

**Meeting Between Federal Reserve Board Staff  
and Representatives of Redwood Trust (Redwood) and Falcon Capital Advisors (Falcon)  
October 7, 2010**

**Participants:** Joseph Nichols, Matthew Eichner, Lawrence Rufrano, Andreas Lehnert, William Treacy, Sean Chu, April Snyder, Sebastian Astrada, and Flora Ahn (Federal Reserve Board)

Marty Hughes (Redwood) and Armando Falcon (Falcon)

Staff of the Federal Reserve Board met with representatives of Redwood and Falcon to discuss mortgage-backed securities and the Federal Reserve Board's responsibilities under Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Representatives of Redwood and Falcon provided Federal Reserve Board staff with a presentation of the various structures of mortgage-backed securities and their overall views on risk retention requirements and the private mortgage-backed securities market. A copy of the handouts provided by Redwood and Falcon at the meeting is attached below. The handouts formed the basis for discussions at the meeting and summarize the issues discussed.



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## **A Redwood Trust Whitepaper: Essential Steps to Rebuilding the Private MBS Market**

### **Executive Summary**

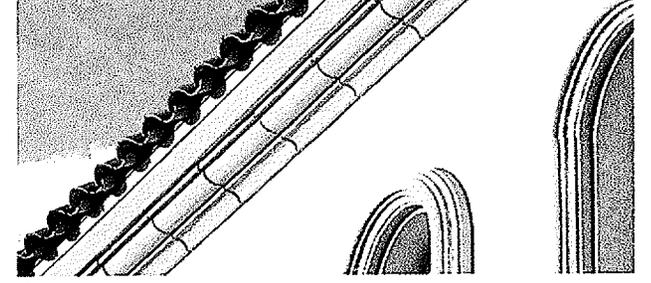
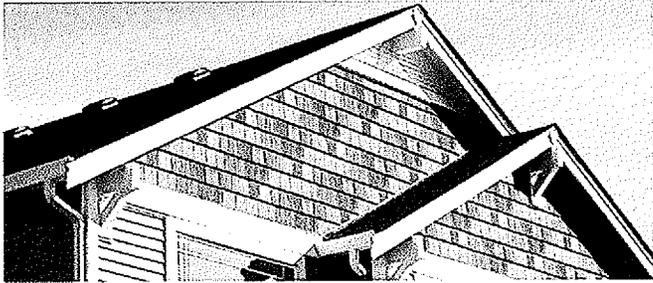
The debate on how to best reform our nation's housing finance system often begins with a broad philosophical discussion of the appropriate role of the government in the mortgage market. As a practical matter, there are no options to debate – without private market reforms the government will continue to finance nearly all new mortgage originations indefinitely. That outlook results in a great financial burden on taxpayers that will not change until private investors regain sufficient confidence in mortgage assets and once again invest in mortgage-backed securities (MBS) without a government guarantee of any kind.

Redwood Trust, an issuer and investor in MBS, has held many market reform discussions with private investors and other stakeholders in the MBS market. We firmly believe that private capital will begin flowing into the non government guaranteed mortgage market at a strong and confident pace if the following reforms are supported by policymakers:

1. Promulgate National Underwriting Standards For Residential Mortgage Loans Securitized by Non-Government Entities. The national standards should only apply to certain minimum requirements in the non government guaranteed securitized mortgage market, such as down payment amount, documentation and verification requirements, but should not be so overly prescriptive as to restrict mortgage innovation.
2. Enact a Federal Standard on Deficiency Judgments. A uniform federal law that governs mortgage borrower recourse and preempts all conflicting state laws would protect investors from “strategic defaults”, and reduce loan costs to all borrowers while permitting those with real financial need to still seek bankruptcy protection.
3. Adopt Minimum Standards and Restrictions on Home Equity Loans. Protect first-lien holders on single-family homes by prohibiting second-lien mortgages that would result in a combined loan-to-value ratio (LTV) in excess of 80%, unless consent for a higher LTV is subsequently given by the first-lien holder. If no consent is given, the home equity lender could always unilaterally refinance and hold the first-lien on the property.

4. Require Meaningful Risk Retention in the form of First Loss “Horizontal” Risk for Private Sponsors of Residential Loan Securitizations. Risk retention in the form of a “vertical” slice of risk does little to bolster investor confidence in the quality of the mortgages in the MBS pool. The percentage risk retention should vary with the risk of the mortgages, rather than be set at a constant “one size fits all” number.
5. Adopt Uniform Standards for Reliable Representations and Warranties. The standards should provide an investor with the ability to investigate potential claims through ready access to loan files, include an arbitration mechanism that is an efficient way to deal with conflicts, and establish some reasonable assurance of financial recovery on valid claims.
6. Establish Uniform Standards Governing Servicer Responsibilities and Conflicts of Interest. Recent events have demonstrated the critical need for clarification of a servicer’s obligations and the situations that constitute a prohibited conflict of interest.
7. Allow for a Longer Transition Before Implementing Rating Agency Liability. Mortgage market participants need additional time to either adapt to a new world without credit ratings or accept the cost of increased fees by rating agencies to cover their increased liability. In the interim, investors should be able to invest in transactions where ratings are provided outside of a prospectus at a reasonable cost that will not render securitizations uneconomic. If the SEC extends its no-action letter for two years, the market should have time to resolve the rating agency issue without significantly disrupting the asset-backed securitization markets.
8. Future Government Interventions in the Mortgage Market Should be Preceded by a Full and Public Assessment of the Impact on Investor Rights and Confidence. The legal rights of mortgage investors must be considered and protected in order to attract efficiently priced capital back into the private securitization market. Recent government policies and actions have subordinated investors’ rights in the pursuit of near-term social and economic stabilization. However well intentioned, these policies may have long-term consequences on the availability and affordability of mortgage credit in the United States. An impact assessment has wide precedence in government policy and should be employed in this vital sector of our economy.

In conclusion, we are optimistic about the potential for private sector capital to once again help finance the housing needs in the US without the need for government subsidies. However, the recovery of the private mortgage market will happen much more quickly with the support of government policies in the areas described above. We cannot wait with false hope that economic forces alone will rebuild this vital market.



# RISK RETENTION



## IMPLEMENTATION CONSIDERATIONS

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## Risk Retention - The Goal



- The goal of risk retention should be to protect investors from unsafe, risky behavior by originators and securitizers
  
- Risk retention requirements need to balance this goal with
  - Maintaining the availability of mortgage credit to borrowers on attractive terms and
  - Promoting a fully functioning private securitization market

## Risk Retention – Step One Is to Define a “Qualified Mortgage”



### Qualified

- Prime credit quality
- Fully underwritten and documented
- Minimum 20% down payment
- 15/30 year fully amortizing fixed rate
- Longer duration hybrids?

### Non-Qualified

- Non-prime credit quality
- Reduced documentation
- Less than 20% down payment
- Interest-only
- Shorter duration hybrids?

## The Method and Amount of Risk Retention are Critical



- ▣ **The method and amount of risk retention should deter risky behavior and the “penalty” should fit the “crime”**
  
- ▣ **A fixed rate of risk retention is conceptually simple and easy to apply, but is fundamentally flawed**
  - The level of risk retention should vary with risk; a one-size-fits-all approach does not make sense
    - 5% may prove to be insufficient to deter a low quality (non-prime) securitization
    - 5% may be too high, rendering a high-quality (prime) securitization uneconomic
  
- ▣ **Vertical risk retention is flawed: it does not align the securitization sponsor’s interests with the interests of investors**
  
- ▣ **Instead, risk retention should be in the form of a horizontal slice (the bottom credit tranches), resulting in:**
  - Better alignment of interests between sponsors and investors
  - More focus on risk control by sponsor
  
- ▣ **There are several ways to set variable risk retention levels, including:**
  - Linking to rating agency subordination levels (i.e. on securities below investment grade)
  - Use another independent third-party evaluation to set retention levels
  - Other regulatory action

# Shifting Interest Structure



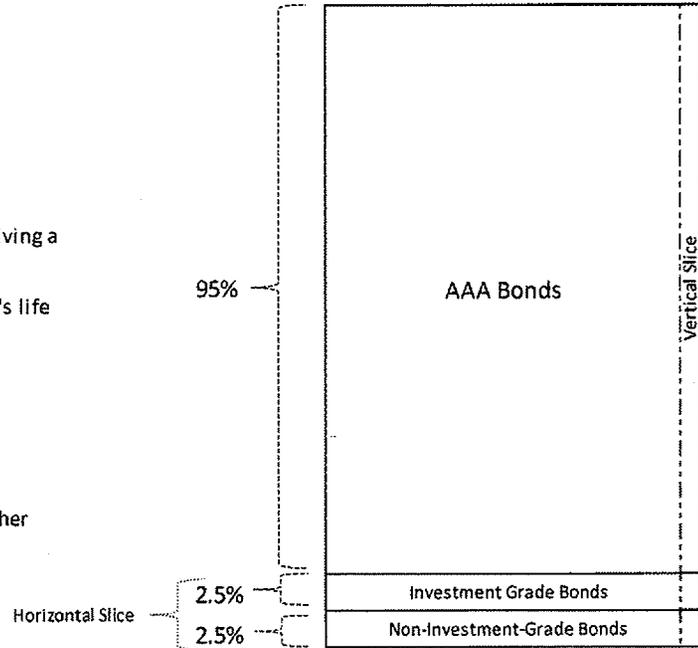
## Shifting Interest Structure Example

### Historical Facts (RWT Securitization Program)

- Prime credit quality
- Retained subordinate bonds
- Monthly trigger tests for life of deal
- Positive deal performance can result in subordinate bonds receiving a proportionate share of unscheduled principal payments
- No large cash outlays to subordinate bonds at any point in deal's life

### Enhancements

- Issuer must retain some subordinate bonds through life of deal
- Prevent manipulation through buy-outs or modifications by further adjusting cash flow triggers



### Economics at Risk

#### Vertical Slice    Horizontal Slice

	Face	Face	Retention Risk
Deal Size	\$300mm	\$300mm	
AAA Bonds	\$14.25mm	-	
Investment Grade Bonds	\$0.375mm	\$7.5mm	
Non-Investment-Grade Bonds	\$0.375mm	\$7.5mm	
<b>Total</b>	<b>\$15mm</b>	<b>\$15mm</b>	

# Over-Collateralization (OC) Structure



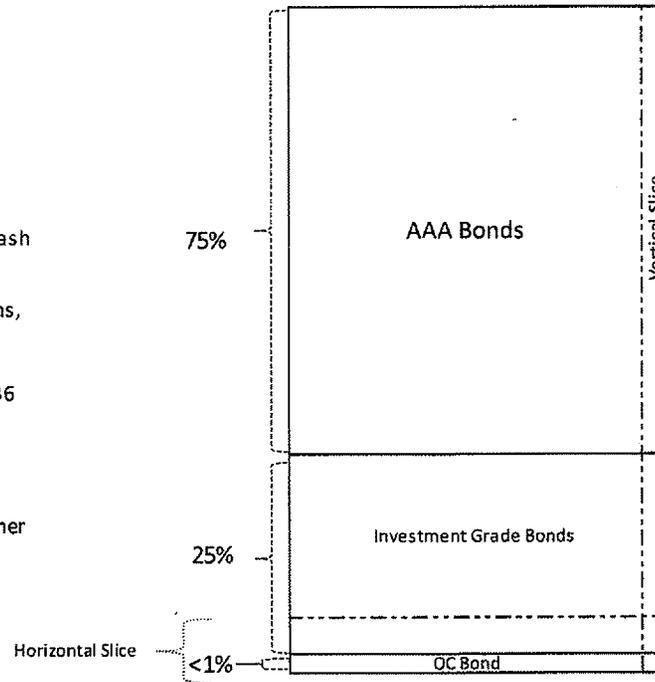
## Over-Collateralization ("OC") Structure Example

### Historical Facts

- Primarily non-prime
- Retained piece was generally OC
- Little cash flow to retained piece until month 36
- Trigger test impact primarily at month 36, when possible large cash outflow to retained piece
- Cash flows were manipulated through buy-outs, slow liquidations, and loans modifications
- Holder of retained piece not vested in performance after month 36

### Enhancements

- Issuer must retain some subordinate bonds through life of deal
- Prevent manipulation through buy-outs or modifications by further adjusting cash flow triggers



### Economics at Risk

#### Vertical Slice    Horizontal Slice

	Face	Face	
Deal Size	\$300mm	\$300mm	
AAA Bonds	\$11mm	-	Retention Risk
Investment Grade Bonds	\$4mm	\$15mm	
OC Bond	-	-	
<b>Total</b>	<b>\$15mm</b>	<b>\$15mm</b>	

# Risk Retention - Consolidation Accounting



- Risk retention impacts the new consolidation accounting rules (FAS 166/167) for securitization sponsors and participants
  
- Consolidation accounting analysis is focused on entities with both of the following:
  - Significant economic interests (loss or gain)
  - Decision making power (servicing contract)
  
- Questions:
  - Does the required 5% risk retention (vertical slice) constitute an insignificant economic interest, therefore not triggering consolidation?
  - Does holding a horizontal slice trigger consolidation?
  - Regardless of risk retention, if the securitization sponsor is also the servicer and originator, does this trigger consolidation?
  - How will the FDIC's 5% representation and warranty reserve affect consolidation accounting?
    - Who controls the reserve?

## Risk Retention – Other Considerations



- Impact of new FDIC safe harbor proposal on
  - Bank capital requirements
  - Flow of credit to borrowers
  - Ratings levels