April 26, 2011

By email: Rule-comments@sec.gov

Elizabeth M. Murphy, Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

RE: Proposed Risk Retention Requirement – File No. S7-14-11

Ms. Murphy, SEC Chairperson and Commissioners:

I am grateful for the opportunity to publicly comment on the Securities Exchange Commission's recent proposed rule on Credit Risk Retention, File No. S7-14-11. The rule seeks to implement section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In general, the proposed rule mandates institutions and entities which securitize asset-backed securities to retain at least five percent of the credit risk of the assets collateralizing such securities.

This letter discusses the negative impact that the proposed Credit Risk Retention rule will have on the economy as a whole, specifically its section mandating institutions to retain at least five percent of the credit risk of each loan. Further, the letter disagrees with the rule's exemption given to government-sponsored enterprises (GSE) such as Freddie Mac and Fannie Mae.

Political over-reactions to crises are as inevitable as death and taxes. History tells us that knee-jerk reactions are especially present during financial crises. In the past three decades alone, the federal government has addressed financial "catastrophes" with sweeping reform and regulation, only to sit by and watch as the next financial disaster plows through American markets. The Recovery and Enforcement Act of 1989 was the answer to the savings and loan crisis. The Sarbanes-Oxley Act was the answer to the Enron and WorldCom collapses. The Dodd-Frank Wall Street Reform and Consumer Protection Act is the latest attempt from the federal government to cure our current crisis and to prevent another from happening again. While filled with good intentions, these reforms are the result of political pressure to act swiftly and resolutely in a time of crisis. Rather than addressing the actual root cause of each respective financial debacle, politicians who champion such reform demonize the "culprits" yet ignore any warning signs of an impending future crisis while refusing to accept responsibility for past crises.

To avoid history from repeating itself, and to avoid harming our economy further with overzealous regulation, rules must seek to address the actual causes and consequences of the current financial crisis.[1] The proposed Credit Risk Retention rule does not succeed in this capacity. In fact, the proposed rule not only ignores the causes of the current crisis, it works to

[1] For a comprehensive explanation of the factors that contributed to the most recent financial crisis, *see* John Allison, Former Chairman and CEO, BB&T Corporation, Address at the 2011 Federalist Society Annual Student Symposium: The U.S. Financial Crisis: Causes and Consequences (Feb. 26, 2011). Available at http://www.youtube.com/watch?v=-OCzqi3oGmg

further weaken our economy by insulating large financial institutions, punishing smaller regional and community institutions, perpetuating a credit crunch, and discouraging first time buyers out of the housing market.

There are many unintended, negative consequences from the Credit Risk Retention rule. First, the rule serves to protect the biggest nation-wide financial institutions – the same institutions that were blamed for causing the current crisis. Forcing the largest institutions in the country to take an economic interest in five percent of each loan does not place a very large burden upon them because they have the capital to take on that risk. Generally, smaller banks do not have the capacity to take on that risk. Thus, smaller banks will be unable to compete with the larger institutions because it will no longer be cost effective for the smaller banks to issue certain loans if they have to retain a five percent stake. Therefore, the rule will not impact the biggest financial institutions as much as smaller banks, and they will suffer as a result. In effect, the rule serves to insulate the largest banks in the country. The counter intuitive nature of this rule goes directly against the "too big to fail" mantra touted by politicians throughout the current crisis because it seeks to make those deemed "too big," even bigger. To no surprise, it was the nation's largest banks that were among those lobbying most ardently in favor of this rule.[2]

Again, for smaller financial institutions – e.g. regional and community banks – the five percent risk retention is too large. Larger banks will be able to make loans that do not meet the defined qualifications of a qualified residential mortgage (QRM),[3] while smaller banks will most likely only be able to issue loans that meet QRM requirements. As such, the smaller banks will not be able to compete with the larger banks. This is also true for lenders that take on commercial loans. Many commercial loans are too big for a single bank. As a result, large commercial loans are arranged by banks that then sell or participate portions of such loans to a broad secondary loan market.[4] Applying risk retention standards to loans of this type will significantly limit the number of lenders available to make and participate in these loans.[5] Thus, overall commercial credit lending opportunities will be severely limited, stunting economic growth, prolonging the current recession, and potentially creating a credit crunch. It cannot be said enough that a healthy secondary trading market is necessary to enable banks and financial institutions to spread market risk to sophisticated investors, thereby reducing the systemic risk associated with concentrated loan holdings in large banks and financial institutions.[6] This negative effect on the commercial

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[2] Clea Benson and Lorraine Woellert, *Dodd-Frank Mortgage Risk Retention Rule Would Reinforce Role of Fannie Mae*, Bloomberg (Mar. 29, 2011) http://www.bloomberg.com/news/2011-03-29/risk-retention-rule-may-increase-government-s-mortgage-role.html

[3] According to the Credit Risk Retention, File No. S7-14-11, in order to be considered a QRM, a 20% down payment is required by the potential purchaser of a home.

[4] Patrick M. Hardiman and Ronald H. Jacobson, *Refinancing Cliff: The risks of retention*, The Deal Magazine (April 9, 2010) http://www.thedeal.com/magazine/ID/034105/community/refinancing-cliff:-the-risks-of-risk-retention.php

[5] *Id.*

[6] *Id.*

loan market is especially relevant because by the end of 2014, nearly $1.5 trillion in commercial loans are set to mature and will need to be refinanced or repaid.[7]

Another downfall of the proposed rule is the exemption given to GSE's Fannie Mae and Freddie Mac. The exemption allows lenders to avoid the five percent retention on asset-backed securities if they sell the securities to Fannie Mae or Freddie Mac. When Fannie and Freddie went broke in 2008-09, they had $1000 of debt for every dollar of equity.[8] The reason they were so extremely overleveraged was solely because the federal government guaranteed their debt.[9] Without the government guarantee, Fannie and Freddie would not be able to exist in the free market. The rule's exemption seeks to further perpetuate this government sponsored encouragement of rewarding large, failed financial institutions. The rule exempting Fannie and Freddie further works to make those financial institutions "too big to fail." GSE's being propped up and made larger is a dangerous endeavor, as they were major contributors to the current crisis. Additionally, along with the Federal Housing Administration, Freddie and Fannie now own or insure more than 96 percent of home loans being originated in the U.S.[10] Making their loans exempt from the rule would maintain the government as the main holder of mortgage-market risk.[11] The taxpayer already bore that risk as a result of the recent crisis; they certainly should not have to bear that risk again.[12]

Finally, the rule would negatively impact access to homeownership at a time when the housing market is extremely fragile. The rule's definition of a QRM requiring a minimum down payment of twenty percent makes it more difficult for potential homeowners seeking affordable housing to purchase a home. First-time home buyers historically average 40 percent of home-buying activity.[13] Most first time buyers do not have enough money up front to meet the twenty percent down payment. It would take an average family 12 years to scrape together a 20 percent down payment.[14] As the American Securitization Forum writes, "the QRM proposals will keep a significant amount of private capital on the sidelines, while pressuring the Federal Housing Administration (FHA) to continue to fill this role with American taxpayers as the backstop for mortgage credit risk."[15] This drawing private capital out of the mortgage finance system, rather than encouraging its entry, "will only serve to further depress home prices nationwide and keep

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[7] *Id.*

[8] *See* Allison, The U.S. Financial Crisis: Causes and Consequences.

[9] *See id.*

[10] *See* Benson and Woellert, *Dodd-Frank Mortgage Risk Retention Rule Would Reinforce Role of Fannie Mae*

[11] *Id.*

[12] Fannie Mae and Freddie Mac owed $5 trillion dollars when they went broke. Those costs, however, got shifted to the taxpayer. *See* Kaite Benner, *The $5 Trillion Mess*, CNNmoney.com (July 14, 2008)
http://money.cnn.com/2008/07/11/news/economy/fannie_freddie.fortune/index.htm

[13] Bill McBride, "Lawler: The 'Shrill Cry' from Lobbyists on QRM," *Calculated Risk* http://www.calculatedriskblog.com/2011/03/lawler-shrill-cry-from-lobbyists-on-qrm.html (Mar. 30, 2011) (last visited Apr. 26, 2011).

[14] *Id.*

[15] *Id*.

first-time home buyers out of a housing market suffering from a severe oversupply of available homes."[16]

For the aforementioned reasons, the proposed Credit Risk Retention rule is ill advised. The proposed five percent risk retention section of the rule protects the largest financial institutions in the country. After subsequently being bailed out by the federal government, these were the same institutions then blamed for being too big to fail. This rule would effectively make these institutions even bigger. As a result, the rule punishes smaller regional and community banks that will not be able to retain such risk on their loans. Consequently, these banks will not be able to issue loans to potential homebuyers without requiring a twenty percent down payment. Unless, of course, they sell these loans to Fannie Mae or Freddie Mac, furthering government favoritism of GSE's.

To be sure, my letter does not proclaim that markets are perfect. On the contrary, the free market has weaknesses. These weaknesses underscore our responsibility to make well thought-out and informed decisions about government regulation. However, policies based on political pressure and ideological finger pointing do not solve problems nor prevent them from happening again. The above-mentioned attempts at economic reform over the last three decades illustrate that point. Each respective Act did nothing to prevent subsequent financial breakdowns. As such, automatically assuming that more regulation is necessary seems counter intuitive, as rules and regulations in our recent past have not been successful at preventing future failures. The current proposed rule is no different. In our case, the Credit Risk Retention rule will create more problems than it seeks to solve.

Thank you again for the opportunity to comment on this important issue.

Respectfully yours,

Charlie Lehmann
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[16] *Id.*