**Meeting Between Federal Reserve Board Staff**
**and Andrew Davidson & Co., Inc. (Davidson)**
**October 5, 2010**

**Participants:** Andreas Lehnert and Flora Ahn (Federal Reserve Board)

Andrew Davidson (Davidson)

**Summary:** Staff of the Federal Reserve Board met with Mr. Davidson to discuss credit risk retention and the Federal Reserve Board's responsibilities under Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Mr. Davidson presented on his overall views on risk retention and mortgage securitizations. A copy of the handout provided by Mr. Davidson at the meeting is attached below. The handout formed the basis for discussions at the meeting and summarizes the issues discussed.

Discussion Topics
October 5, 2010.

1. Structuring of Explicit Guarantee
    a. Structure
        i. Use of Senior/Subordinate Structure
        ii. Government Guarantee is only on Senior Bond
        iii. Utility provides a limited guarantee on Senior Bonds
    b. Subordinate bond alternatives
        i. Retained by the utility
        ii. Sold into market
            1. With utility guarantee
            2. Without utility guarantee
    c. Rationale
        i. Government guarantee provides liquidity to MBS market
        ii. Government is protected by subordination and utility guarantee
        iii. Reduces requirement that government accurately assess capital requirements for utility as the subordination can provide an additional cushion.
        iv. Non government guaranteed subordinate bonds offer several advantages
            1. can be used in part as risk retention for the utility
            2. if sold into market, decrease cost of mortgages vs. equity
            3. if sold into the market, increase price transparency
        v. Subordinate bonds without utility guarantee (or other forms of reinsurance) decrease risk to the utility while not increasing risk to the government

2. Role of Cooperatives
    a. Advantages of cooperative structure
        i. Monitor performance of other members
        ii. Originators are the source of capital
        iii. Operate on an at-cost basis, or keep profits in industry, where they can be competed away
        iv. Generally take less risk
    b. Disadvantages of cooperative structure
        i. Resolving conflicts between large/small players
        ii. Slower to innovate
        iii. Harder to attract outside capital

3. Mortgage Market Structure
    a. Who holds mortgages?
        i. What products?
        ii. How much equity do they hold against risks?
    b. What was their pathway/channel to those investors? Examples:
        i. GSE debt is pathway to foreign investors
        ii. Guaranteed MBS is pathway to mutual funds
        iii. Private securitization is pathway to insurance companies

4. Risk Retention
    a. Mortgage Risks
        i. Term funding (liquidity)
        ii. Interest rate
            1. Duration
            2. Convexity
            3. Curve shape
        iii. Prepayment
            1. Systematic (Turnover, refinancing)
            2. Surprise (model error)
        iv. Credit
            1. Systematic (home prices, employment)
            2. Origination (faulty underwriting, fraud)
            3. Surprise (model error)
    b. Approaches to risk retention
        i. Vertical slice
        ii. Horizontal slice
        iii. L-shaped
        iv. Reps/Warrants
    c. Analysis
        i. Reps and Warrants backed by capital provides best mechanism to limit origination risks
        ii. Adding a penalty (beyond repurchase) increases effectiveness of Reps and Warrants
    d. Proposal
        i. "Origination Certificate" is a guarantee of reps and warrants created by originator that travels with the loan.
        ii. Certificate is backed by capital requirements or surety bond
        iii. Reporting of rep/warrant claims against originators
        iv. Origination Certificate would also provide a guarantee to borrowers and negate the need for assignee liability