REDWOOD TRUST

One Belvedere Place
Suite 300
Mill Valley, CA 94941

PHONE 415.389.7373
FAX 415.381.1773

July 1, 2010

Via Facsimile Transmission – comments@fdic.gov
Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments

RE: Notice of Proposed Rulemaking ("NPR") – Treatment by the Federal Deposit Insurance Corporation ("FDIC") as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation after September 30, 2010

Dear Mr. Feldman:

This comment letter is submitted on behalf of Redwood Trust, Inc. ("Redwood Trust"), which is a publicly-traded company listed on the New York Stock Exchange. Through its wholly-owned subsidiaries (together with Redwood Trust, "Redwood," "we," or "our"), Redwood sponsors securitizations of residential mortgage debt (with a focus on the prime jumbo sector of this market) and retains investments in the securitizations it sponsors. In addition, Redwood is an investor in residential mortgaged-backed securities issued in securitizations sponsored by insured depository institutions and other third parties. As a result, Redwood has the perspective of both a sponsor of, and investor in, residential mortgage-backed securities.

In April 2010, Redwood sponsored the first private-sector securitization of newly originated prime residential mortgage loans since 2008. This securitization was very well received by investors, and has since performed well in the secondary market. Through the process of completing this transaction, we gained valuable experience and perspective with regards to how various stakeholders currently view the private securitization market (and how those views have changed since we had last sponsored a private-sector securitization in mid-2007). We believe that this recent experience and perspective, which has informed this comment letter, should be taken into account as the FDIC finalizes the Proposed Rule.

Against the background provided above regarding the role Redwood plays in the residential mortgage markets, we offer the following comments in response to the NPR.

General Comments – Effect of the Proposed Rule on the Availability of Mortgage Credit

As a review of the comment responses to the related Advanced Notice of Proposed Rulemaking ("ANPR") shows, many industry participants argue that without an expanded Safe Harbor provision, the availability of residential mortgage credit will be significantly reduced because insured depository institutions ("IDIs") will incur higher costs to make new loans. These higher costs could potentially arise from higher financing rates to the extent IDIs cannot obtain triple-A credit ratings on certain residential mortgage-backed securities ("RMBS") without an expanded Safe Harbor. This is said by some to put IDIs at a competitive disadvantage versus non-depository institutions and foreign entities, despite the competitive advantages that remain as a result of low-cost deposit base funding that is insured by the federal government through the FDIC's Deposit Insurance Fund.

Much of the debate over how the Final Rule might affect the competitive landscape or the availability of affordable residential mortgage credit appears to be speculative. In fact, the vast majority of residential whole loans originated by IDIs have historically been sold outright to third parties and not securitized by IDIs. During the first quarter of 2010, for instance, the federal housing agencies and government-sponsored enterprises ("GSEs") purchased or insured nearly 97% of all newly originated residential mortgage loans, according to the industry trade publication Inside Mortgage Finance. While this level of involvement represents an extraordinary expansion of the role of the government in the mortgage markets, even prior to this expansion, a large percentage of the mortgage loans originated by IDIs were purchased by GSEs or sold to well-capitalized private mortgage investment institutions such as real estate investment trusts (REITs).

While this most common form of the originate-to-distribute model – which entails IDIs originating loans and then selling them to independent non-depository institutions that sponsor their own public or private securitizations – has recently resulted in an inappropriate concentration of risk at the GSEs, the model has consistently worked reliably (and profitably) for banks and thrifts as a means of distributing risk and accessing liquidity. This model also remains largely unaffected by changes to the accounting rules that govern the sponsorship and consolidation of mortgage securitizations that prompted calls for the NPR discussed herein. Most importantly, the model most thoroughly safeguards depositors and the Deposit Insurance Fund from the ongoing credit and liquidity risks associated with IDIs structuring and sponsoring residential mortgage securitizations.

Institutions such as REITs are often better positioned to incur these risks as they generally fund their loan purchases with either equity or term-based capital that is more closely matched to the duration and risk profiles of residential mortgage loans[1]. Conversely, the risks associated with investing in long-term mortgage loans and securities that are backed by short-term sources of financing are apparent from a review of comment responses to the original ANPR. For example, a number of industry participants that may finance much of their mortgage operations with customer deposits asserted that a twelve month "seasoning" requirement for securitized loans included in the ANPR could adversely affect their ability to lend.

By maintaining strong, but fair, regulation for securitizations of loans that are sponsored by IDIs, the FDIC can both (i) allow the originate-to-distribute model to continue to effectively function as a source of risk reduction and liquidity to IDIs and (ii) ensure that when IDIs originate with a view to securitization, the securitizations sponsored by IDIs will not add undue risks to the banking system. By allowing both of these business models to function effectively, the NPR should not have an adverse effect on the availability of mortgage credit to homebuyers.

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1 The Securities and Exchange Commission ("SEC") has proposed new rules pertaining to securitization that would apply to REITs and other sponsors of securitizations that are in many aspects similar to those put forth in the NPR.

Specific Comments

The following comments are meant to address specific elements of the Proposed Rule as they would apply to securitizations of residential mortgage loans.

1. Risk Retention - Required Form of Retention

According to the NPR, sponsors of securitizations must retain at least five percent (5%) of the credit risk of the securitized assets, either by retaining at least five percent (5%) of each tranche sold to investors or by retaining a "representative sample" of the securitized assets equal to at least five percent (5%) of the principal balance of the securitized assets.

While our April 2010 residential mortgage securitization began the process of revitalizing the private sector's participation in the residential mortgage markets through securitization, we think that having the right risk retention requirements in place will be critical to drawing a deep and diverse investor base to securitizations sponsored by IDIs. In our April 2010 securitization, we received feedback regarding the risk retention issue from many of the large institutional investors who typically invest in the triple-A rated tranches of residential mortgage securitizations. Based on their feedback, we have concluded that these investors overwhelmingly believe that the sponsor of a securitization should retain "first-loss" risk, by retaining the most subordinate tranches of a securitization as opposed to the "at least five percent (5%) of each tranche sold to investors" criterion set forth in the Proposed Rule. As such, we retained significant first-loss risk in the transaction, and believe that it was this "horizontal" retention of risk that was most persuasive in instilling confidence in investors in the triple-A rated securities.

First-loss horizontal risk is the strongest method for incentivizing sponsors and aligning the interests of sponsors and investors. A sponsor that is exposed to significant first-loss horizontal risk is fully exposed to the weakest assets included within a securitized pool. By contrast, a sponsor that is only exposed to "vertical" risk (or the alternative representative sample of securitized assets) may only be exposed to five percent (5%) of losses that may occur with respect to the weakest assets included in a securitized pool. We believe that this is the "investment math" that investors considered when they exhibited strong demand to purchase triple-A rated securities in our April 2010 Sequoia Securitization.

The potential conflicts of interests that the Proposed Rule would address through sponsors owning a percentage of each tranche issued by a securitization can be better addressed through the structure and terms of the securitization without weakening the strong alignment of incentives provided through first loss horizontal risk retention. As an example, private sector securitizations of residential mortgage loans often include collateral performance triggers that, if met, would distribute increasing amounts of principal and interest cash flows generated by the collateral loans to subordinate security holders. Often times these triggers were based on stated delinquencies within a collateral loan pool. This type of trigger could potentially be manipulated by modifying the terms of delinquent loans and, thereby, returning them to "current" or non-delinquent status. This would allow the trigger criterion to be met and reduce cash flows to triple-A rated investors in the securitization.

As a way to address this type of potential conflict, in our April 2010 securitization, modified loans and loans repurchased by Redwood as the sponsor will be counted as delinquent for 12 months following the date of modification or repurchase, thereby reducing the impact of these events on the allocation of cash flows between senior and subordinate tranches. This simple change was viewed by investors as a strong disincentive for servicer/sponsors to use their rights to favor one tranche of a securitization over another.

2. Risk Retention - Required Amount of Retention

In the Supplementary Information Section of the NPR, references were made to previous comments that had objected to the five percent (5%) risk retention requirement, asserting that the requirement would constrict mortgage credit and would discourage banks from securitizing low risk assets and high quality jumbo prime loans. Certain comments also suggested that certain types of assets, such as prudently underwritten loans or prime credit mortgage loans, be exempted from the risk retention requirement.

We share the FDIC's belief that the sponsor must be required to retain an economic interest in the credit risk relating to a securitization in order to help ensure quality origination practices. However, we believe the FDIC should engage in a more thorough analysis of whether a flat 5% requirement imposed across all types of asset-backed securitizations compromises the effectiveness of risk retention for the sake of simplicity. While simplicity, where appropriate, may aid in the application of the Final Rule, we strongly believe this approach in the context of risk retention requirements could result in securitization becoming a vehicle for inappropriately distributing credit. For example, a fixed percentage for risk retention could fail to discourage aggressive market practices for riskier classes of assets, such as subprime residential mortgage loans.

A better alternative, in our view, would be to tie the amount of required risk retention to rating agency subordination levels. Risk retention requirements for sponsors of securitizations could be set at a level equal to one hundred percent (100%) of the non-investment grade subordinate securities. For example, a securitization of high-quality prime residential mortgages with investment grade securities (i.e., securities rated AAA to BBB-) comprising ninety-seven percent (97%) of the transaction would require three percent (3%) risk retention by the sponsor. Alternatively, under the same methodology, a securitization of lower quality subprime mortgages with investment grade securities comprising seventy percent (70%) of the transaction would require thirty percent (30%) risk retention by the sponsor.

Setting risk retention in a transparent way that takes into account this variation in underlying credit quality will be more effective over time than relying on an arbitrary percentage that can potentially be manipulated through collateral structuring. This form of variable risk retention can also be easily achieved in conjunction with the proposed rule that the structure of RMBS securitizations may not feature more than six credit tranches. While we recognize that the FDIC may hesitate to implement a regulation that relies on independent credit ratings, any desire or requirement to disengage regulations from ratings should not, itself, drive an overly-simplistic (and potentially flawed) approach to risk retention.

3. Loan Representations and Warranties

According to the NPR, securitization transaction documents must require the sponsor to establish a reserve fund equal to five percent (5%) of the cash proceeds of the transaction in order to cover any repurchases of mortgage loans due to material breaches of representations and warranties. After one year, the remaining balance of such reserve fund may be released to the sponsor.

We support the rationale behind this enhancement to the proposed rule. Loan representations and warranties are a straightforward check intended to hold lenders accountable for the quality of, and adherence to, their underwriting standards. And as recent history has shown, many lenders have not stood behind their representations and warranties to investors, despite GAAP requirements to provision for such contingencies. The lack of adequate repurchase reserves, combined with insufficient enforcement mechanisms, has effectively kept more defective loans in private residential loan securitization trusts and increased losses to investors, undermining investor confidence in securitization and increasing the cost of credit to homebuyers. We therefore feel that greater transparency over capital reserves to honor repurchase claims will result in a significant positive impact to investor confidence without necessarily representing an additional cost to loan sellers, as these reserves should already be established. It is also important to note that repurchase reserves are at risk only to the extent that underwriting representations are not met, thus providing further incentives to loan originators to maintain sound underwriting processes.

With regards to the specific language relating to the establishment of a repurchase reserve fund, we propose the following enhancements and clarifications:

- The repurchase reserve should be intended to separate the underwriting risk associated with originating residential loans from the credit risk associated with owning residential securities, thereby incentivizing lenders to originate loans consistent with their underwriting standards. In that regard, the reserve should be funded by the loan originators. In some cases, loan originators may be different than the securitization sponsor. Absent a direct link between the originator and the reserve requirement, the intended effect of establishing the reserve requirement may be lost.

- Where possible, the repurchase reserve should be established through the governing securitization documents and included as part of the securitization trust to ensure that repurchase reserve funds are set aside specifically for the benefit of investors and are included within the scope of the Safe Harbor afforded by the FDIC for securitizations.

- The repurchase reserve, and all repurchase claims, should be controlled independently by the securitization trustee, or a third party to the extent the trustee is related to the sponsor. This will ensure that the resolution process for repurchase claims will be conducted fairly and timely, and that the existence of the repurchase reserve does not otherwise affect the sponsor's determination of whether a sale for GAAP accounting purposes has been achieved.

- The size of the repurchase reserve should be based upon both a quantitative and qualitative assessment that factors in the direct risk inherent in the sold loans as well as the indirect risk of the lender, similar to the variable cost underwriting model already used by IDIs for loans sold to Fannie Mae and Freddie Mac. For example, the reserve could be based on (i) a specified percentage of outstanding loan principal balances applicable for all industry participants based upon "prime" and "nonprime" collateral quality designations, and (ii) a secondary funding requirement based upon annual reviews of the loan seller's underwriting infrastructure and their historical track record for producing high-quality and properly represented loans. This review could be based upon compliance to the provisions of Regulation AB as overseen by the Securities and Exchange Commission.

4. Loss Mitigation Authority

According to the NPR, servicers must be provided with complete authority to maximize the net present value of mortgage loans underlying RMBS securitizations by executing loss mitigation strategies. Such authority may include loan modifications to address reasonably foreseeable defaults.

We fully support the concept of servicers acting in the best interest of the entire securitization trust and not being constrained by any particular subset or class of securitization investors that might otherwise influence their loss mitigation activities. However, there may be an unrelated consequence of such full discretionary authority with regards to GAAP sale accounting criteria and the application of the Safe Harbor in general; namely, the increased likelihood that residential loans originated and serviced by IDIs and subsequently securitized by non-depository institutions may not be consolidated by any institution.

The inability of third party sponsors to exercise sufficient control over the performance of the securitizations they sponsor may therefore have the unintended consequence of promoting a "shadow" banking system which – when combined with bank sponsored securitizations that meet sale accounting treatment in accordance with GAAP – results in most loans not being recorded on any company's balance sheet.

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We appreciate the opportunity to submit comments on the NPR. You may direct any questions regarding this comment letter to the undersigned, who can be reached at 415-380-3455.

Sincerely,

Martin S. Hughes
President and Chief Executive Officer
Redwood Trust, Inc.