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July 15, 2011

Office of the Comptroller of the Currency  
250 E Street, SW., Mail Stop 2-3  
Washington, DC 20219  
Docket Number OCC-2011-0002

Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090  
Attn.: Elizabeth M. Murphy, Secretary  
File Number S7-14-11

Board of Governors of the Federal Reserve  
System  
20th Street and Constitution Avenue, NW  
Washington, DC 20551  
Attn: Jennifer J. Johnson, Secretary  
Docket No. R-1411

Federal Housing Finance Agency  
Fourth Floor  
1700 G Street, NW  
Washington, DC 20552  
Attn.: Alfred M. Pollard, General Counsel  
RIN 2590-AA43

Federal Deposit Insurance Corporation  
550 17th Street, NW  
Washington, DC 20429  
Attn.: Comments, Richard E. Feldman,  
Executive Secretary  
RIN 3064-AD74

Department of Housing and Urban  
Development  
Regulations Division  
Office of General Counsel  
51 7th Street, SW, Room 10276  
Washington, DC 20410-0500

**Re: Credit Risk Retention; Proposed Rule**

Ladies and Gentlemen:

Shellpoint Partners LLC ("Shellpoint") is pleased to submit this comment letter in response to the respective notices of proposed rulemaking as published on or about March 30, 2011 by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development (collectively, the "Agencies") relating to the Agencies' jointly proposed rules (the "Proposed Rules") as mandated by section 941(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), in connection with credit risk retention requirements to be imposed on securitizers in connection with the issuance of asset-backed securities.

Shellpoint Partners is a recently formed company created to originate and own residential mortgages or the credit risk thereon. It currently originates over \$1 billion annually of primarily FHA and GSE eligible mortgages, but intends to dramatically expand its origination of non-agency mortgages over the next year. We view securitization as a means of helping to fund our ownership of these loans and are fully supportive of the concept of risk retention; we intend to meet and, in many cases, exceed the 5% risk retention guideline on our non-agency origination. Because we intend to use securitization as one of several alternatives by which to fund our investment in residential mortgages, our perspective on the Proposed Rules is ultimately that of an investor; however, we also have a strong interest in seeing that the Proposed Rules do not impede private-label securitization from becoming once again the viable funding alternative that it traditionally has been.

Our comments set out below address the following aspects of the Proposed Rules:

- Inadequacy of the vertical slice as an incentive for better underwriting (with a numerical example)
- Structuring flexibility for the L-shaped alternative
- Specific concerns relating to the premium capture rules as drafted
- Duration of risk retention
- Unaddressed concerns regarding second liens
- Qualified Residential Mortgage definition, and
- Concerns about conflict of interest and adverse selection

#### 1. Inadequacy of the Vertical Slice

There are two phrases that are popularly used to describe the objectives of risk retention: "alignment of interests" and "skin in the game". From an investors' perspective, we have always believed that the primary objective of risk retention should be to encourage sound underwriting practices in the origination and securitization of assets. In other words, that the securitizer (or originator as the case may be) has a substantial economic incentive in favor of sound underwriting.

We maintain that this requires that the securitizer have a meaningful exposure to financial detriment if the assets do not perform as expected, and that the securitizer feels economic pain in that event. Viewed from this perspective, "skin in the game" we think better captures the intent of risk retention.

The phrase "alignment of interests" in this context should reflect the objective that the securitizer not be indifferent to asset quality as a result of the securitization process. Unfortunately, it appears that sometimes the phrase is used to mean that the securitizer's interests should be aligned with those of investors in the aggregate.

But a substantial majority of the interests in a typical securitization are senior, and are protected by credit enhancement, either internal (such as subordination) or external (such as by insurance). We do not believe that alignment of the securitizer's interests with the interests of senior investors achieves the goal of risk retention.

In this regard, we note that where credit enhancement is external, the Proposed Rules do not permit the securitizer to benefit from that coverage. That aspect of the proposal is intended to prevent a securitizer from escaping exposure to risk of loss on the assets by benefiting from external enhancement. But, as our example discussed below demonstrates, a similar argument could be made with respect to internal credit enhancement. Under a vertical slice risk retention, the securitizer is insulated from 95% of the anticipated losses on the assets as opposed to a horizontal slice where the issuer absorbs 100% of the first credit losses. For example, assuming that losses equal 3%, then a vertical slice bears only 15 bps of these losses while the horizontal slice bears all of the losses.. Thus, if losses prove to be greater than anticipated, the securitizer is insulated from 95% of those unanticipated losses. We do not believe that this represents an "alignment of interests" that would make a meaningful difference in encouraging sound underwriting practices.

Please see the example attached to this letter as Exhibit 1. As shown in this example, which assumes low coupon loans that do not give rise to premium capture, the risk of loss to the securitizer due to inadequate underwriting of the assets in the pool is substantially lower under vertical slice retention

than it is under horizontal slice retention. While the effect of premium capture, if applicable to a particular security, may mitigate some of this difference, we do not believe that it generally results in the vertical slice approach leading to any better alignment of interests. Accordingly, we question the efficacy of vertical slice retention as means of achieving what we understand to be the intended goals of the Proposed Rules.

In addition, with a vertical slice, if the issuer is also the servicer and has other credit exposure to the borrower (such as a second mortgage), the issuer/servicer can be incented to act against the interests of the securitization, and in favor of its other credit.

## 2. Structuring Flexibility for the L-shaped Retention

Notwithstanding our reservations about the vertical slice alternative, if the alternative is allowed, with respect to the L-shaped slice alternative, we recommend that structuring flexibility be added. We suggest that the entire range of combinations of horizontal and vertical, adding up to 5%, be allowed. However in both a vertical or L-shaped Retention, there should be a minimum horizontal risk retention of at least 1% to ensure that the issuer is exposed to credit loss risk. Because of the overlap of the two components, it is necessary to augment one component, which should be added to the horizontal portion, by a percentage resulting from multiplying the two components together. This is illustrated in the Proposed Rules, where a combination of a 2.5% horizontal slice and a 2.5% vertical slice requires that .0625% be added to the horizontal slice. We suggest that the rules include a formula whereby this additional element be added to the horizontal slice under any permitted combination.

For example, if the securitizer wishes to target a 3% horizontal slice combined with a 2% vertical retention, in order to take into account the overlap such that the total retention was 5%, the horizontal slice would be increased to 3.06%.

## 3. Concerns with the Premium Capture Rules

With regard to the premium capture proposed rules as drafted, we have a number of concerns.

First, Dodd-Frank mandated a baseline risk retention of 5% of the credit risk of the asset pool. Since premium capture is in addition to the proposed risk retention, it means the issuer will be required to retain a significantly greater amount than mandated. The requirement to hold all profit and probably an additional part of the issuer's investment in the loan and to capture all profit from originating and securitizing a loan for 30 years (or for a shorter but still significant time period if instead of funding the account, the issuer chooses to hold additional amounts of the bonds) would have a chilling effect on all but the largest banks' ability to securitize any residential mortgage loan. In no other business is recovery of cost and receipt of profit expected to be delayed for 30 years. To offset the costs of the premium capture account and to enable the issuer to earn an appropriate equity return on its investment, we estimate that mortgage rates would need to increase by 0.76% (see Exhibit 2 for calculation). In addition to the direct costs of premium capture, there are indirect costs to the securitizer; the income on the premium capture account is taxable although cash is not released from the account to pay such taxes. Therefore, the securitizer also needs to have the capital to fund tax payments for 30 years in addition to its investment in the account.

Second, we note that the proposal fails to take into account the cost of origination. A securitizer's cost basis in a mortgage loan is typically not par (the principal amount), but an amount greater than par that reflects out of pocket origination costs that are not passed on to the borrower, as well as costs of carrying and hedging the loan during the period from rate lock until origination and then from origination through securitization. However, the proposal fails to recognize this, and treats any securitization

proceeds in excess of par as if it were profit rather than a recovery of costs. This could result in a securitizer being unable to recoup the cost of acquisition of the mortgage loans from the cash proceeds of the securitization, which could make securitization economically unfeasible. At a minimum, therefore, the premium capture proposal should be revised such that premium recapture only applies to proceeds of the offering in excess of the securitizer's cost basis in the pooled assets.

Third, it is normal for an originator of mortgage loans to hedge its interest rate risk, which is prudent for both regulated and non-regulated institutions. The proposed rules would discourage such risk reduction since any loss on the hedge (when interest rates rally) could not be recovered and would represent additional investment for the life of the security making securitization economically unfeasible.

Absent a revision as described above to take into account the cost basis, one way to mitigate the possibility of premium capture would be to simply impose more of the origination costs on the borrower. Or, to the extent that a lower interest rate would reduce the likelihood of premium proceeds resulting from the securitization, borrowers could be encouraged to pay higher fees and points to reduce the interest rate. Prospective homebuyers would as a result be burdened further, by having to come up with more cash to close a purchase, over and above the necessary equity investment in the property. These likely consequences of the proposed rules would be highly undesirable, especially at a time when the housing markets continue to struggle to recover. As discussed in the last paragraph of Exhibit 2, the cost in points to the borrower could be in the range of 3.5% of the principal amount to offset the impact of premium capture.<sup>1</sup>

If the premium capture requirement is not eliminated as we strongly recommend, we would then recommend that it be revised so that the premium capture account is not required to be held for the entire life of the transaction. Since amounts in the account represent assets of the securitizer that could otherwise be used as working capital or to make new loans, it would impose an unnecessary burden on the securitizer to retain the amounts for a longer period of time than is appropriate to help assure asset quality. Generally, we believe that five years is an appropriate point in time, because most defaults and losses associated with underwriting quality issues will generally have occurred by then<sup>2</sup>. Furthermore, it would be reasonable to permit the premium capture account to be allowed to be released in part even before the five year mark, in response to pool performance criteria. For example, if the pool pays down more quickly than expected, or if losses are at or below expected case parameters, then a partial release prior to the five year mark would appear appropriate.

#### 4. Duration of Risk Retention

The Proposed Rule would require across the board that any mandatory risk retention be retained for the life of the transaction. We believe that risk retention should be required to be held no longer than needed to support the regulatory purpose, which is to help assure asset quality. Allowing risk retention positions to be sold at an appropriate time will ease the regulatory burden on securitizers, by removing an artificial restraint on liquidity for assets that have a readily ascertainable market value. For loans held under a representative sampling risk retention, easing the retention requirement would allow those loans to be sold, and also to be serviced without regard to the servicing of the corresponding assets in the securitized pool.

It is, of course, difficult to generalize as to what period of time would be sufficient such that the performance of the loans in the pool would be influenced predominantly by current conditions, and would

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<sup>1</sup> This would make it ineligible for the proposed QM safe harbor and might mean that the consumer would be unable to obtain mortgage credit.

<sup>2</sup> This time period is consistent with our proposal for Duration of Risk Retention in section 4, below.

be affected only to the most minimal degree by the quality of underwriting at the time of origination. But, from an investor's perspective, and with respect to first lien residential mortgage loans generally, we believe that a five year period would be appropriate, after which any remaining risk retention positions could be released. Allowing the securitizer to sell at or after the five year point allows for a recycling of capital into new loans and keeps credit available to homeowners. By the five year point, any problems in underwriting will have become apparent to investors in the securities, and investors purchasing new securities from the same issuer will reflect in their price the performance to date of that issuer's prior series and expected future performance of its newly pooled loans thus causing the issuer to bear the consequences of poor origination.

#### 5. Concerns Regarding Second Liens

Investors in residential mortgages are very concerned, on a going forward basis, about the interplay between first and second liens on the same property. Investors in residential first liens are particularly frustrated by the lack of appropriate burden sharing by second lien holders in non-foreclosure loss mitigation. For example, when a first lien is modified by means including a principal forbearance or forgiveness under HAMP as well as other typical servicing procedures, there is frequently no ability to mandate that any second lien holder bear a share of the pain. Yet the fair and correct result in such circumstances is that the principal amount of the second lien should be wiped out entirely before any principal loss or forbearance is allocated to the first lien holder.

While a complete resolution of this issue is beyond the scope of the Proposed Rules, we believe that a comprehensive approach to risk retention for first lien residential mortgage loans should take into account the possibility of a second lien serviced by an affiliated entity. Where the same or affiliated entities service both a first and second mortgage loan on the same property, the existence of the second lien can have an effect on the impact to the securitizer of any risk retention related to the corresponding first lien if included in a securitized pool. For example, servicing decisions that benefit the second lien to the detriment of the first lien would undercut any risk retention on the first lien.

We are not advocating that a comprehensive set of servicing standards generally be added to the Proposed Rules, or that they be part of the Qualified Residential Mortgage (QRM) definition.

We are advocating that a general condition be added to the Proposed Rules, applicable to all securitizations backed by residential mortgage loans (regardless of whether they meet the QRM criteria), to the following effect in all cases where 1) an asset-backed security subject to the Proposed Rules includes any residential mortgage loan, and 2) the same or an affiliated servicer services both the mortgage loan included in the securitized pool, and also any other mortgage loan of higher or lower priority that is secured by the same mortgaged property:

- the operative securitization documents shall require that the servicer engage an independent advisor for the purpose of reviewing and advising on any proposed major servicing decisions as to either loan (including commencement of foreclosure, modification or other loss mitigation), from the perspective of whether such proposed action is in the best interest of holders of interests in the respective loans taking into account their respective lien priority, and
- specifically prohibiting any principal forbearance or forgiveness on any such first lien mortgage loan, unless the principal amount of any related second lien mortgage loan is completely written off.

## 6. "Qualified Residential Mortgage" Definition

Finally, we wish to express our view that the debt-to-income ratio criteria as proposed in the QRM definition are unduly restrictive. As proposed, the monthly housing related debt-to-income ratio ("front end DTI") must not exceed 28%, and the total monthly debt-to-income ratio ("back end DTI") must not exceed 36%. As a general rule, traditionally, prime quality jumbo mortgage loans have permitted maximum front-end DTIs of 33%, and back end DTIs of 38%. Given all other elements of the QRM definition, we believe that moving to these DTI levels would not materially increase the risk profile, from an investor's perspective. Additionally, we believe loan-to-value ratios ("LTV") up to 85% with mortgage insurance should be allowed; this would permit many additional potential home purchasers to qualify for the lower interest rates expected for QRMs. Numerous studies have shown that prime, well underwritten 85% LTV loans default only 10% more often than 80% LTV loans which still represents a prudent risk. At levels above 85% LTV, historical experience shows such a significant increase in defaults that these loans should not qualify for QRM. For example, loans with an 86 to 90% LTV default approximately 18% more often than loans with an 80% LTV, and loans with a 90 to 95 LTV default approximately 27% more often.

## 7. Concerns about Conflict of Interest and Adverse Selection

The proposed rules do not address the incentive a lender who only securitizes a part of its portfolio would have to adversely select loans for securitization. Currently, the incentives are aligned so a portfolio lender is incented to retain the best loans where it has 100% risk retention and to securitize its riskiest loans where it would only have a 5% risk retention (and, if a vertical risk retention, a de minimis investment in the credit risk). We believe originators who also retain loans for portfolio should be required to disclose the performance of their retained portfolio on a bucketed basis to investors (similar to what is required under the representative sample method of risk retention) so investors can compare the relative performance and make informed investment decisions.

Thank you for the opportunity to provide comments on this very important regulatory initiative.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Saul Sanders", followed by a long horizontal line extending to the right.

Saul Sanders  
Co-Chief Executive Officer

## Exhibit 1

### Risk Retention and Sponsor Credit Risk:

This Exhibit compares the credit risk implications of the “horizontal” and the “vertical” retention proposals, in a hypothetical case involving a low coupon loan that does not give rise to premium capture. In each case the sponsor must retain a 5% share of the face amount of issued securities. In the “horizontal” case – the left-hand panel – the retained securities comprise the entirety of those classes (shaded grey) immediately exposed to the first risk of credit losses. In the “vertical” case – the right-hand panel – the retained securities are a 5% pro-rata share of each class of security issued.

Items (i) and (ii), highlighted in green, show that the holder of the “horizontal” retention is exposed to the entire amount of credit losses to a trust, up to 5%. If, as in case (i), there are credit losses to the trust equal to the size of the junior-most class of securities, the sponsor loses the entire value of that security, here valued at 0.06%, and no other debt holders experience any credit losses. If, as in case (ii), there are credit losses to the trust equal to the total size of the five junior-most classes of securities, the sponsor loses the entire value of those securities, or 3.11%, and no other debt holders experience any credit losses.

Items (iii) and (iv), highlighted in blue, show that the holder of the “vertical” retention is exposed to a small fraction of the credit losses to a trust. Case (iii), like case (i), supposes losses to the trust equal in amount to the size of the junior-most class of securities. In the case of vertical retention, however, the sponsor only suffers losses of 5% of the value of that security, or 0.003%, and other debt holders experience the rest of the credit losses (.057%). Case (iv), like case (ii), supposes losses to the trust equal in amount to the size of the five junior-most classes of securities. But, as in case (iii), the sponsor suffers only 5% of the diminished value, or 0.156%, and other debt holders experience the rest of the credit losses (2.954%).

These examples show that “vertical” retention imposes very little credit risk on the sponsor of a securitization and defeats the purpose of Dodd-frank risk retention. 95% of credit losses are traded away to the third party buyers of securities, offering little incentive to the sponsor to ensure sound lending.

**EXHIBIT 1**

**5% Horizontal Retention Example**

Prime Paradigm Securitization Table: 7.5% Subordination to AAA		
AAA Bonds - 92.5% of Principal, Priced at par, or \$92.50	AAA IO, Notional 92.5% of Principal, Valued at \$1.3	Sold to Third Parties
AA Bonds - 2.50% of Principal, Priced at 83.91%, or \$2.10		
A Bonds - 2.00% of Principal, Priced at 80.64%, or \$1.61		5% Horizontal Retention
BBB Bonds - 1.50% of Principal, Priced at 74.67%, or \$1.12		
BB Bonds - 0.50% of Principal, Priced at 34.44%, or \$0.17		
B Bonds - 0.50% of Principal, Priced at 29.69%, or \$0.15		
Non Rated Bonds - 0.50% of Principal, Priced at 11.93%, or \$0.06		

Sold to 3rd Parties:	Percent of Principal	Value
AAA	92.50	92.50
AAA IO	n/a	1.30
AA	2.50	2.10
	95.00	95.90

Retained:	Percent of Principal	Value
A	2.00	1.61
BBB	1.50	1.12
BB	0.50	0.17
B	0.50	0.15
Non Rated	0.50	0.06
	5.00	3.11

Retained:	Percent of Principal	Value
Exposure to 1st 50 basis points of loss	0.50	0.06 <sup>(i)</sup>
Exposure to 1st 5 points of losses	5.00	3.11 <sup>(ii)</sup>

Premium Capture:	Value
Proceeds	95.90
Costs	(0.90)
Threshold	(95.00)
Premium Capture Amount	-

Economics to Securitizer:	Value
Value of Proceeds + Retention	99.01
Value of Servicing Rights	1.13
Cleanup Call Rights	-
Premium Capture Account Deposit	-
Premium Capture Value	-
Cost to Securitize	(0.90)
Price Paid for Mortgage	99.23

Economics to Originator:	Value
Sale Value of Mortgage	99.23
Cost to Originate Mortgage	(101.50)
Profit	(1.00)
Points Charged Borrower	3.27

Economics to Borrower:	Value
Coupon	4.70
DTI	38.00
Points Paid	3.27

**5% Vertical Retention Example**

Prime Paradigm Securitization Table: 7.5% Subordination to AAA			
Sold to Third Parties		5% Vertical Retention	
AAA Bonds - \$92.50 * 95%, or \$87.875	AAA IO - \$1.23	AAA Bonds - \$92.50 * 5%, or \$4.629	AAA IO - \$0.065
AA Bonds - \$2.098 * 95%, or \$1.993		AA Bonds - \$2.098 * 5%, or \$0.105	
A Bonds - \$1.613 * 95%, or \$1.532		A Bonds - \$1.613 * 5%, or \$0.081	
BBB Bonds - \$1.120 * 95%, or \$1.064		BBB Bonds - \$1.120 * 5%, or \$0.056	
BB Bonds - \$0.172 * 95%, or \$0.164		BB Bonds - \$0.172 * 5%, or \$0.009	
B Bonds - \$0.148 * 95%, or \$0.141		B Bonds - \$0.148 * 5%, or \$0.007	
Non Rated Bonds - \$0.060 * 95%, or \$0.057		Non Rated Bonds - \$0.060 * 5%, or \$0.003	

Tranche	Sold to 3rd Parties		Retained		Total	
	Percent of Principal	Value	Percent of Principal	Value	Percent of Principal	Value
AAA	87.875	87.875	4.625	4.629	92.500	92.504
AAA IO	n/a	1.230	n/a	0.065	n/a	1.295
AA	2.375	1.993	0.125	0.105	2.500	2.098
A	1.900	1.532	0.100	0.081	2.000	1.613
BBB	1.425	1.064	0.075	0.056	1.500	1.120
BB	0.475	0.164	0.025	0.009	0.500	0.172
B	0.475	0.141	0.025	0.007	0.500	0.148
Non Rated	0.475	0.057	0.025	0.003	0.500	0.060
	95.000	94.056	5.000	4.954	100.000	99.101

Retained:	Percent of Principal	Value
Exposure to 1st 50 basis points of loss	0.025	0.003 <sup>(iii)</sup>
Exposure to 1st 5 points of losses	0.250	0.156 <sup>(iv)</sup>

Premium Capture:	Value
Proceeds	94.06
Costs	(0.90)
Threshold	(95.00)
Premium Capture Amount	-

Economics to Securitizer:	Value
Value of Proceeds + Retention	99.01
Value of Servicing Rights	1.13
Cleanup Call Rights	-
Premium Capture Account Deposit	-
Premium Capture Value	-
Cost to Securitize	(0.90)
Price Paid for Mortgage	99.23

Economics to Originator:	Value
Sale Value of Mortgage	99.23
Cost to Originate Mortgage	(101.50)
Profit	(1.00)
Points Charged Borrower	3.27

Economics to Borrower:	Value
Coupon	4.70
DTI	38.00
Points Paid	3.27

**Assumptions:**

The capital structure used in both retention examples is adopted from Table 1, "Breakdown Of Loss Estimates For the Archetypical Pool By Rating", of Standard & Poor's publication "Methodology And Assumptions For Rating U.S. RMBS Prime, Alternative-A, And Subprime Loans", dated September 10, 2009

The collateral consists of 30-year term, fully amortizing, fixed rate mortgages, run at a conditional prepayment speed of 10%.

The defaults were run at a 0.25% conditional default rate, with a 12 month delay, and a 30% severity, for a total of 0.5% collateral losses over the life of the loans.

The P&I bonds were priced at spreads over the 6/24/2011 treasury curve: AAA: 200 bps, AA: 350 bps, A: 400 bps, BBB: 500 bps, BB: 1,800 bps, B: 2,100 bps, NR: 2,400 bps

The IO bond was priced at an approximate 4.50:1 multiple of coupon.

Costs to securitize mortgages are 0.90%, as a fraction of the mortgage principal balance, costs to originate mortgages are 1.5%, and Originators expect to earn 1% profit.

The Servicing Rights are a certificated, transferrable mortgage coupon strip of 0.25% which is dedicated solely to the cost of servicing. The strip is valued at a 4.50:1 multiple, or 1.125%.



## Exhibit 2

### Premium Capture and Borrower Affordability:

Taken together Exhibits 1 and 2 illustrate the cost of the proposed premium capture on the borrower.

Exhibit 1 features the securitization of a 4.7% coupon, fixed-rate, thirty-year mortgage. Because Exhibit 1 assumes a low coupon loan, the economics of that transaction are such that the net proceeds to the sponsor do not exceed 95%, so premium capture is not relevant. The economics to the borrower, highlighted in red, are identical between the two cases, with an assumed 38% Back-end Debt-to-Income Ratio ("DTI") and 3.27 points paid by the borrower at origination.

Exhibit 2, which directly shows the impact of premium capture, features, on the left-hand panel, securitization through the same structure of a similar mortgage, but the coupon has been changed to 5.7%. The coupon was increased by 1% to show the deleterious effect of premium capture on a borrower's attempt to reduce origination costs. The resulting securitization economics, highlighted in orange, show that the borrower's burden of points paid at origination is lessened, to 2.16, but is offset by an elevated DTI of 41.69%. The right-hand panel shows the securitization economics for the same loan as if there were no premium capture requirement. Targeting the same points paid by the borrower, and shown highlighted in yellow, the borrower's coupon drops dramatically, from 5.7% to 4.94%, producing a DTI of 39%. Therefore, for every 1.1 reduction in up-front points, the premium capture requirement costs the borrower approximately 0.76% per annum and results in an increase in a DTI of 2.69%, significantly reducing affordability.

### Cost in Points of Premium Capture:

For an alternative illustration of the same effect, the coupon can be maintained near but below 5.7% and the borrower's points paid can be eliminated entirely. The net cost of premium capture is computed as the sum of the pink-highlighted items (v), the Premium Capture Account Deposit, and (vi), Premium Capture Value, or  $(4.35)\% + 0.81\% = (3.54)\%$ . In absolute value, this exceeds by 1.38% the borrower's points paid of 2.16%. In the absence of the premium capture cost, the borrower would pay no points and the excess 1.38% points (approximately valued using the same 4.5:1 multiple as the IO bond) would get the borrower a coupon reduction of about 0.31% per annum. In other words, a 0.69% increase in mortgage coupon would eliminate entirely the borrower's need to pay 3.27 points up front if the securitization process were not subject to premium capture .

Moreover, premium capture disproportionately impacts lower credit borrowers. Securitizations of lower credit quality mortgages, in which the rating agencies generally require higher subordination, become economically viable only when the mortgages carry a higher coupon. This is because the higher coupon generates excess interest which offsets the lowered proceeds of bond sales. For example, a securitization capital structure with 15% subordination to AAA, and targeting the same borrower points paid of 2.16%, requires a borrower coupon of 6.76%. The same transaction will, absent premium capture, require a borrower coupon of 5.30%. As a result, the premium capture requirement costs the lower credit quality borrower approximately 1.46% per annum and results in a DTI increase of 5.25%.

**EXHIBIT 2**

**5% Horizontal Retention Example**

Prime Paradigm Securitization Table: 7.5% Subordination to AAA		
AAA Bonds - 92.5% of Principal, Priced at par, or \$92.50	AAA IO, Notional 92.5% of Principal, Valued at \$5.47	Sold to Third Parties
AA Bonds - 2.50% of Principal, Priced at 91.29%, or \$2.28		
A Bonds - 2.00% of Principal, Priced at 87.76%, or \$1.76		5% Horizontal Retention
BBB Bonds - 1.50% of Principal, Priced at 81.30%, or \$1.22		
BB Bonds - 0.50% of Principal, Priced at 37.81%, or \$0.19		
B Bonds - 0.50% of Principal, Priced at 33.25%, or \$0.17		
Non Rated Bonds - 0.50% of Principal, Priced at 14.57%, or \$0.07		

Sold to 3rd Parties:	Percent of Principal	Value
AAA	92.50	92.50
AAA IO	n/a	5.47
AA	2.50	2.28
	95.00	100.25

Retained:	Percent of Principal	Value
A	2.00	1.76
BBB	1.50	1.22
BB	0.50	0.19
B	0.50	0.17
Non Rated	0.50	0.07
	5.00	3.40

Retained:	Percent of Principal	Value
Exposure to 1st 50 basis points of loss	0.50	0.07
Exposure to 1st 5 points of losses	5.00	3.40

Premium Capture:	Value
Proceeds	100.25
Costs	(0.90)
Threshold	(95.00)
Premium Capture Amount	4.35

Economics to Securitizer:	Value
Value of Proceeds + Retention	103.65
Value of Servicing Rights	1.13
Cleanup Call Rights	-
Premium Capture Account Deposit	(4.35) <sup>(v)</sup>
Premium Capture Value	0.81 <sup>(vi)</sup>
Cost to Securitize	(0.90)
Price Paid for Mortgage	100.34

Economics to Originator:	Value
Sale Value of Mortgage	100.34
Cost to Originate Mortgage	(101.50)
Profit	(1.00)
Points Charged Borrower	2.16

Economics to Borrower:	Value
Coupon	5.70
DTI	41.69
Points Paid	2.16

**5% Horizontal Retention Example**

Prime Paradigm Securitization Table: 7.5% Subordination to AAA		
AAA Bonds - 92.5% of Principal, Priced at par, or \$92.50	AAA IO, Notional 92.5% of Principal, Valued at \$2.3	Sold to Third Parties
AA Bonds - 2.50% of Principal, Priced at 85.64%, or \$2.14		
A Bonds - 2.00% of Principal, Priced at 82.32%, or \$1.65		5% Horizontal Retention
BBB Bonds - 1.50% of Principal, Priced at 76.23%, or \$1.14		
BB Bonds - 0.50% of Principal, Priced at 35.23%, or \$0.18		
B Bonds - 0.50% of Principal, Priced at 30.57%, or \$0.15		
Non Rated Bonds - 0.50% of Principal, Priced at 12.57%, or \$0.06		

Sold to 3rd Parties:	Percent of Principal	Value
AAA	92.50	92.50
AAA IO	n/a	2.30
AA	2.50	2.14
	95.00	96.94

Retained:	Percent of Principal	Value
A	2.00	1.65
BBB	1.50	1.14
BB	0.50	0.18
B	0.50	0.15
Non Rated	0.50	0.06
	5.00	3.18

Retained:	Percent of Principal	Value
Exposure to 1st 50 basis points of loss	0.50	0.06
Exposure to 1st 5 points of losses	5.00	3.18

Premium Capture (ignored):	Value
Proceeds	96.94
Costs	(0.90)
Threshold	(95.00)
Premium Capture Amount	-

Economics to Securitizer:	Value
Value of Proceeds + Retention	100.12
Value of Servicing Rights	1.13
Cleanup Call Rights	-
Premium Capture Account Deposit	-
Premium Capture Value	-
Cost to Securitize	(0.90)
Price Paid for Mortgage	100.34

Economics to Originator:	Value
Sale Value of Mortgage	100.34
Cost to Originate Mortgage	(101.50)
Profit	(1.00)
Points Charged Borrower	2.16

Economics to Borrower:	Value
Coupon	4.94
DTI	39.00
Points Paid	2.16

0.76

**Assumptions:**

The capital structure used in both retention examples is adopted from Table 1, "Breakdown Of Loss Estimates For the Archetypical Pool By Rating", of Standard & Poor's publication "Methodology And Assumptions For Rating U.S. RMBS Prime, Alternative-A, And Subprime Loans", dated September 10, 2009

The collateral consists of 30-year term, fully amortizing, fixed rate mortgages, run at a conditional prepayment speed of 10%.

The defaults were run at a 0.25% conditional default rate, with a 12 month delay, and a 30% severity, for a total of 0.5% collateral losses over the life of the loans.

The P&I bonds were priced at spreads over the 6/24/2011 treasury curve: AAA: 200 bps, AA: 350 bps, A: 400 bps, BBB: 500 bps, BB: 1,800 bps, B: 2,100 bps, NR: 2,400 bps

The IO bond was priced at an approximate 4.50:1 multiple of coupon.

Costs to securitize mortgages are 0.90%, as a fraction of the mortgage principal balance, costs to originate mortgages are 1.5%, and Originators expect to earn 1% profit.

The Servicing Rights are a certificated, transferrable mortgage coupon strip of 0.25% which is dedicated solely to the cost of servicing. The strip is valued at a 4.50:1 multiple, or 1.125%.