was not addressed in the proposal is why the housing markets of California, Florida, Nevada and Arizona fared so much worse than the rest of the country. The same loan level credit models that applied in California and Florida with such disastrous effect also were applied equally in the rest of the country. The failure of regulators to take into account the special factors in California and Florida led to an extremely tight QRM definition that effectively punishes the rest of the country for what happened in those states. Because many borrowers in these states bought homes with no money down, first-time home buyers in states such as South Dakota and Alabama will be required to come up with 20 percent down payments. Because speculators led to a massive over-building of condominiums and detached single-family homes in Florida, borrowers in states such as Texas and New Jersey will need spotless credit records and little other debt if they want to buy a home, or they will pay much more for their mortgages.

Estimated impact on FHA

It is not at all clear from the proposal whether the regulators reflected on the relationship between the proposed QRM definition and the FHA's eligibility requirements in light of FHA's exemption from risk retention requirements. The proposed QRM definition appears to conflict directly with the Obama administration's plan for reforming the housing finance system. In its report to Congress, "Reforming America's Housing

Finance Market," the administration made clear that it intends to shrink FHA from its current role of financing one-third of all mortgages, and one-half of all purchase mortgages.

We support FHA's role as a source of financing for first-time homebuyers and other underserved groups. However, because of the wide disparity between FHA's down payment requirement of 3.5 percent and the QRM's requirement of 20 percent, MBA is concerned that the FHA programs will be over utilized. While FHA should continue to play a critical role in our housing finance system, MBA firmly believes that it is not in the public interest for a government insurance program like FHA to dominate the market, especially if private capital is available to finance and insure mortgages that exhibit a low risk of borrower default.

MBA suggests a better solution is to allow the use of credit enhancements to offset part of the down payment requirement for QRMs to provide some of the financing for low down payment loans that FHA would provide.

GSE Exemption

The proposal includes an exemption from risk retention requirements for securities issued by Fannie Mae or Freddie Mac so long as these two GSEs are in conservatorship or receivership. The housing market remains severely weakened, and liquidity through the GSEs is still essential to the availability of mortgage credit. Additional risk retention restrictions applicable to the issuance of MBS by the GSEs would increase the GSEs' costs of funding and constrict the availability of otherwise scarce mortgage credit to consumers. At this time, given the weakness in the market, and the very narrow QRM proposal, we support the limited GSE exemption. However, we note that this exemption runs counter to the Obama administration's stated policy objective, as well as the emerging congressional preference, to attract additional private capital to the housing finance market. GSE reform measures hinge on the return of private capital. The proposed risk retention requirements, however, pose significant obstacles to private capital's return.

Although we support the exemption considering the fragility of the market, MBA is concerned that the GSEs or their regulator might unilaterally change the GSEs' loan eligibility requirements, possibly making the requirements even narrower than the QRM-eligibility criteria. This is a concern because while the QRM definition is being developed on an interagency basis with the opportunity for public comment, the GSEs on the other hand may alter their loan eligibility criteria at their own discretion.

Non-QRM Issues

MBA is concerned about the lack of a risk retention duration limit in the proposal. The purpose of the so-called "skin in the game" requirement is to hold originators and securitizers accountable for the quality of the loans they underwrite and securitize. Historical data indicates that any underwriting deficiencies will likely present themselves within a relatively short time following origination of the loan. During that time, it will be clear whether the loan was underwritten poorly, or the borrower misrepresented key information. After that point, the way a loan was underwritten has little bearing on the incidence of default. Instead, economic or life events that were unforeseeable at origination become the primary default determinants. Any risk retention requirement beyond this timeframe is essentially overcollateralization and a constraint on funds that could be redeployed into funding more loans to creditworthy borrowers.

Originators and securitizers should not be held accountable for the performance of a loan if it met the investor's guidelines and all applicable laws and regulations, but failed due to changing economic circumstances. For these reasons, we believe the regulators should clearly limit the duration of a securitizer's risk retention requirements to a reasonable time following the origination date.

The proposed rule also prohibits sponsors from monetizing excess spread by selling premium or interest-only tranches. If the sponsor sells interest-only or premium tranches at issuance of the MBS, the sponsor is required to place the proceeds in a cash reserve account, which would serve as the first-loss piece to the transaction. This restriction would greatly decrease the attractiveness of securitizations, as it would push issuers to realize gains over time rather than up front. As a result, issuers will need to devote greater balance sheet resources to securitizations. Furthermore, because these amounts become the first-loss piece of the securitization, historical up front profits now become risky, cash flows paid out over a longer timeframe.

Additionally, this risk retention requirement jeopardizes true sale, both from an accounting standpoint and from a legal standpoint, rendering securitization potentially uneconomical from an accounting perspective. Because the proposed rule references par value only, any downward rate movement between the time of loan origination and deal issuance would trigger a need for a reserve account even for a loan originated as a par loan. This makes it difficult, if not impossible, to hedge and rate lock borrowers. In essence, this portion of the proposal penalizes a securitizer for putting together a successful deal, i.e., one that sells for above its par value. Moreover, this penalty is layered on top of the five percent retention requirement.

Operational Issues

While we believe consumers will receive more favorable pricing for QRM loans as compared to non-QRM loans, MBA also believes the operational impact of the risk retention requirements will increase consumer borrowing costs regardless of whether a loan is QRM-eligible. For example, the proposal includes additional disclosure and certification requirements for both originators and securitizers. Moreover, some of the QRM-eligibility criteria do not presently have standard metrics. For example, in the proposal, the regulators cite the common industry practice of using credit scores in qualifying a prospective borrower for a loan. Instead of using credit scores in the QRM-eligibility matrix, however, the regulators incorporate so-called "derogatory factors" relating to a borrower such as payment, bankruptcy and foreclosure activity. For lenders accustomed to using credit scores instead of these derogatory factors, the proposal will entail reworking their underwriting, tracking and reporting systems and making other operational adjustments.

Cumulative Impact of Regulatory Activity

It is important to keep in mind that the risk retention regulations are not the only changes taking place in the financial services industry. We note that the Federal Reserve's Report to Congress on Risk Retention urged regulators to consider the credit risk retention requirements in the context of all the rulemakings required under the Dodd-Frank Act, some of which might magnify the effect of, or influence, the optimal form of credit risk retention requirements. MBA notes that the Securities and Exchange Commission's proposed modifications to Regulation AB, the new version of the Basel Capital Accord and the new securitization safe harbor provisions of the Federal Deposit Insurance Corporation also overlap the proposed risk retention regulations. Individually, each one of these actions increases the costs of credit, which in turn imposes further restrictions on the availability of affordable real estate financing. We urge Congress to maintain a high degree of vigilance so that the cumulative impact does not forestall the recovery in the housing finance sector.

The layering effect of multiple regulations on similar topics causes market disruptions in a number of ways. Multiple rulemakings perpetuate uncertainty in the market. For example, the agencies' proposed risk retention regulations overlap the "Qualified Mortgage" provisions of the Federal Reserve's future regulations implementing the Dodd-Frank Act's revisions to the Truth in Lending Act. The proposal also includes an exemption for securities issued by Fannie Mae and Freddie Mac while they are in conservatorship or receivership. Regardless of the status of the QRM rulemaking, uncertainty will persist until both of these issues are resolved.

Multiple rulemakings also raise the level of difficulty from a compliance perspective. As mentioned above, the entire financial services regulatory landscape is being transformed and the changes are likely to stretch the capacity of even the largest financial institutions, to say nothing of smaller community lenders.

Regulatory Due Diligence

MBA reiterates its recognition of the inherent challenges associated with issuing proposed regulations on such a complex topic involving a significant number of regulatory agencies. Considering the stakes involved, we believe it is in the interests of the regulators and the entities they regulate to avoid making hasty decisions. We believe it would be far better to allocate time and resources to issuing a final rule that is cogent and analytically sound rather than sacrifice quality for speed.

Distortions inevitably occur whenever the government decides to intervene in credit markets, whether with the promotion of under-priced credit through vehicles such as GSE affordable housing goals, depository institution Community Reinvestment Act requirements, or the restriction of credit through regulations such as those implementing the Home Ownership Equity Protection Act or the proposed risk retention regulations. The crucial decision is whether the regulations actually address the root cause of the problems and whether the cost of the distortion is offset by other benefits to the public and the markets. It appears the proposed risk retention regulations fail on both measures.

We therefore urge you to instruct regulators to assess and report to Congress on the impact of the proposal on the cost and availability of mortgage credit. We also request that you direct the regulators to extend the public comment period in order to give interested parties sufficient time to assess the impact and provide considered views on the proposal. The current 60-day comment period is inordinately short given the complexity, potential market impact, and significance of the subject. In this vein, we also request that Congress instruct the regulators to seek comment in a more proactive manner by conducting regional hearings on this proposal. Before these rules are adopted, the nation deserves that discussion.

Commercial and Multifamily Real Estate Perspectives on Risk Retention

The Dodd-Frank Act mandated that the federal banking agencies and the SEC jointly promulgate rules applicable to the commercial mortgage-backed securities (CMBS) market. MBA believes that operating within the act's parameters, the regulators have worked diligently and met repeatedly with MBA to propose rules that would meet our mutual goals of a responsible and vibrant CMBS market. As noted below, MBA applauds the regulators for providing flexibility in certain areas, in concert with our policy. However, in their current form, elements of the proposed rule, such as the Premium Capture Cash Reserve Account, are unworkable. MBA will work with the industry and the regulators throughout the comment period to provide feasible alternatives to the proposed rules in areas that currently present challenges to the viability of the CMBS market going forward.

MBA supports elements of the proposed risk retention rule applicable to CMBS and will be seeking greater clarification and refinement of other parts of the proposed rule. Areas of the proposed rule that MBA supports include: (1) the flexibility afforded the issuer to select from a range of risk retention options, including the five percent vertical slice; (2) the ability of the issuer and originator to negotiate the allocation of risk retention via third-party, arms-length contractual agreements; (3) a qualified exemption of issuer-held risk retention when a third-party purchases the first loss-position; (4) a qualified exemption of the risk retention requirement when certain prescribed underwriting, product and other standards are followed; and (5) the definition of an originator which would not include commercial and multifamily mortgage bankers who do not provide loan funding for purposes of CMBS risk retention. MBA will be seeking additional clarification and, in some instances, modification of specific elements of the proposed rule that fall outside of existing commercial and multifamily real estate finance industry conventions, practices and norms in order to meet the goals of a vibrant and responsible CMBS market.

MBA Commercial and Multifamily Risk Retention Principles

MBA is committed to facilitating the establishment of a fully-functioning, transparent, liquid and responsible securitization market for commercial real estate mortgages. The CMBS market involves a complex set of interactions among numerous stakeholders. Corrective remedies for this market should: (1) advance an alignment of interests among investors, issuers, originators, servicers and borrowers; and (2) support credible, safe and sound lending practices that reflect the needs and sophistication of CMBS investors. Consequently, static and narrowly defined government-prescribed regulations are ill-suited to address CMBS market challenges in a comprehensive manner. MBA promotes a robust and constructive dialogue to create a new CMBS program construct that works

for and is designed by the market. In terms of promoting a robust CMBS market, MBA believes any regulation should support the following principles:

- Support the efficient flow of mortgage capital from investors to borrowers;
- Help restore investor confidence and the ability of investors to accurately assess the risks in the collateral and in the securitization structure;
- Ensure risks are properly assessed, mitigated and/or priced by those who take them on or control them;
- Support credible, safe and sound lending practices that reflect the needs and sophistication of both the investors in commercial real estate securities and the owners of commercial real estate properties;
- Advance alignment of interests among investors, issuers, servicers, originators and borrowers;
- Increase transparency across all aspects of the market, assuring adequate information for investors while protecting individual privacy and proprietary business models;
- Promote accurate accounting that is understandable and reflects the true risks and benefits of securitizations; and
- Provide flexibility to allow for a number of different forms of risk retention and risk allocation.

Proposed Rule's Method and Allocation of Risk Retention

The above principles were used to develop MBA policy for CMBS risk retention. A central issue is that the proposed rules must offer flexibility that will facilitate competition. They must also support a variety of business models, helping them to develop and thrive in the recovering CMBS market. We are pleased that elements of the proposed rule allowed for flexibility in two important areas: (1) the form of risk retention; and (2) the allocation of risk retention between the originator and the issuer.

First, regarding the form of risk retention, the proposed rule allows issuers to select between seven forms of risk retention options. MBA supports inclusion in the proposed regulations of a 5 percent vertical slice as a mechanism for retaining necessary financial risk. This structure would not trigger consolidation of the entire CMBS issuance on the issuer's balance sheet under FAS 167, a major concern of MBA members.

Second, MBA strongly supports the proposed rule's approach for allocating risk retention between the issuer and originator. If an originator contributes 20 percent or more of the CMBS pool's loans, the issuer and originator may have a discussion regarding the allocation of risk retention between these two parties. However, the proposed rule does not force the originator to assume any of the retained risk and in

cases where the originator agrees to assume risk, this share cannot be more than the originator's pro-rata share of the CMBS.

The proposed rule specifies that the retained risk would be held for the duration of the CMBS. MBA will evaluate and comment in its letter to the regulators on whether this is an appropriate duration for retained risk.

Premium Capture Cash Reserve Account

Although not specified in the Dodd-Frank Act, the proposed rule introduces the concept of a Premium Capture Cash Reserve Account. Because CMBS transactions have an unique structure, one of MBA's priorities will be to thoroughly evaluate this reserve account concept and the impact it would have on reestablishing a functional CMBS market. MBA will also offer constructive alternatives to the proposed Premium Capture Cash Reserve Account in its response to the proposed rule.

Hedging

As a general matter, the proposed rule prohibits a securitizer from hedging its required retained interest or transferring it, unless to a consolidated affiliate. The rule would permit hedging of interest rate or foreign exchange risk; pledging of the required retained interest on a full recourse basis; and hedging based on an index of instruments that includes the asset-backed securities, subject to limitations on the portion of the index represented by the specific securitization transaction or applicable issuing entities. MBA will be working with its members to identify any other hedging strategies that would be appropriate for the proposed rule.

Risk Retention Exemptions Under the Crapo Amendment

The proposed rule reflects the flexibility authorized in the inclusion of the Crapo amendment to the Dodd-Frank Act. MBA strongly supports the ability to reduce retained risk if certain underwriting requirements are met or if a third-party purchases the first-loss position in a CMBS that meets certain proposed requirements. We will be working with MBA members and the regulatory agencies throughout the comment period to provide specific recommendations regarding the form and structure these proposed requirements should take.

Underwriting, Product and Other Standards
The Crapo amendment allows the regulatory agencies to specify the loan underwriting characteristics that would allow a commercial real estate loan to be classified as a "low risk loan" and thus be eligible for reduced risk retention requirements. The proposed rule specifies a zero percent risk retention requirement for loans that meet certain

underwriting and product standards. MBA supports reduced retained risk for loans that clearly meet the parameters of a low-risk loan. The proposed rule specifies an extensive inventory of these standards. During the course of MBA's evaluation of this portion of the proposed rule, MBA will examine the underwriting parameters of loans slated for securitization that meet the proposed definition of qualifying commercial real estate (CRE) loans, including the loan to value, debt service coverage ratios and the amortization and loan terms, as well as other proposed standards.

B-Piece Buyers in CMBS transactions

The regulatory agencies propose to exempt the issuers from the requirement to retain risk when a third-party purchaser ("B-piece buyer") buys the five percent horizontal risk retention slice and is subject to certain conditions. MBA supports reduced retained risk for CMBS whose first-loss position of five percent or greater is purchased and held by a third-party. Under the proposed rule, the B-piece buyer would have to meet six conditions to qualify for reduced risk retention.

During the course of MBA's evaluation of this portion of the proposed rule, MBA will be examining issues related to the specific role of the Operating Advisor, disclosure issues regarding the purchase price paid for the first loss position and other issues related to regulatory compliance.

Conclusion

With respect to commercial real estate, MBA is working hard to identify and implement positive CMBS program designs, structures and executions as the market returns. We also look forward to continuing our work with the regulators, both during the comment period and the 2-year implementation period to affect the Dodd-Frank Act's regulatory mandates. Through this rule making process and industry initiatives, MBA remains committed to fostering a fully-functioning, transparent, liquid and responsible securitization market for commercial real estate mortgages.

On the residential side, when finalized, the risk retention regulations will have a significant negative impact on credit availability and affordability for first-time, minority, low-to-moderate income homebuyers as well as others in the marketplace. While the real estate finance industry seeks to ensure better standards through the QRM exemption, we urge that they be redrawn to avoid unintended consequences.

These proposals are of the utmost importance to restoring a strong and stable housing and mortgage finance market, and we would be pleased to contribute our experience and insights throughout the process.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Henry V. Cunningham, Jr.	Mortgage Bankers Association

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.