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