

June 3, 2011

U.S. Department of the Treasury
Office of the Comptroller of the Currency
250E Street, SW, Mail Stop 2-3
Washington, DC 20219
Docket Number OCC-2011-0002

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Elizabeth M. Murphy, Secretary
File Number 57-14-11

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

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

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

U.S. Department of Housing and Urban
Development
Regulations Division
Office of General Council
51 7th Street, SW, Room 10276
Washington, DC 20410-0500

RE: Credit Risk Retention: Proposed Rule

Ladies and Gentlemen:

I am writing today as a private, concerned citizen with over 30 years of mortgage experience in investment banking; securities trading with a bulge bracket broker dealer; working within a GSE; as a depository executive and am currently an executive with a mortgage insurer. The thoughts, comments and recommendations expressed herein are my own and are not meant to speak for any other party.

The goal of this effort is to establish a defined set of loan attributes such that these loans will be exempt from risk retention in an Asset Backed Security (ABS), including Residential Mortgage Backed Securities (RMBS). Residential mortgage loans sold as whole loans are not regulated within this proposed regulation.

My three main points are simple. First, the definition of a Qualified Residential Mortgage (QRM) is too narrow and exclusive. Second, the allowed procedures to prove "skin in the game" are far too broad, and very vulnerable to considerable manipulation, resulting in a lack of enforceability and as such produce a competitive advantage for the "Too Big To Fail Banks" (TBTF) that conflicts sharply with Administration goals for a less hazardous future for our banking industry. Finally, not addressed is the structural misalignment on the one hand by Sponsors, Trustees, Rating Agencies and Servicers and the other hand, Investors. The existing framework of perverse incentives produces an environment in which investors will pay for the misdeeds of any party involved in the deal. The resurrection of the mortgage securities market requires that investors be in a stronger position.

QRM Definition

In summary, the QRM proposed definition (from page 20 of 376 of the proposed regulation) is:

“These underwriting standards include, among other things, maximum front end and back end ratios of 28% and 36%, respectively; a maximum loan to value ratio of 80% in the case of a purchase transaction (with a lesser combined LTV permitted for refinance transactions); a 20% down payment requirement in the case of purchase transaction; and credit history restrictions.”

The rest of the definitions for a QRM merely define the points in the summary above.

The impact of the definition is clearly seen in the chart on page 188 of 376 of the proposed regulation:

Percent of Total Dollar Volume for QRMs and Mortgages that Do Not Meet One of the Qualification Requirements

Year	QRM [eligible]	Product Type	PTI/DTI	LTV	FICO	All Loans [purchased by the GSEs]
1997	20.44%	3.75%	13.04%	13.74%	5.81%	\$ 286,497,878,371
1998	23.29%	2.17%	13.30%	17.10%	6.24%	\$ 691,033,994,509
1999	19.48%	3.16%	14.83%	12.95%	5.37%	\$ 481,450,519,442
2000	16.44%	3.70%	17.00%	8.40%	4.53%	\$ 356,779,731,420
2001	19.37%	3.01%	14.33%	13.11%	4.62%	\$ 1,039,412,013,403
2002	22.37%	4.28%	15.35%	10.72%	4.62%	\$ 1,385,056,256,240
2003	24.57%	4.55%	16.68%	10.02%	4.98%	\$ 1,924,265,340,603
2004	17.03%	6.35%	17.68%	6.25%	4.34%	\$ 937,643,914,289
2005	14.41%	6.74%	18.78%	5.45%	3.36%	\$ 939,069,358,457
2006	11.52%	7.11%	17.59%	3.91%	2.73%	\$ 887,443,942,464
2007	10.72%	5.44%	16.14%	4.95%	2.24%	\$ 1,027,460,511,244
2008	17.39%	4.64%	22.01%	9.22%	2.12%	\$ 793,136,249,487
2009	30.52%	3.38%	24.47%	15.26%	1.74%	\$ 1,176,445,135,548
Total	19.79%	4.62%	17.36%	9.86%	3.91%	\$11,925,694,845,477

The table clearly shows that the QRM definition is extremely narrow and does not define the “mortgage of my parents” (unless they were well heeled) for the majority of homeowners. The definition does in fact produce high quality mortgage loans but also excludes very high quality mortgage loans. The effect of such a narrow definition is the cost to finance a home purchase will be low for those that are the most well-off and higher for the remaining 80%.

The economics of 5% risk retention is an increase of about 25 basis points (0.25%) to the note rate assuming the holder of the illiquid risk retention portion needs to earn about 10%. Given a 5% mortgage market rate and a 10% risk retention yield for a vertical slice, the simple equation $((95\% \times 5\%) + (5\% \times 10\%) = 5.25\%)$ produces a 5.25% mortgage coupon. It appears not that burdensome economically, only about \$31 more on a monthly basis for a \$200,000 loan. But the real impact is that a 25 basis point

increase on that loan is a present value of about \$2,850. That is real money that could be used to pay closing costs, additional down payment or serve as a cushion. (Calculation: DV01 of FNMA 4.5% MBS= 5.7; $0.25\% * 5.7 * 200,000 = \$2,850$; DV01 is a present value statistic that defines the current dollar value of a basis point change in underlying coupon and can be calculated from cash flow models or derived from security prices. It is often referred to as a present value factor).

As a further note, this enriches the holder of the “skin in the game”, which is most probably a TBTF.

So far, the definition is exclusive (20% or so of the market) and expensive to homeowners that do not fit the definition.

Does the QRM define a quality portfolio? It certainly defines a high quality loan. I define a quality portfolio of mortgage loans as a portfolio that over the life of the portfolio meets or exceeds the estimated return expected at the time of investment and has a low volatility of cash flow (read low delinquency, low default).

In Fannie Mae’s most recent 10Q SEC filing, Fannie Mae disclosed performance by book year that illustrates the first half of the definition above with a chart from page 5 and the accompanying text:

Acquisition Year	Expectation for Profitability	Percentage of Single-Family Guaranty Book of Business as of March 31, 2011
1991 to 2000	Profitable	19%
2001	Profitable	
2002	Profitable	
2003	Profitable	
2004	Break-even	
2005	Not Profitable	36%
2006	Not Profitable	
2007	Not Profitable	
2008	Not Profitable	
2009	Profitable	45%
2010	Profitable	
2011 to date (three months)	Profitable	

As Table 1 shows, the key years in which we acquired loans that we expect will be unprofitable are 2005 through 2008. The vast majority of our realized credit losses since the beginning of 2009 were attributable to these loans. Although loans we acquired in 2004 were originated under more conservative acquisition policies than loans we acquired from 2005 through 2008, our 2004 acquisitions were made during a time when home prices were rapidly increasing, and their performance has suffered from the subsequent decline in home prices, which continued in the first quarter of 2011. We currently expect these loans to perform close to break-even, but changes in home prices, other economic conditions or borrower behavior could change our expectation regarding whether these loans will be profitable.

Underwriting guidelines in the industry began a slow retreat in quality starting around 2000 and eroded up until 2008. Not only were guidelines loosened, but many originators became sloppy in verifications of selling representations and even fraudulent activities were accepted by some as part of the business. The only reason that the 2001-2004 portfolios were profitable is that rising home prices bailed out mortgage investors when they foreclosed. The “originate to distribute” model fueled free access to credit for speculative purchases, driving up home prices and increasing the severity of the resulting bubble’s collapse. The 2001-2004 books of business and the post-2008 books have been profitable, without any help from a QRM definition. It is noted that the profitability of the post-2008 books is during a period of declining home prices that continues today and really reflects the tightened standards and verification of the selling representations (value of collateral, income and assets of the borrower, credit standing, etc).

The second portion of the definition deals with volatility of cash flows. A mortgage loan investor is always on the wrong side of a put (an option to sell, in this case the option by the homeowner to refinance). When interest rates rise, the investor is stuck with a discounted, longer dated security and when interest rates fall, the security prepays and the investor is forced to re-invest at a lower yield. This is traditionally caused by interest rate movements. A number of vehicles and tactics are available to the investor to somewhat hedge these effects or to minimize the impact due to changes in voluntary prepayment rates. Prepayment models are readily available.

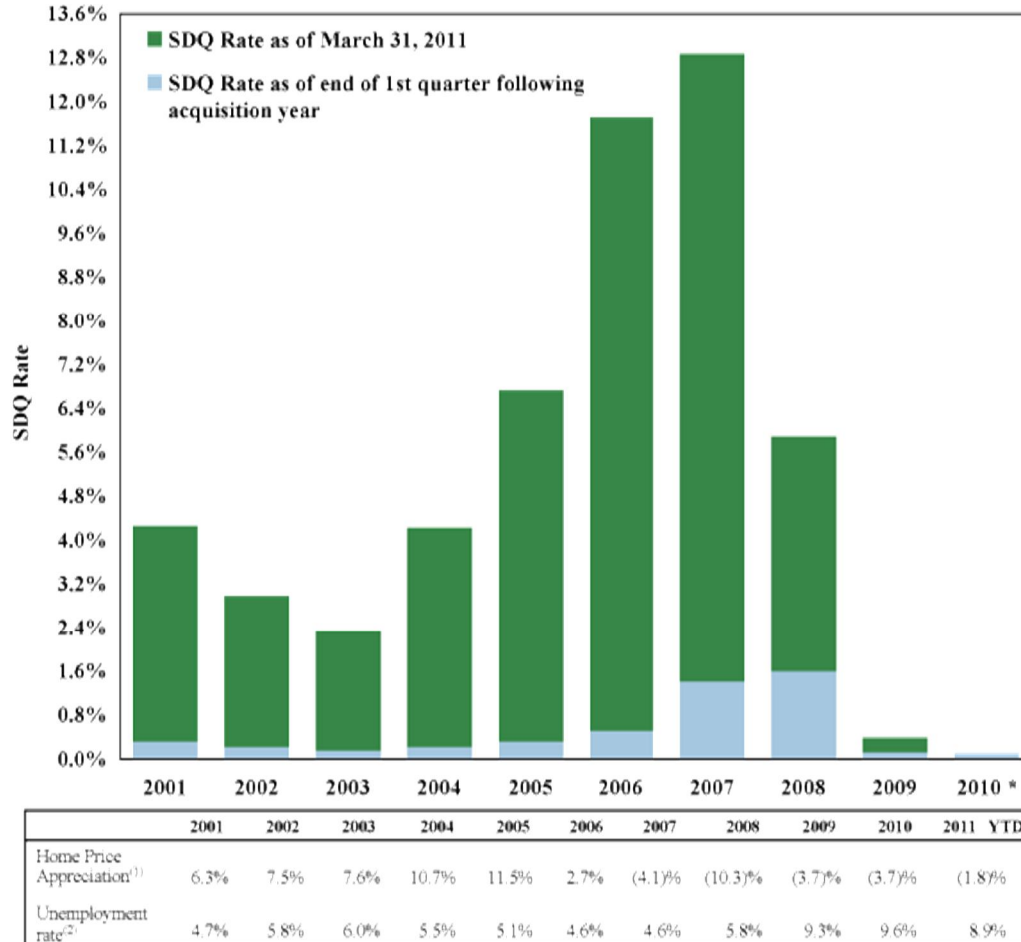
All loan portfolios will have defaults, even a portfolio as narrowly defined as the proposed regulation. People die, become ill, lose their jobs, get divorced, or suffer ill fortune that drives defaults. In a high quality portfolio, the effect of defaults on cash flow is within an expected range that ebbs and flows with the economy but rarely generating a catastrophic occurrence. Poorer quality portfolios have a flatter expected curve with longer, fatter tails. In other words, the investor in poorer quality portfolios is exposed to a greater probability of loss in all scenarios. This means added uncertainty and volatility and hence greater exposure to catastrophic incidence and severity of default losses.

For investors in GSE securities, where the ultimate payment of principal is guaranteed, high defaults merely add unexpected prepayment volatility. In a structured transaction (a transaction that relies on credit support from separate asset classes rather than a guaranty), as has been observed during the current crisis, default volatility was inherently large and the tail risk became all too evident as highly rated securities suffered downgrade and default.

An excellent early predictive statistic for future portfolio performance is the default rate that occurs early in the life of a portfolio. Higher early payment default rates almost certainly predict higher lifetime default rates. As an example of Seriously Delinquent Rates, let’s look at the 1Q2011 Fannie Mae 10Q (page 7):

Single-Family Serious Delinquency Rates by Year of Acquisition

[SDQ are seriously delinquent loans 3 months past due or in process of foreclosure]



* For 2010, the serious delinquency rate as of March 31, 2011 is the same as the serious delinquency rate as of the end of the first quarter following the acquisition year.

⁽¹⁾ Based on Fannie Mae's Home Price Index (HPI), which measures average price changes based on repeat sales on the same properties. For 2011, the data show an initial estimate based on purchase transactions in Fannie-Freddie acquisition and public deed data available through the end of March 2011, supplemented by preliminary data that became available in April 2011. Previously reported data has been revised to reflect additional available historical data. Including subsequently available data may lead to materially different results.

⁽²⁾ Based on the average national unemployment rates for each month reported in the labor force statistics current population survey (CPS), Bureau of Labor Statistics.

The table clearly shows that tightened underwriting guidelines put in place in mid 2008 produced quality books of business for 2009 and 2010, even during periods of home value deflation. The early payment defaults (EPD) in the last two book years implies low loss rates and low loss volatility.

Fannie Mae and Freddie Mac have statistical underwriting engines, Desktop Underwriter and Loan Prospector, respectively. As the subprime market during the buildup years to the crisis prevented each GSE from finding quality loans that met HUD mandated housing goals, the underwriting engines were tweaked to allow goals rich product to be approved. That decision generated poor quality loans without any positive outcome for the homeowners who could not support the loans. This activity appears to have stopped and the engines appear to once again generate valuable results. The quality of these engines has been demonstrated in the recent past.

The above Fannie Mae chart includes loans with LTVs in excess of 80% and all such loans have mortgage insurance. I do not have the data to determine if the presence of mortgage insurance provides a higher quality loan than a high LTV loan without mortgage insurance. I do have experience in “pull through” rates for requests for mortgage insurance (the approval rate for loans submitted by originators for mortgage insurance). These relatively low pull through rates imply a value to the second look underwriting performed by the MIs.

Mortgage Insurers protect their capital by underwriting the exposure with each loan they insure. The underwriting of risk is a serious business and only about 2/3's of the loans submitted receive insurance. The remaining loans are not made; restructured to reduce the risk profile or converted for FHA delivery. That underwriting coupled with the originators' representations and warranties provide the comfort required to place the insurance on that loan. Note that Mortgage Insurance is a contract (the policy) between the insurer and the originator (including all successors). The representations are the originators, not the borrower; the borrower is neither the owner nor the beneficiary of the policy. The insurer relies on the information supplied by the originator.

Current underwriting guidelines coupled with rigorous verification of originator representations create a quality portfolio. The guidelines in place today for sale to the GSEs for loans with an LTV of 80% or less without MI and up to 95% LTV with MI should be the definition of the QRM, which includes the usage of Loan Prospector (LP) and Desktop Underwriter (DU), or many other privately created engines with demonstrated predictive value. These underwriting engines provide clarity of default probability when used in conjunction with traditional underwriting practices (including guideline overlays that include product type, credit score, DTI, etc.) to protect the investor in the credit risk. The maintenance of LP and DU as purely stochastic underwriting engines freed from political manipulation could be a further charge of FHFA oversight, as it probably is today, to maintain the value of these engines for quality loan production.

“Skin in the game”

In the event of a default of an insured loan, someone has serious skin in the game. The mortgage insurer is obligated to pay up to the extent of the policy (on average about 25% of the loan amount) unless it is discovered that a material misrepresentation had occurred in the application for insurance and that had the insurer been aware of such, the insurer would not have insured such loan. This is the cause of a rescission. An MI rescission is based on verification of selling representations and warranties in the loan file. Rescissions occur only after a very thorough due diligence and investigation which includes an invitation to the insured to provide additional information in support of their representations and warranties. The results of these insurance investigations are compelling.

A rescission is the ultimate skin in the game for GSE loans. A loan in which the policy has been rescinded is no longer a legal investment of the GSE and is therefore put back by the GSE to the lender. This completely eliminates the cost of that default to the GSE and the originator that made a misleading representation suffers the entire loss on that loan.

Unfortunately, my experience with ABS and RMBS transactions is not as investor positive. Mortgage insurers routinely share the investigation with the insured. The results of these investigations, again in my experience, should be more than adequate for the Trustee to force a repurchase by the Sponsor. However, it does not appear that the information is ever shared by the servicer and hence not acted upon for the benefit of investors.

The “skin in game” numbers for loans with mortgage insurance are huge. Fannie Mae and Freddie Mac, on a combined basis for the years 2009 and 2010, received \$13.8 billion in MI claim payments. Fannie Mae further reported anticipated future claim payments as of December 31, 2010 of \$16.4 billion. Repurchase activity, measured in unpaid principal balance, for the same two years was \$24.4 billion with outstanding repurchase requests of \$8.8 billion (data from 2010 10K filings for each GSE). This is real “skin in the game” for the originator as well as the insurer. Based on the previous, I recommend that loans with MI up to 95% LTV be included in the QRM definition as such loans have more than the required credit risk retention.

Weaknesses of Credit Risk Retention

Each of the methods for credit risk retention (vertical slice, horizontal slice, hybrid slice) are all various forms of insurance. These are really new businesses for the TBTFs to enter (a new source of revenue and profits) at the expense of the consumer.

The nature of credit risk retention requires balance sheet strength and therefore favors institutions with considerable capital. The largest players in the mortgage market today are also the same institutions defined as Too Big to Fail. The consolidation of the mortgage business presents risks that are further exacerbated by this requirement as only these institutions can produce, sell and hold risk retention in the riskier portion of the mortgage market. These banks already have substantial mortgage portfolios and will continue to retain the best loans. The riskier, non-QRM loans will be sold, premium rates will be charged and the 5% retention will be held at higher risk premiums than occurs today.

The vertical structures (5% across the issued securities and a 5% random selection of similar loans) are just an investment decision. Both positions are illiquid and will require a liquidity premium. I am sure that a selection process could generate “average” statistics to match very nicely with the issued security but will always outperform. The straight vertical slice on 5% of risky assets sold into the market is minimal expense for shedding mistakes. The retained assets will probably be profitable in any event as the Sponsor will require excess yield to cover liquidity and then some.

Sponsors of ABS transactions have always held the bottom, toxic asset as a residual. The hope was to earn enough cash to make money on this position (plus all of the fees generated) before it completely dissipated. This was the skin in the game that caught dealers at the start of crisis (Bear, Lehman, the list goes on).

This horizontal position can be profitable. Look at a successful deal issued during the depth of the securities crisis, the Sequoia Trust 2010-H1. The collateral carried a weighted average coupon of 4.803%

on \$237.8 million in collateral. Bonds of \$230.7 million were sold at a pass through rate of 3.75%. The Depositor retained the credit through subordination of about \$7.1 million. The gross current cash flow yield on the retained portion, given the rates on the collateral and the bonds, is a comfortable 39%. The retained credit risk at a sufficiently high interest cash flow creates a premium like flow for the retained risk. In good times, mortgage insurance style investments can be very profitable, especially if they can transacted without insurance capital requirements, contingency reserves, state oversight or payment of premium taxes. This is a great business with high quality assets that fall outside of the QRM.

The example above illustrates the value of capital arbitrage between different capital regimes. Given that difference, the new issue REIT market is the current hot spot in housing finance.

TBTF capital requirements under Basel III would be punitive when holding a pure first loss position. The hybrid idea (2.5% vertical, 2.5% horizontal) is merely a push to generate a smaller capital restrictive first loss account. Historically, 2%-4% was needed in front of any bonds that were then sold. This option caters to the higher quality collateral that does not require a large first loss account and that can be held by the TBTF at lower capital investment.

ABS Goal Misalignment with Investor Interests

In the absence of oversight, mortgage loan originators will do whatever it takes to close a loan (QRM or not QRM). A large portion of GSE originations are extremely clean since originators know that they will be audited and that failure to make accurate representations and warranties will result in an expensive repurchase (or worse, loss of approval). The ABS markets do not have this feedback loop.

Servicers theoretically are agents of the investor. The vast majority of mortgage backed ABS are serviced by the same company that originated the loans. While the investor is feeling assured given the Pooling and Servicing Agreement, the servicer is not aligned with the investor. The GSE loans were higher quality than the ABS market collateral. The GSEs pushed huge quantities of loans back to the originators (see previously referenced numbers) due to representation and warranty violations. Similar numbers of repurchases in the ABS market are absent. The servicers do not investigate loans that would cause their parent financial loss.

Trustees are also in on the support of the Sponsors. The Sponsor is the entity that hires these businesses for each of their transactions. Any Trustee that is known as “activist” knows that they will not get any new business and hence none ever look too closely at the collateral, hiding behind the servicers. Also, trustee fees have been declining for a decade. Trustees do not have the ability to perform the required investigations to put back loans and are not even required in most agreements to do anything other than perform investor reporting based on reports from the servicer (or Master Servicer). Investors should not rely on the Trustee to align with the investors’ best interests.

Reference my previous comments on MI rescissions. Rescission events should be positive events for the investor as these are the only events in which the collateral’s representations and warranties are vigorously examined. An MI rescission should result in repurchase at the unpaid principal balance of the defaulted loan by the Sponsor, making the investor whole.

The same goal misalignment exists from due diligence providers. During the buildup to the crisis, many talented and well meaning companies provided loan level due diligence for ABS Sponsors. The Sponsors selected and paid the due diligence firm. These vendors were incented to find few problems. When

problems were found, the Sponsor frequently made an “exception” to allow the loan in the security. This increased the size of the security (increased fees) and disposed of a problem loan while the Sponsor was protected from repurchase due to Servicer and Trustee insulation.

The ABS markets need some level of believable collateral due diligence at the inception of the deal and a separate company to investigate defaults during the first 3 to 5 years of every deal. These companies need to be paid from deal proceeds or interest strips in an amount adequate to perform a thorough task and to report independently to the Trustee and the Investor. An excellent model for both can be found in the mortgage insurance business. Front end due diligence and default investigation are both key attributes. I believe that had the ABS market been able to investigate and force repurchase due to failed representations and warranties, the AA rated and above investors would not have suffered any principal losses.

Summary

The best definition of a QRM loan would encompass current loan production practices using origination underwriting models plus traditional underwriting methods with fully documented loans as required under the proposed current QRM definition (as well as the QM). Loans up to 95% LTV with mortgage insurance need to be included as they already have both enhanced quality and considerable risk retention backed by private capital. A broad definition for a QRM would limit the use of retained credit enhancement arbitrage by the TBTFs to truly risky loans. Some form of investor alignment needs to be in place so that the cabal of misaligned structural players can be defused.

If you have any comment, question or ideas, please do not hesitate to request my contact information at TAfultz@aol.com.

Best Regards,

/s/

Tom Fultz