REDWOOD
TRUST

ONE BELVEDERE PLACE, SUITE 300
MILL VALLEY, CALIFORNIA 94941

January 16, 2024

SUBMITTED ELECTRONICALLY AND VIA E-MAIL

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551
regs.comments@federalreserve.gov

James P. Sheesley, Assistant Executive Secretary
Attention: Comments/Legal OES (RIN 3064-AF29)
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429
comments@fdic.gov

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, D.C. 20219

RE: Notice of Proposed Rulemaking ("NPR") – Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity ("Basel Endgame")
Dkt. No. R-1813, RIN 7100-AG64 / RIN 3064-AF29 / Dkt. ID OCC-2023-0008

Ladies and Gentlemen:

Redwood Trust, Inc. ("Redwood") appreciates the opportunity to share our views with the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC" and, together with the Board and the FDIC, the "Agencies") in response to the above-referenced NPR.[1] We applaud the Agencies for the desire to implement sensible bank capital standards and strengthen the safety and soundness of the U.S. banking system.

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[1] *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*, Office of the Comptroller of the Currency, Federal Reserve System, and FDIC, 88 Fed. Reg. 64028, Sept. 18, 2023, *available at* https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf.

We begin by noting that while Redwood is not a bank, we are a publicly-traded company with 30 years of experience in underwriting, pricing and investing in the types of residential mortgage loans that many of the U.S.'s largest banks originate and hold in portfolio. We serve as an important source of liquidity to close to 200 bank and non-bank mortgage originators. Through all economic cycles during our firm's history, we have purchased over $65 billion of residential mortgage loans and completed approximately 125 private-label securitizations, acting as a conduit for capital to efficiently flow from fixed-income investors to U.S. homeowners. Through our role as a liquidity provider to this market, and in line with our mission of making housing more accessible to all American households, we advocate for policies we believe will benefit consumers, strengthen the housing finance system and promote prudent and risk-based pricing, enabling this market to responsibly meet the financing needs of all consumers. Given Redwood's significant role in the housing ecosystem, any primary and secondary effects of the rulemaking on mortgage markets and mortgage lending are deeply important to us.

The failures of large regional banks in early 2023 were, by definition, an indication of excessive risk taking by certain institutions that manifested through mortgage pricing strategies – particularly mortgages made in service of wealthier bank clients – that were not market-based. As a non-bank, Redwood must provision capital for its business and structure its balance sheet without access to the Federal Reserve, the Federal Home Loan Bank system, the U.S. Treasury, or other forms of government-supported liquidity. Our portfolio operations must continually utilize risk-based pricing processes when owning mortgages, and account for a range of possible downside scenarios in evaluating the adequacy of our capital, including its callability, and its liquidity in response to exogenous market events. Irrespective of one's funding structure, the 30-year residential mortgage in the United States is a unique and complex product relative to products offered by banks in most developed nations, and therefore should command prescriptive rulemaking that takes into account the unique risks.

History has shown that it is not in consumers' long-term interests for banks (or, for that matter, non-banks) to operate their mortgage origination platforms in a manner that results in excessive risk taking and creates systemic risks within the U.S. financial services sector. Through that lens, we support the intention of the NPR as it relates to ensuring banks operate with a safe amount of capital when originating and/or holding in portfolio long-duration residential mortgages.

However, we believe changes to capital requirements should be as targeted and specific as possible in order to mitigate unintended consequences, and we encourage an in-depth deliberative process with key bank and non-bank stakeholders, including thorough quantitative analyses. In particular, we encourage the Agencies to focus on the operational risk capital calculation, given its widely encompassing nature and potential to impact both primary and secondary facets of mortgage lending and/or servicing.

With the help of feedback received through this rulemaking process, we believe that the Agencies can define sensible enhancements that account for the risks banks face when originating and holding residential mortgages without having a material impact on homebuyers and homeowners in the United States.

* * *

EXECUTIVE SUMMARY

In this submission, we provide our perspective on the portions of the proposed rules most pertinent to our role as a leading non-bank participant in the U.S. residential mortgage finance system. The content of this Executive Summary is supported by data provided in the body of this comment response.

- We begin with commentary on those whom the NPR would most directly impact – namely, large banking organizations with greater than $100 billion in assets.
  - Within this cohort, we estimate that only 25 are active in residential mortgage lending, with fewer still considered to be significant mortgage industry participants.
  - The proposed new capital requirements impact risk weightings on residential mortgages that these banks hold in portfolio and, via operational risk capital metrics, fees earned through mortgage origination and servicing and other related revenue-generating activities.
    - Most residential mortgages that banks hold in portfolio carry low loan-to-value ratios and are made to consumers with very high credit scores. The proposed rules would not appear to have much, if any, impact on risk weights associated with these types of loans. And while much has been made of the NPR's potential impact on bank lending to low- to moderate-income consumers, the fact remains that the majority of mortgage loans held on balance sheet by larger banks are to high credit quality customers.
    - The proposed operational risk rules, however, may influence how banks price the wholesale funding they provide to non-bank market participants, something that bears closer analysis given the key role non-banks play in this important part of the mortgage market.
- Unlike the Great Financial Crisis, the 2023 regional banking crisis was precipitated by issues with interest rates and the associated durability of funding, not fundamental problems with home values or consumer credit. This recent episode underscored that while residential mortgage loan delinquencies have remained low, many banks may remain exposed with respect to their residential mortgage portfolios due to core asset/liability mismatches and a lack of effective interest-rate hedging.
- While we agree that – broadly speaking – higher capital requirements are prudent, we hope an output of the Agencies' work is recognition that many residential mortgage loans in banking portfolios were not only unhedged, but also not originated to meet standards beyond those of their own deposit-funded portfolios. Banks are best-served to lend at market-based terms and pursuant to underwriting standards that meet the needs of arms-length capital partners. The depth and sophistication of private capital – including capital flowing through the private-label securitization market – is more than sufficient to meet the needs of consumers that banks have traditionally served through balance-sheet lending activities, and banks should originate loans on terms and under standards that facilitate the acquisition or long-term funding of their originations by this private-sector capital.

- Even as the NPR remains out for comment, we at Redwood are actively purchasing loans from banks seeking to build capital partnerships for their go-forward mortgage production. This is a healthy development for the market in our view.

- Aided by several years of record profits, the U.S.'s largest banks have capacity to absorb additional costs associated with participation in this market without passing them along to the homeowner, while still profitably helping ensure an efficient and liquid private market for the origination and distribution of residential mortgages.

- Elements of the NPR promote a safe and sound banking system by addressing unique risks faced by participants in U.S. mortgage markets.

    - Had they been in place, enhanced mortgage capital rules like those set forth in the NPR may have helped avert – or at least cushion – the 2023 regional banking crisis.

    - The NPR proposes a graduated framework that, like the Basel III framework itself, requires large banks to reserve more capital against riskier assets. In our view, this tailored approach is sensible and an improvement over the current system, under which virtually all residential mortgage loans, regardless of risk profile, are assigned the same risk weight.

    - However, the NPR also proposes an operational risk capital calculation that ascribes higher capital charges to higher revenue business lines, likely impacting fee-generating activities within residential mortgage finance, which warrants close further examination.

- Over the past decade, banks have ceded an increased share of residential mortgage lending, most notably in loans eligible for government-backed funding – a sector of the market through which the majority of low- to moderate-income consumers procure funding to buy a home. However, banks remain a critical source of wholesale funding to the market's non-bank participants to support both origination and ongoing servicing activities that help support consumers in acquiring and remaining in their homes.

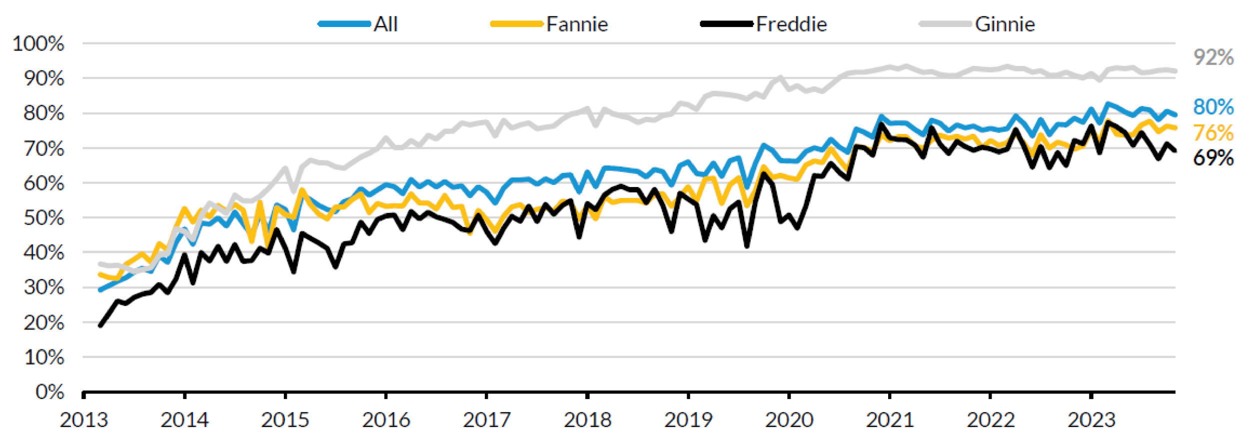
    - As noted, elements of the proposed rule that impact capital held against fee revenues – particularly for higher-volume businesses like residential mortgage banking – should be carefully considered through this lens.

* * *

I. PRIVATE CAPITAL IS EQUIPPED TO MEET MARKET NEEDS.

Should the pertinent elements of the proposed rule ultimately be established for the largest U.S. banking institutions, we believe that the U.S. mortgage market will continue to look and function largely the same as it does today, though with a leveling of the playing field that may shift the composition and scale of market participants.

During the first half of 2023, non-banks originated approximately 80% of total GSE- and Ginnie Mae-eligible U.S. residential mortgages.[2] Market share estimates indicate that "large banking organizations" that would be subject to the NPR originated approximately half of the remainder, or 10%, of these mortgages. Specifically, non-banks originated 76% of all Fannie Mae-eligible conforming mortgages, 69% of all Freddie Mac-eligible conforming mortgages, and over 90% of Ginnie Mae-eligible mortgages, helping the market continue to function smoothly while the banking sector reckoned with the high-profile failures of three large regional banks. Additionally, private capital markets have continued to provide ample liquidity for non-conforming loans or those less efficiently priced by the GSEs, even in volatile market periods like 2023.



Sources: eMBS and Urban Institute.

Notwithstanding this trend, banks remain large and significant participants in mortgage markets. The U.S. residential mortgage market totals close to $13 trillion in total outstanding mortgage debt, with banks holding an estimated 20% of these loans on balance-sheet[3] and comprising an estimated 35% of residential servicing volume.[4] However, the role of large banks has evolved in important ways, with several either exiting key origination channels or residential mortgage lending altogether over the past several years.

Akin to when Fannie Mae and Freddie Mac began issuing credit-risk transfer transactions over 10 years ago, this evolution has provided private capital and non-bank lenders the opportunity to establish themselves as a reliable source of liquidity and operational soundness. While the GSEs have pivoted to being more opportunistic in how and when they issue credit-risk transfer bonds – notwithstanding

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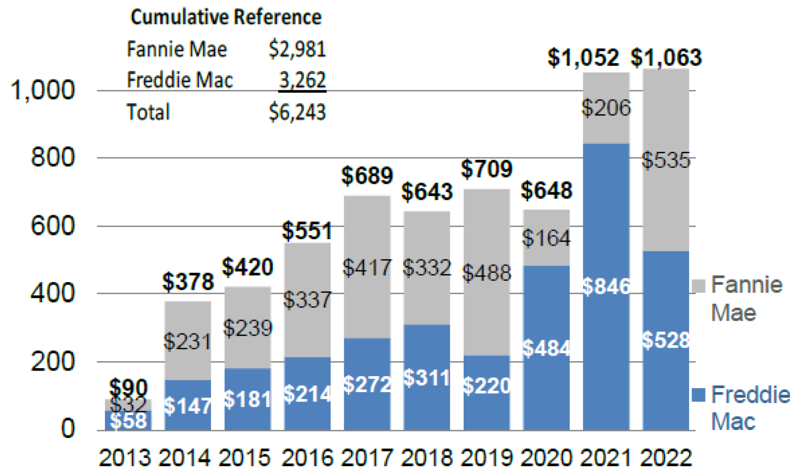
[2] *Housing Finance at a Glance: A Monthly Chartbook*, Urban Institute Housing Finance Policy Center, December 2023.

[3] Unsecuritized first liens. *Housing Finance at a Glance: A Monthly Chartbook*, Urban Institute Housing Finance Policy Center, December 2023.

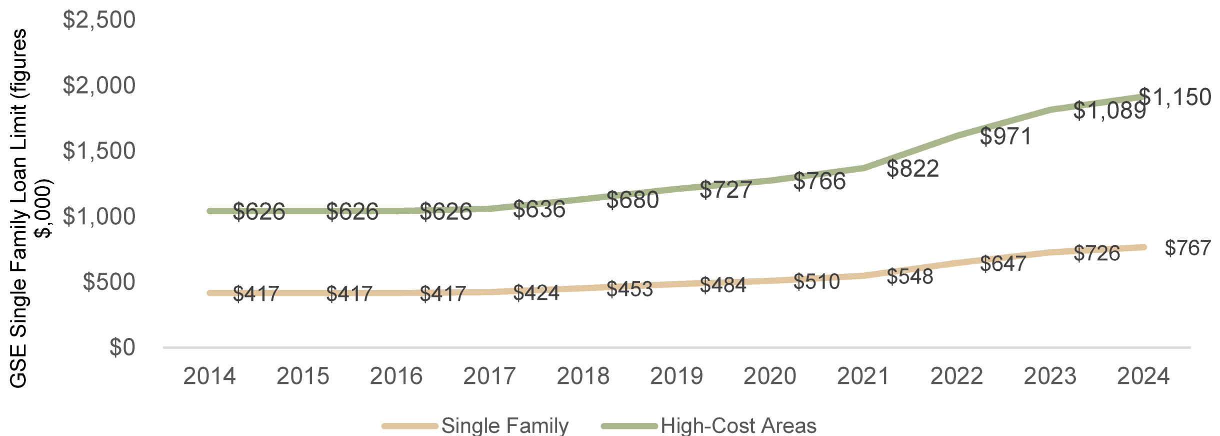
[4] Percentage estimate based on top-10 residential mortgage servicers. Source: SNL Financial, company filings, Inside Mortgage Finance as of Q2 2023.

the fact that the GSEs now routinely purchase loans with balances in excess of $1,000,000 – the success and overall liquidity of their CRT issuance programs are evidence that private capital has the depth and sophistication to provide reliable liquidity through market cycles. As illustrated below, since 2013 private capital has supported CRT transactions referencing over $6 trillion of GSE originations.

GSE CRT Activity



GSE-Conforming Loan Size Limits



Meanwhile, non-banks have been rising to the occasion to meet the market and ensure qualified consumers are not left with unmet financing needs. Since at least 2013, non-banks' share of originations has steadily increased. During 2023, the non-bank sector again demonstrated its ability to "pick up the slack" as banks dealt with declining deposits and asset-liability management challenges during and after the regional banking crisis. The non-bank sector provided the necessary stability to ensure a properly functioning market.

Despite protestations to the contrary, we believe the NPR would not significantly impact lending to low- to moderate-income ("LMI") or underrepresented borrowers or communities. As noted, non-banks have been handling a much larger share of lending to these borrowers and communities for years. Ginnie Mae-guaranteed loan products, for example, are disproportionately relied upon by LMI and minority borrowers. As of November 2023, non-banks were responsible for ***92%*** of Ginnie Mae-eligible originations.[5] With respect to the government-backed sector in particular, banks have largely moved away from making Federal Housing Administration-eligible loans, which are more costly to originate and service and pose key compliance challenges, effectively rendering them less profitable.

This is not to say that banks do not lend in these communities. Based on blended HMDA and other lending data, a report by the Urban Institute estimates large banks made 18% of their loans during 2021 and 2022 to LMI borrowers (28% of loans with LTVs above 80%).[6] The report also estimates those banks made around 14% of their loans during the same period to Black or Hispanic borrowers (22% of their higher-LTV loans). However, the substantial majority of the loans banks make to LMI and minority borrowers are originated for sale into conventional GSE or government-backed channels, not held in portfolio. And since the bulk of bank lending to these communities is promptly sold off, the real impact, if any, on such lending would result from operational risk capital requirements rather than increased capital requirements for portfolio holdings. Again, we recommend the Agencies closely review how the NPR's operational risk capital charges might impact banks' GSE and government-backed mortgage origination activities.

II. THE PROPOSED RULEMAKING APPROPRIATELY RECOGNIZES THE UNIQUE STRUCTURE OF THE U.S. RESIDENTIAL MORTGAGE MARKET.

While Basel III long predates the failures of Silicon Valley Bank, Signature Bank, and First Republic Bank, the 2023 regional banking crisis serves to highlight the need for prudent capital reform. As stakeholders weigh in on bank capital requirements, we should remind ourselves that just ten months ago markets witnessed the failure and placement into FDIC receivership of these three institutions, each of which had greater than $100 billion in total assets. Postmortem reports on all three banks cite, among other problems, failures to properly manage interest-rate and liquidity risk coupled with an overreliance on uninsured deposits. When the banks' liquidity sources became unstable, their mortgage assets were trading significantly below face value and could not be sold without sustaining heavy losses or, in many cases, were not salable at all due to origination defects such as incomplete loan files.

Large banking organizations have enjoyed record profitability in recent years. Shareholder returns among large banking organizations stand at, or near, their highest levels in decades—indeed, the fourteen largest U.S. banks earned over $42 billion of net income (profit) during the third quarter of 2023 alone, with industry net interest margins still hovering over 300 basis points.

Banks are for-profit entities and entitled to generate strong returns. We would argue, however, that such strong results leave room for banks to hold more capital against certain elements of their businesses without passing costs along to consumers, including more robust interest-rate hedging regimes (a topic not directly addressed in the NPR) or more durable loan distribution strategies. An inherent part of the profitability equation for banks are relatively inexpensive retail deposits and federally supported, low-cost borrowings through the Federal Home Loan Banks ("FHLBs"). As of

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[5] *Housing Finance at a Glance: A Monthly Chartbook*, Urban Institute Housing Finance Policy Center, December 2023.

[6] Goodman and Zhu, *Bank Capital Notice of Proposed Rulemaking: A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios*, Urban Institute, September 2023.

September 30, 2023, the top five large bank borrowers from the FHLBs had $165 billion in outstanding FHLB borrowings, with the top ten having close to $250 billion.[7] These are key tools that provide large banks the capacity to absorb costs and source attractively priced borrowings, if needed, were capital requirements to increase. The capacity to absorb costs is not infinite, but likely sufficient to avoid passing material cost increases to consumers.

Regardless of which loans large banks are retaining in portfolio, these organizations enjoy broad access to the U.S. capital markets, through a variety of channels, to sell or match-fund their loan holdings rather than fund them with demand deposits. This includes access to securitization markets, low-cost secured or unsecured long-term debt, or bulk sales of whole loans. Several large banks have in place their own securitization issuance platforms, enabling them to package loans for structured sale to the private credit sector. Those banks that do not possess in-house securitization capabilities have access to other secondary market mortgage conduits, such as Redwood's, that aggregate loans for the private securitization market.[8] Through multiple economic cycles, the private securitization market has demonstrated its ability to expand and contract, readily absorbing excess supply to counterbalance fluctuations in mortgage rates.

Importantly, non-banks have capacity to process and securitize additional loan volume. In recent months, many banks have already begun working with non-bank mortgage conduits, like Redwood's, to build necessary processes and procedures into their lending practices to be able to sell bank-originated product to the private secondary market. As exemplified by the regional banking crisis in 2023, portfolio origination practices had saddled many large banks with significant portfolios of loans not readily salable because of deficiencies in underwriting and origination, such as incomplete loan files. To sell loans through securitization ultimately involves a number of gatekeepers to ensure robust documentation and pricing rigor – including due diligence providers, rating agencies, underwriters and, of course, bond investors themselves. If nothing else, we hope that analyzing the events of last spring has caused both banks and non-banks alike to become nimbler in navigating sources of liquidity and in appropriately pricing risk, which will ultimately lead to a more robust secondary mortgage market and a safer banking system overall.

In addition, many opponents of the rulemaking have taken issue with what they refer to as "gold-plating," or the fact that the risk weights applicable to U.S. mortgage assets are comparatively higher than those adopted in other jurisdictions such as Europe. While we also caution against regulatory overreach, we would note that U.S. and international mortgage markets have very little in common in terms of product offerings and risk-taking. U.S. residential mortgage markets are unique the world over, something that can be attributed to the size and scope of U.S. housing markets, how U.S mortgages are funded, and the predominance in the U.S. of the fully prepayable, 30-year fixed-rate mortgage.

European mortgages are primarily shorter-duration (*e.g.*, 15- or 20-year), floating-rate products. Those European mortgages that include a fixed-rate feature often convert to floating-rate debt after only a small portion of the loan's term (*e.g.*, 3-5 years). In Europe, when interest rates go up, a homeowner's mortgage rate generally does too. Because of this distinction, banks in floating-rate markets are better

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[7] American Banker, *20 U.S. Banks with the Most Borrowings from FHLBs* (Dec. 2023), available at: https://www.americanbanker.com/list/20-u-s-banks-with-the-most-borrowing-from-federal-home-loan-banks-at-the-end-of-q3

[8] In fact, Redwood actively dialogues with more than half of the 20 largest U.S. banks (by total assets) regarding potential mortgage loan purchase/sale transactions.

able to match-fund mortgage lending with retail deposits and do so with a much lower level of overall interest-rate risk.

In contrast, the U.S. 30-year, fixed-rate mortgage, which is generally prepayable at any time, is a complex financial instrument and substantially more difficult to effectively hedge or price, making match-funding U.S mortgages via securitization more prudent. The U.S. RMBS market is the second-largest fixed-income market in the world, in large part because of its unique GSE securitization programs. In Europe, RMBS are much less frequently used to finance mortgage lending, with banks relying more on retail deposits and covered bonds. Covered bonds typically remain on bank balance sheets as secured senior debt, are backed by dynamic asset pools, and are regularly evaluated to ensure investors remain overcollateralized—*i.e.*, covered bonds have very little in common with U.S. RMBS.

III. THE ROLE OF BANKS IN THE RESIDENTIAL MORTGAGE MARKET HAS EVOLVED SINCE THE GREAT FINANCIAL CRISIS; THE AGENCIES SHOULD CLOSELY EXAMINE ANY POTENTIAL IMPACTS OF THE NPR ON BANK WAREHOUSE LENDING.

As discussed above, non-banks currently are responsible for a meaningful majority of U.S. residential mortgage originations. Of banks' share of mortgage originations, the vast majority of loans are sold directly to the GSEs or other government-backed programs, usually within days of origination. Out of the multiple trillions of dollars in outstanding U.S. mortgage debt, the share of bank portfolio holdings has been in decline for decades, falling from around 40% in 1990, to 30% in 2000, 25% in 2010, and remaining somewhere in the range of 20-25% since. Today, the residential mortgage loans banks keep on balance sheet are typically high-balance, low-LTV loans to more affluent banking clients with high FICO scores. Recent data from the top-20 largest U.S. banking organizations that report on portfolio holdings (approximately 15), suggest that the largest banks are holding loans with a weighted-average FICO score of around 760 and weighted-average LTV around 70% at origination. Such lower-LTV portfolio loans would not be subject to higher risk weighting (and may, in fact, be subject to lower risk weighting) under the NPR.

However, large banks are significant providers of warehouse financing to the mortgage industry, and the NPR's impact on such lending activities will be critical to the health and wellbeing of U.S. mortgage markets. As non-bank origination share has grown, banks' role in funding the activities of non-banks has become increasingly critical to the overall functioning of mortgage markets. If warehouse lenders and mortgage originators see significant cost increases in wholesale financing through higher borrowing costs from banks or the need to procure alternative sources of more costly financing, borrowers downstream are far more likely to feel a cost impact. As such, we encourage the Agencies to focus on the potential impact of the NPR on the bank lending footprint to non-bank market participants.

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We appreciate the opportunity to provide our views and commentary in response to the NPR. Should you have any questions or desire clarification concerning the comments we have provided here, please do not hesitate to contact me at 415-384-7373.

Sincerely,

/s/ Christopher J. Abate
Chief Executive Officer,
Redwood Trust, Inc.