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July 28, 2011

By E-mail: rule-comments@sec.gov
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Elizabeth M. Murphy, Secretary
Re: Release No. 34-64148
(File No. S7-14-11)

By Email: Comments@FDIC.gov
Federal Deposit Insurance Corporation
550 17th Street, N W
Washington, DC 20429
Attn: Robert E. Feldman,
Executive Secretary, Comments
Re: Rin 3064-AD74

By E-mail: regs.comments@occ.treas.gov
Office of the Comptroller of the Currency
250 E Street, SW - Mail Stop 2-3
Washington, DC 20219
Re: Credit Risk Retention
Docket Number: OCC-2011-0002

By E-mail: regcomments@fhfa.gov
Federal Housing Finance Agency
Fourth Floor, 1700 G Street, NW
Washington, DC 20552
Attn: Alfred M. Pollard, General Counsel
Re: RIN 2590-AA43

By E-mail: regs.comments@federalreserve.gov
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attn: Jennifer J. Johnson, Secretary
Re: Docket No. R-1411

By Website: www.regulations.gov
Department of Housing and Urban Development
Regulations Division
Office of General Counsel
451 7th Street, SW - Room 10276
Washington, DC 20410-0500
Docket Number FR-5504-P-01

Ladies and Gentlemen:

Redwood Trust, Inc. ("Redwood") submits this letter in response to the request for comments made by the Securities and Exchange Commission, the Office Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Department of Housing and Urban Development (the "Agencies") regarding the Notice of Proposed Rulemaking (the "NPR") to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 (15. U.S.C. § 78o-11), as added by section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Background on Redwood

Redwood commenced operations in 1994 as an investor in residential mortgage credit risk. We are not a mortgage originator or servicer. Similar to the GSEs, Redwood provides credit enhancement, but our

focus is on the prime jumbo mortgage market – or that portion of the mortgage market where loan balances exceed the limits imposed by Fannie Mae and Freddie Mac (the “GSEs”) for participation in their programs. We provide credit enhancement by investing in the subordinate securities of private-label residential mortgage securitizations, which enables the senior securities to obtain triple-A ratings. From 1997 through 2007, Redwood securitized over \$35 billion of third party originated mortgage loans through 52 securitizations.

Recent Securitization Activity

In April 2010, Redwood was the first company, and is so far the only company, to sponsor a securitization of newly originated residential mortgage loans without any government support since the market froze in 2008. The size of that first transaction was \$238 million. In March 2011, we completed a second securitization of \$295 million, and we plan on completing additional securitizations this year.

Completing these transactions required that we address the concerns and interests of triple-A investors who, in the wake of the financial crisis, had lost confidence in the securitization structures, that their rights and interests would be protected, and that their investments would, as a result, be safe and secure. We worked hard to regain their trust by putting together transactions that included even more comprehensive disclosure, better structure, and a new enforcement mechanism for representation and warranty breaches. In addition, Redwood retained meaningful exposure to the credit performance of the loans underlying the securitization, through risk retention or “skin-in-the-game.” In retaining risk, we aligned our interests with those of investors by taking all of the first-loss risk exposure through a horizontal slice of credit risk. Investors responded with significant demand to acquire the triple-A rated securities, as evidenced by the fact that the first offering of those securities was oversubscribed by a factor of six to one. The second securitization was also quickly and fully subscribed.

We believe that our history of sponsoring residential mortgage securitizations and our more recent role in completing the only two private residential securitizations of newly originated mortgages qualifies us to offer our opinions on the NPR.

Context for our Comments on Risk Retention

As market participants and policy makers debate the proposed rules around risk retention for securitization sponsors, it is important that we remember why we are establishing risk retention requirements. The goal is to incent securitization sponsors to create quality transactions that will attract private investors *and their capital* back to the market. We also note that private investors must also receive an appropriate rate of return on their investments while borrowers must have access to affordable mortgage credit. To facilitate these seemingly conflicting requirements, it is critical that future securitization structures and risk retention requirements do not result in mandated inefficiencies that render new securitizations safe but uneconomic. Without renewed private investment on terms that are also attractive for borrowers, the government will not be able to accomplish its goal of reducing its current unsustainable level of support for the mortgage market.

While our comments are not focused on the issue of defining a qualified residential mortgage (QRM), we have the following brief comments. For those who are critical of the proposed 20% down payment requirement, let’s step back for a minute. The intent of defining certain loans as QRMs is that they are so safe that they do not require sponsors of securitizations backed by such loans to retain risk. It seems reasonable that such “super safe” loans would be a relatively small subset of the overall mortgage market. We note that contrary to some public comments, borrowers with non-QRMs will still be able to access affordable mortgage credit from the FHA or from the private sector. The NPR does not preclude

non-QRM loans from either being issued or securitized; it just requires sponsors to retain risk if non-QRM loans are securitized.

Summary

Our comments will be focused on the NPR as it relates to residential mortgage securitization, and specifically on three issues: 1) par value versus fair value, 2) premium capture, and 3) retained risk cash flow. We recommend that: 1) fair value should be used to calculate required risk retention; 2) that securitizations that use the senior/subordinate (also known as shifting interest) structure, as defined, be exempt from the premium capture provision; and 3) that unscheduled principal payments should be passed through to retained risk holders after a lock-out period and if certain tests are met.

It is critical that the final rule takes into consideration the differences between the two securitization structures. Senior/subordinate structures have traditionally been used for prime securitizations and over-collateralization structures have been used for subprime securitizations. The securitization structure matters because the NPR, as written, will force sponsors of prime residential mortgages to use the subprime over-collateralization structure, which is inefficient for prime securitizations and which, by our calculations, will unnecessarily raise prime mortgage rates by about 75 basis points (as discussed in Appendix A on pages 9-13), without offsetting benefits to borrowers or investors.

We agree that it is important for sponsors to retain risk and, accordingly, we support the intent of the NPR that sponsors should not be allowed to withdraw cash from a securitization prematurely if it reduces their investment basis below the 5% minimum risk retention requirement. We believe that horizontal risk is the best choice of risk retention for a senior/subordinate securitization structure, which is the structure traditionally, used in prime mortgage securitizations. We also acknowledge that there are practical arguments for other forms of risk retention as suggested in the NPR. In Appendix B, page 14, we illustrate examples of different forms of risk retention. We offer our comments with the intent of proposing changes to the NPR that will facilitate the creation of a safe, efficient, robust private residential securitization market for prime mortgage loans for the benefit of borrowers, investors, sponsors, and tax payers.

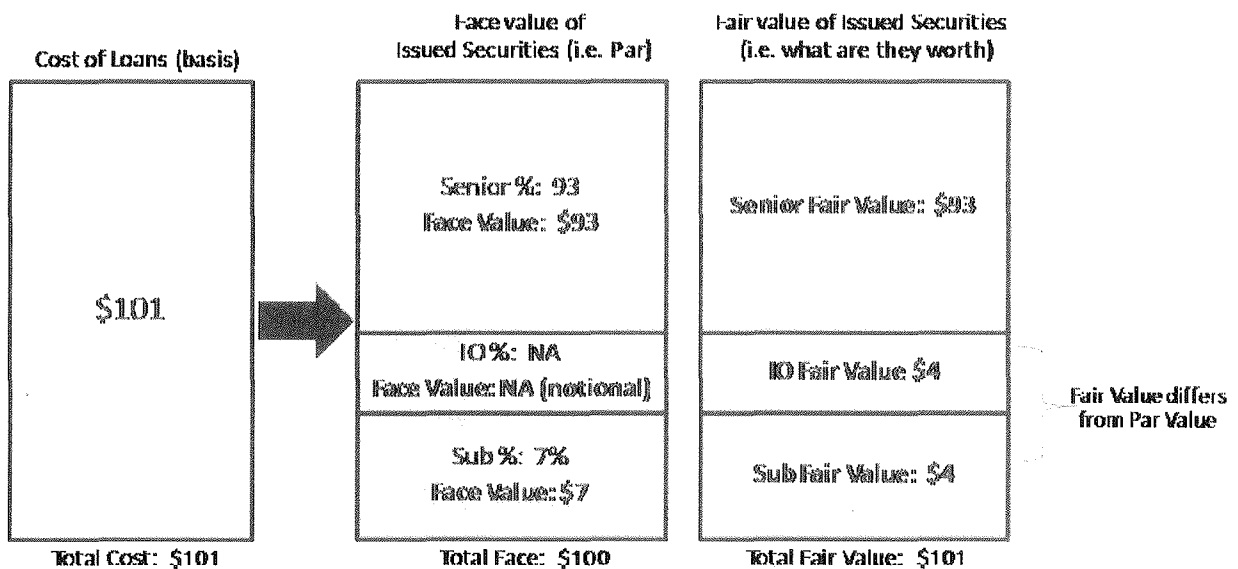
1) Par Value vs. Fair Value

The issue: The proposal is not clear on whether the basis for calculating risk retention should be par value or fair value.

The Regulatory Objective: To ensure that securitization sponsors retain the required amount of risk, it is necessary to have a common method for determining the real economic value of the retained risk.

Redwood's Comments: The use of par value or fair value will often result in substantially different values for the securities issued in a securitization. In most securitizations, only the most senior securities are issued at or near par value; the subordinate securities, depending upon their priority in the capital structure, are often issued at discounts from par value. For example, subordinate securities are often issued at successively larger discounts from par with the least senior, or the first-loss, non-rated security issued in a range of 15% to 40% of par value. Interest-only ("IO") securities, which are created from the excess interest rate spread between the coupon on the underlying mortgage loans and the lower rate typically paid to the triple-A holders, do not have a stated par value but do have a fair value. The sum of the fair values of the senior, subordinate and IO securities usually is close to the fair value of the underlying mortgage collateral.

The following hypothetical example illustrates the amount of the cash or economic investment required, depending on whether par value or fair value is used as the basis for calculating risk retention. Assume \$100 of loans at par (or face) value is purchased for a price of 101% of par value, or \$101. (Assume a premium of \$1 was paid because the loans had an above market interest rate.) These loans are then securitized into a simple three class structure. The senior security represents 93% of the securitization (based upon the par value of securities issued) and therefore has a par and fair value of \$93. The subordinate security represents 7% of the securitization and has a par value of \$7 and fair value of \$4, (which equates to a price of 57.14% for the subordinate security). The IO has an initial notional value equal to the senior security of \$93, has no stated par value, and has a fair value of \$4. In total, the par value of the senior and subordinate securities equals \$100 and the fair value of the senior, subordinate, and IO securities equals \$101, which is equal to the cost of the underlying loans.



There is relatively little difference between the cost of the loans of \$101, the par value of the securities of \$100, and the fair value of the securities of \$101. There is, however, a dramatic difference between the dollar amounts that will be invested by the sponsor depending upon risk retention method chosen. Using the *par value* approach and the horizontal risk retention option, the sponsor's investment or real economic risk is only \$2.86 to retain the required 5% risk retention (\$5.00 par value X 57.14% price). Using the *fair value* approach and the same horizontal risk retention method, the sponsor's investment or real economic risk is \$5.00 to retain the required 5% risk retention; \$4 to retain all \$7 at par value of the subordinate securities, plus \$1 to retain \$1 of the senior securities at a price of 100%.

There are other issues with the use of par value and fair value. Par value does not always reflect the fair value of the loan collateral, or of the securitization at time of issuance. The only time the par value will be the same as the fair value of the loans or the securities issued is if the interest rate on the loan collateral reflects market rates at the point of securitization, after taking into account deal expenses and servicing fees. As markets are typically volatile and it takes time to accumulate a sufficient quantity of loans to securitize, par and fair values of the securitization will usually differ due to changes in interest rates, hedging costs, and spread movements during the accumulation period. For instance, using the example above, if triple-A security yields decline after the loan collateral has been acquired, the IO would have a larger coupon resulting in a higher value, say \$5, at issuance. (It is likely that this increased value would be largely offset by pipeline hedging losses of a near equal amount, which we will ignore for

now.) Conversely, interest rates could move unfavorably resulting in the IO being worth less, perhaps \$3 at issuance.

We believe that what happens between the accumulation period of the loans and the securitization date should not be a factor in determining the amount of risk retention. However, if par value is used to set risk retention, the proposed premium capture does just that. Specifically, using par value generates larger premium capture which could result in a sponsor retaining far more than 5% risk (under certain interpretations of the NPR as currently written). Sponsors will be taking risk in the accumulation phase and can therefore make or lose money in that effort. Restrictions that effectively, even if inadvertently, and unnecessarily limit the profitability of securitization will create disincentives to take the risk of loss during accumulation.

Our Proposed Solution: Use fair value of securities issued at the time of issuance as the basis for calculating risk retention. Risk retention should be 5% of fair value of securities issued.

Our Proposed Wording: Risk Retention shall be calculated as 5% of the fair value of securities issued, calculated at the time of issuance. In order to determine fair value, the sponsor will use the price received from third party investors as a basis for determining the fair value for each class of securities sold, or the sponsor shall enlist a third party to independently value any class of security not sold to a third party.

2) Premium Capture

The issue: The proposed premium capture provision renders *prime* residential mortgage securitizations uneconomic and will cause sponsors to require higher mortgage rates of prime borrowers to offset the effect of the premium capture requirement.

The Regulatory Objective: To prevent excess interest from being monetized, which could reduce the sponsor's basis in retained risk below the required minimum amount?

Redwood's Comments: The NPR uses a "one-size-fits-all" approach, which would require significant changes to how prime residential mortgage-backed securities ("RMBS") are structured. Applying the premium capture rule as written will unnecessarily raise mortgage rates for prime borrowers, who represent approximately 90% of all mortgage borrowers.

The proposed premium capture rule requires excess interest (or the IOs created in the securitization process) to be used as credit support. Prime securitizations have not traditionally been structured to use interest as credit support because prime mortgages have high prepayment volatility. When mortgage rates decline, prime borrowers have traditionally quickly refinanced into lower rate mortgage loans. IOs cannot be relied upon as a source of credit support for prime securitizations since their values can diminish quickly when prepayments increase.¹ As a result, prime securitizations have relied upon subordinate principal-based tranches to serve as credit support.

The economics of prime securitizations rely on maximizing the value of the IOs in order to offset the discount applied to the par value of the subordinate securities at the time of sale, as shown in the earlier example. The fair value of all the securities issued must be equal to or greater than the cost of the

¹ In subprime securitizations, where borrowers have less ability to prepay mortgages, there is a greater ability to rely upon excess interest as a form of credit protection to the senior securities.

underlying mortgage loans in order for there to be an economic incentive to securitize loans. The value of IOs is maximized when the securities are sold to “yield” investors, rather than “credit” investors. If IOs on prime securities are forced into the most junior position, as contemplated by the NPR, their value would be significantly reduced, making securitizations uneconomic and/or forcing sponsors to require higher prime mortgage rates by about 75 basis points on the underlying mortgage collateral based on our calculations to make up for the lost value on the IO. Please see Appendix A, pages 9-13, for an illustration of this issue.

Our Proposed Solution: Make a distinction between securitizations which rely on excess interest and principal for credit support and securitizations which rely solely on principal for credit support. We propose that prime residential mortgage securitizations that use the senior/subordinate structure be excluded from the premium capture requirements. The objective of our proposal is to maintain the structural efficiencies of prime RMBS, which are passed on to the borrower in the form of a lower borrowing rate. For prime securitizations, it is best to allow excess interest to be stripped off of the triple-A bond in the form of a triple-A IO, and to treat this class just like any other class of senior securities in the securitization for purposes of risk retention.

In our Proposed Wording below, we define those securitizations which would be classified as Exempt, and therefore are exempt from premium capture requirements.

In order to prevent sponsors from gaming the risk retention proposals and stripping the subordinate bonds of much of their economic value (assuming par value is adopted for measuring risk retention), we recommend that the minimum coupon on the subordinates to be equal to the gross mortgage rate of the underlying mortgage loans minus the servicing fee.

For non-prime securitizations that rely on both excess interest as well as principal for credit support, we support the premium capture provision in the NPR.

Our Proposed Wording: The rules regarding risk retention recognize that sponsors must have flexibility in structuring transactions which are economically efficient, such that the borrowing rate is optimized. As a result, the rules allow an exemption from premium capture for securitizations that fit the following definition:

1. Credit support for senior securities is provided solely by the par value of subordinated securities funded at time of issuance.
2. Losses on the securities issued are realized in reverse order of seniority, beginning with the most junior bonds until their balance is written to zero.
3. Subsequent losses are absorbed by the next most junior class outstanding.
4. Subordinate classes may not receive unscheduled principal for the first five years.
5. Subordinate classes of securitizations may never receive more than their pro rata share of principal and interest in any distribution period. Pro rata share is calculated as the unpaid principal balance of subordinate class to the total unpaid principal balance of all classes.*

6. Subordinate bonds may begin to receive a portion of their pro rata share of unscheduled principal payments on the mortgages beginning in year 6, and can receive their full pro rata share of such unscheduled principal beginning in year 10, provided that certain quality tests related to delinquencies and cumulative losses are being met. Calculation of tests is done by an independent trustee according to deal documentation.
7. Securitization sponsor must designate the securitization as Exempt. Designation must be supported by deal documents which will be subject to audit.

*Note, we strongly recommend extending this provision to all securitizations, including those classified as Non Exempt.

3) Cash Flow on Retained Risk

The issue: The restriction on subordinate bonds receiving any share of principal reduces their value to the sponsor making securitization uneconomic unless mortgage rates are increased.

The Regulatory Objective: To prevent subordinate bonds from receiving more than their share of principal relative to the triple-A class, which would erode credit support and reduce the sponsor's retained risk in the transaction.

Redwood's Comments: For prime RMBS securitizations, which already incorporate conservative limits on the distribution of principal cash flow to subordinate bonds, the rule overly penalizes the most conservative securitization structures (the senior sub structure), needlessly increases subordination levels substantially above the amount necessary to provide safety to the holders of the senior securities, and would result in unnecessary higher mortgage rates for prime borrowers.

Our Proposed Solution: Restrict subordinate bonds from receiving any *unscheduled* principal for a minimum of five years. During this period, as senior bonds amortize due to receiving both their scheduled principal and all of the unscheduled principal payments, the subordinate bonds will grow as a percentage of the overall securities outstanding. In this way, credit support is growing over time for the seniors, and horizontal risk retention is also growing over time.

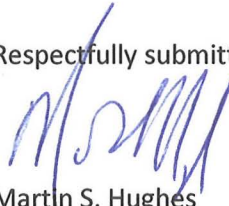
Assuming credit quality tests are met with respect to delinquencies and cumulative losses, allow the subordinate bonds to receive *a portion* of their pro rata share of unscheduled principal, beginning after year five. Allow a gradual increase in the amount of unscheduled principal that a subordinate can receive until ten years, after which the subordinate bonds can receive its pro rata unscheduled principal.

At no time would a subordinate bond be allowed to receive more than their pro rata share of principal and interest.

Our Proposed Wording: Our definition of Exempt securitizations incorporates these objectives so no further definition is needed.

Redwood Trust, Inc. appreciates the opportunity to comment on the Notice of Proposed Rulemaking. Please do not hesitate to contact Marty Hughes at 415-389-7373 if you have any questions or would like to discuss these matters further.

Respectfully submitted,



Martin S. Hughes
President and CEO
Redwood Trust, Inc.

Appendix A

Examples 1 and 2: The following two examples show why, in the context of a prime securitization that uses a senior/subordinate structure, the IO proceeds matter, why the IO does not represent profit, and why the IO should be treated like any other class of security issued.

Example 1: Senior Sub Structure with IO created from AAA class						
				Gross Prime Mortgage Rate:	5.50%	
				Servicing:	0.25%	
				Net Rate to Securitization:	5.25%	
Security	Bond Face	% of Deal	Price	Proceeds	Coupon	Market Yield
AAA	\$950,000,000	95%	100.00%	\$950,000,000	4.5%	4.5%
IO	Notional	*	3.30	\$23,500,000	0.8%	14.0%
Inv Grade Subs	\$20,000,000	2%	80.00%	\$16,000,000	5.3%	7.0%
Non Inv Grade	\$30,000,000	3%	60.00%	\$18,000,000	5.3%	14.0%
Total Principal	\$1,000,000,000	100%				
Sources and Uses of Funds						
Gross proceeds raised from securitization:				\$1,007,500,000		
Securitization Expenses:		0.75%		-\$7,500,000		
Net proceeds raised from securitization:				\$1,000,000,000		
Cost of purchasing the loans (par price for \$1 billion loans) :				\$1,000,000,000		
Net Gain or Loss:				\$0		

The structure above is a standard senior/subordinate structure, the IO does not serve as credit support, and the underlying mortgage loans have an interest rate of 5.50%.

Note that by virtue of the credit enhancement and its triple-A rating, the senior security trades at a yield of 4.50%, which is lower than the net coupon rate on the underlying mortgage loans.

The 100 basis point difference in yield is captured by the IO class, which has a notional balance (\$950 million) equal to the face value of the triple-A class and receives an interest coupon of 0.75% on the face amount outstanding on the triple-A class.

Although an IO was created in this securitization and sold to a third party investor for \$23.5 million, there was no “profit” to the sponsor since the subordinate securities were sold for a \$16 million discount from their \$50 million par value, and there were \$7.5 million of securitization expenses.

Example 2: Senior Sub Structure where IO is not monetized

Gross Prime Mortgage Rate: 5.50%
 Servicing: 0.25%
 Net Rate to Securitization: 5.25%

Security	Bond Face	% of Deal	Price	Proceeds	Coupon	Market Yield
AAA	\$950,000,000	95%	100.00%	\$950,000,000	4.5%	4.5%
IO	Notional	*	0.00	\$0	0.8%	0.0%
Inv Grade Subs	\$20,000,000	2%	80.00%	\$16,000,000	5.3%	7.0%
Non Inv Grade	\$30,000,000	3%	60.00%	\$18,000,000	5.3%	14.0%
Total Principal	\$1,000,000,000	100%				

Sources and Uses of Funds	
Gross proceeds raised from securitization:	\$984,000,000
Securitization Expenses: 0.75%	-\$7,500,000
Net proceeds raised from securitization:	\$976,500,000
Cost of purchasing the loans (par price for \$1 billion loans) :	\$1,000,000,000
Net Gain or Loss:	(\$23,500,000)

If the IO class cannot be sold, then there is not enough money to pay for the loans as the net proceeds from the securitization fall short of the cost of the loans by \$23.5 million. This cost would be in addition to the \$50 million investment (assuming fair value is used) to retain 5% of the securities issued.

Example 3: The following example shows that when the IO is placed in a subordinate position, its value declines resulting in insufficient proceeds to cover the full cost of the loans for the securitization.

Example 3: Senior Sub Structure valuing IO as residual cash flow						
				Gross Mortgage Rate:	5.50%	
				Servicing:	0.25%	
				Net Rate to Securitization:	5.25%	
Security	Bond Face	% of Deal	Price	Proceeds	Coupon	Market Yield
AAA	\$950,000,000	95%	100.00%	\$950,000,000	4.5%	4.5%
IO	Notional	*	1.65	\$11,750,000	0.8%	18.0%
Inv Grade Subs	\$20,000,000	2%	80.00%	\$16,000,000	5.3%	7.0%
Non Inv Grade	\$30,000,000	3%	60.00%	\$18,000,000	5.3%	14.0%
Total Principal	\$1,000,000,000	100%				
Sources and Uses of Funds						
Gross proceeds raised from securitization:				\$995,750,000		
Securitization Expenses:		0.75%		-\$7,500,000		
Net proceeds raised from securitization:				\$988,250,000		
Cost of purchasing the loans (par price for \$1 billion loans) :				\$1,000,000,000		
Net Gain or Loss:				(\$11,750,000)		

Assuming the IO can be released as credit support after the senior and subordinate classes have been paid off and after absorbing credit losses, the valuation of the IO would be materially lower (\$11.75 million in this example versus \$23.5 million in Example 1) than it would if it were senior and paid cash flow on a current basis, resulting in an \$11.75 million shortfall compared to the cost of the loans.

Example 4: Shows that if we require IO proceeds to be fully subordinated and used for credit support, the mortgage rate would have to increase by 75 basis points to 6.25% in order to generate additional interest income for the IO to offset the \$11.75 million shortfall in the prior example and generate sufficient proceeds to pay for the loans at a par price.

Exhibit 4: Break even mortgage rate valuing IO as residual						
					Gross Prime Mortgage Rate:	6.25%
					Servicing:	0.00
					Net Rate to Securitization:	6.00%
Security	Bond Face	% of Deal	Price	Proceeds	Coupon	Market Yield
AAA	\$950,000,000	95%	100.00%	\$950,000,000	4.5%	4.5%
IO	Notional	*	1.65	\$23,500,000	1.5%	18.0%
Inv Grade Subs	\$20,000,000	2%	80.00%	\$16,000,000	6.0%	7.0%
Non Inv Grade	\$30,000,000	3%	60.00%	\$18,000,000	6.0%	14.0%
Total Principal	\$1,000,000,000	100%				
Sources and Uses of Funds						
Gross proceeds raised from securitization:				\$1,007,500,000		
Securitization Expenses: 0.75%				-\$7,500,000		
Net proceeds raised from securitization:				\$1,000,000,000		
Cost of purchasing the loans (par price for \$1 billion loans) :				\$1,000,000,000		
Net Gain or Loss:				(\$0)		

Example 5: Shows that even if we gross up the coupons on the subordinates using excess interest, the prime mortgage rate would still have to be increased by 38 basis points (from 5.50% to 5.88% in this example) in order to generate sufficient proceeds to pay par for the loans.

Example 5: Grossing up the Subordinate Classes to Par						
				Gross Mortgage Rate:	5.88%	
				Servicing:	0.25%	
				Net Rate to Securitization:	5.63%	
Security	Bond Face	% of Deal	Price	Proceeds	Coupon	Market Yield
AAA	\$950,000,000	95%	100.00%	\$950,000,000	4.5%	4.5%
IO	Notional	*	0.79	\$7,505,000	0.3%	14.0%
Inv Grade Subs	\$20,000,000	2%	100.00%	\$20,000,000	8.0%	8.0%
Non Inv Grade	\$30,000,000	3%	100.00%	\$30,000,000	Excess Spread	20.0%
Total Principal	\$1,000,000,000	100%				
Sources and Uses of Funds						
Gross proceeds raised from securitization:				\$1,007,505,000		
Securitization Expenses:		0.75%		-\$7,500,000		
Net proceeds raised from securitization:				\$1,000,005,000		
Cost of purchasing the loans (par price for \$1 billion loans) :				\$1,000,000,000		
Net Gain or Loss:				\$5,000		

Appendix B – The Form of Risk Retention

What is the goal of risk retention?

At the very basic level, the first question we need to address is “whom are we trying to protect from what?” Risk retention by sponsors is intended to align sponsors’ incentives with mortgage investors’ incentives, resulting in *more predictable securitization performance*.² Mortgage security investors have invested a lot of time and money into developing predictive mortgage models that forecast expected losses and prepayments. What aspects of a securitized mortgage are predictive in nature? Predictive items include borrower quality (more creditworthy borrowers tend to pay their mortgages) and loan attributes (lower loan-to-value mortgages have lower predicted losses). These models do not and cannot capture the more unpredictable aspects of a securitization, such as underwriting deficiencies (poor quality underwriters may miss something in the origination file), mortgage fraud and misrepresentations, and structural “quirks” (such as instances in which an unanticipated cash flow occurs, such as recovery of a forbore principal amount, and is allocated to the benefit of a particular tranche).

What are we collectively trying to achieve with risk retention? If, as we believe, our goal is to bring back private capital to the residential mortgage market, then we need to assure that investors get the information they need and that losses from risks that cannot be predicted are minimized. Thus, it makes sense to creating a structure that penalizes originators with high instances of non-predictable errors.

How do we incent originators to originate “good” loans with “predictable” performance?

We want to reward predictable performance and penalize unpredictable performance regardless of borrower credit quality, loan type, or securitization structure. How do we do this? There are three types of risk retention forms under consideration. Two types of risk retention – horizontal and vertical – involve holding mortgage-backed securities. A third alternative would require the sponsor to retain a pool of loans that is representative of the pool of collateral underlying a securitization. These are very different approaches. Which is right? Is one approach vastly favorable to the others?

In our opinion, the best form of risk retention depends on (1) the problem one is trying to solve (poor loan quality, cash flow manipulation, unpredictable problems, or all three) and (2) whether the *securitization* is a senior/subordinate (also known as a shifting interest) structure or an overcollateralization (OC) structure.

Starting with the horizontal vs. vertical discussion, we will use the following hypothetical example of a \$250 million securitization to highlight the advantages and disadvantages of each.

² Risk retention is also intended to incentivize sponsors to choose higher quality loans for securitization, thereby providing an incentive to originate higher quality loans.



The sponsor who holds a 5% horizontal slice of risk holds the entire \$12.5 million (5% of \$250 million) of risk retention (RR) in a first loss position at the bottom of the capital structure. The sponsor who holds a 5% vertical slice of risk holds \$625,000 (5% of \$12.5 million) in a first-loss position, \$250,000 in a mezzanine position, and \$11.625 million in a senior position alongside triple-A investors.

Performance Predictability

In the following example, we highlight the differences in holding horizontal vs. vertical risk retention. Assume the sponsor of the \$250 million collateral pool shown above included \$245 million of well underwritten loans and \$5 million of loans with high instances of poor underwriting decisions. Assume for simplicity that the full \$5 million of loans with poor underwriting is written off in total.

The sponsor who chooses horizontal risk retention will absorb the full \$5.0 million, or all of the losses. This is true skin-in-the-game, as the sponsor takes significant losses due to poor processes, controls, and underwriting decisions. This results in a significant disincentive for sponsors to include poorly underwritten loans in the securitization.

The sponsor who chooses vertical risk retention loses just \$625,000, as that is the only portion of the sponsor’s risk retention that is in a first-loss, subordinate position and exposed to losses from the poorly underwritten loans in the securitization. The remaining \$4.375 million of losses would be borne by the other subordinate security holders, not the sponsor. Thus the sponsor’s risk to the poorly underwritten loans included in the securitization is largely diluted and his incentive to avoid loss could be overwhelmed by possibly conflicting incentives to place these loans in the securitization.

The representative pool approach is a different type of approach to risk retention. We believe holding a representative sample is an ineffective deterrent to the origination of low quality loans. Let’s use an analogy that might help explain why we think it is ineffective. Suppose a farmer buys a hundred cows from a rancher. The farmer is nervous that five cows may come down with mad cow disease, but he is not sure which ones. How should the farmer protect himself? Require the rancher to buy back five random cows at the time of sale (before any cows are sick)? Or require the rancher to buy back the first

five cows that get sick? Obviously, the latter, which equates to horizontal risk retention, is the better choice.

In our opinion, requiring the sponsor to retain a horizontal slice is the superior form of risk retention, as it clearly incents the sponsor to select and include only the better quality loans in a securitization. If an alternate approach to risk retention is used, the penalty to the sponsor for including bad collateral is much less in all cases with vertical risk retention and much less in almost all cases with the representative sample approach. In the end, risk retention should structurally encourage sponsors to do the right thing, even if no one is looking.

Tranche Warfare

One genuine argument against horizontal risk retention is that traditional OC securitization structures may allow the servicer to manipulate cash flows to favor subordinate securities holders (including the sponsor if the servicer is the sponsor). This potential for incentives to manipulate cash flows to favor one class of security holders over another class of security holders has led some to favor a vertical slice of risk retention for the sponsor. In the case where the sponsor holds an equal percentage of each class, the argument is that the sponsor won't have an incentive to favor one class of security owners over another. This argument has some merit, though it is not failsafe and it is relevant only in the OC structure, which, in the mortgage sector, was principally used for subprime securitizations.

In OC structures – in certain cases, sponsors manipulated cash flows to direct cash to the residual or subordinate holders by manipulating “triggers”. Triggers are tripped when certain milestones are reached, intended to indicate that it is a “safe” time to direct cash flow to security holders other than the triple-A owners. In those non-prime deals, sponsors who were also servicers could influence the payment of large amounts of cash to residual tranche holders by manipulating triggers, for example, by repurchasing delinquent loans, aggressively modifying loans, or delaying foreclosures to eliminate their impact on the trigger calculations (thus allowing triggers to “pass”).

While vertical risk retention can address, in part, alignment of interests of the sponsor with all classes of owners, it will not keep the sponsor focused on minimizing credit risk in the same way that horizontal risk retention will. For that reason and because we think prime securitization structures, which do not create this potential for conflict, will be the primary structures for years to come, we advocate horizontal risk retention as a general rule. We would separately and directly address potential conflicts and tranche warfare.

We believe the first step in deterring tranche warfare is to tighten the contractual language regarding how triggers operate in order to prevent manipulation. For instance, in our April 2010 Sequoia securitization (SEMT 2010-H1), we adjusted certain collateral tests to include modified and repurchased loans for a 12-month period following modification or repurchase. This feature of SEMT 2010-H1 reduces the immediate impact of repurchases and modifications on the allocation of cash flows between senior and subordinate tranches. This provides servicer/sponsors little incentive to use control over troubled loan workouts to favor one tranche of a securitization over another. Our recent securitization did not include an over-collateralization feature, but the terms of such a structure could be modified to eliminate the structural incentives that have been the subject of criticism in the market — for example, by adjusting the terms for the release of excess collateral.

Recommendation

We believe the appropriate form of risk retention depends on the structure of the securitization. In prime securitizations, where there is no OC, a horizontal slice is the best approach for risk retention. Note that in shifting interest structures used for prime deals, if there are potential structural manipulations that inappropriately benefit one class of investors at the expense of others, they should be addressed directly through the structural changes suggested above.

For OC structures, the risk of tranche warfare is real as there can be significant financial benefits to a successfully waged war between tranches. As a result, to further protect investors and to incent originators to originate quality loans, we recommend an L-shaped approach to risk retention – which combines a vertical and horizontal slice of retained risk.

Accounting Issue

Under new accounting rules, it appears that sponsors (who are also servicers) will likely be able to get sale treatment for loans sold into a securitization entity if they retain only a small (5%) vertical slice or representative sample. Generally, sponsor/servicers who hold a horizontal slice will likely have to consolidate the securitization. For commercial bank sponsor/servicers, it has been argued that the consequences of having to consolidate a securitization when holding horizontal risk (bloated balance sheets and higher capital charges) would render private-sector residential mortgage securitizations uneconomic. If private-sector mortgage securitizations are not economic for commercial banks, the argument continues, this could significantly reduce the extension of new mortgage credit. The consequences of having to consolidate a securitization is further complicated by the FDIC safe harbor rule, the full benefit of which is dependent on bank sponsors obtaining GAAP “sale” treatment for securitizations. Without the ability to obtain safe harbor status, banks may not be able to finance mortgage loans as efficiently as they would otherwise. This could arguably lead banks ultimately to make fewer mortgage loans.

These are valid concerns by the banking industry. However, if regulators are concerned about accounting rules impacting the supply of mortgage credit, we do not believe the solution is to abandon what we believe is the best idea for risk retention. If regulators want to eliminate the impact of accounting rules on the supply of mortgage credit from commercial banks, they should encourage FASB (as they did with mark-to-market accounting) to consider amendments to the current accounting requirements. Alternatively, changes could be made to the consequences of the accounting result by reviewing the regulatory capital and safe harbor implications. Clearly, ensuring a sufficient supply of credit and providing proper incentives for sponsor behavior are two completely different objectives that should be addressed separately and we should not be trying to solve one issue at the expense of the other.