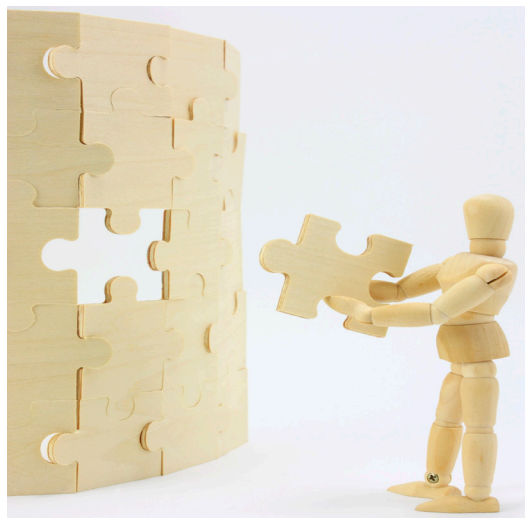


A GUIDE TO REVIVING THE PRIVATE LABEL SECURITIZATION MARKET

AUGUST 2014



REDWOOD TRUST



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Honorable Jacob J. Lew
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 10019

Dear Secretary Lew,

On behalf of Redwood Trust, Inc., we are respectfully submitting the following response to the Treasury Department's request for public comment on the development of a responsible private label securities market. Our response is in the form of this *Guide to Reviving the Private Label Securitization Market*.

The government's decision to intervene and support the mortgage market during and after the Great Recession was critical to making sure there was an uninterrupted flow of mortgage financing to support and revive the housing market. There is now broad agreement that the time has come to reduce the government's outsized role in providing credit support to the residential mortgage market. This requires not just reform of Fannie Mae and Freddie Mac, but also the revival of a healthy, private-label mortgage-backed securities ("PLS") market.

This guide is focused solely on the restoration of a fully functioning PLS market, so that major institutional investors will once again provide capital for mortgage financing alongside government-sponsored mortgage programs and banks.

Redwood Trust has a long and successful history in the business of securitizing prime-quality mortgage loans without any form of government guarantee. Through our Sequoia securitization platform, we have securitized \$42 billion of residential mortgage debt since we were founded in 1994. And, since the end of the financial crisis, we have sponsored more than 40% of all the new-issue PLS transactions.

As a result of our recent experience, we are often asked for our view on the best ways to make the PLS market fully functioning again. We wish there were a simple explanation and a simple fix, but unfortunately this is a complex, multi-dimensional issue. This guide, which is an update of the recommendations we published in November 2010, gives our "boots-on-the-ground" insights into the fits, starts, and struggles of the PLS market over the past four years, as well as, what we believe can be done to fix it for the future.

From our perspective, the problems of the PLS market are not insurmountable. Many of the impediments holding back the PLS market can be fixed with relatively simple structural changes. Furthermore, the Federal Reserve's monetary policy has left the financial world flush with capital looking for safe, attractive investment opportunities such as PLS. We need to connect that capital to investments in triple-A PLS, which we believe can offer meaningful relative value for fixed income investors.

The most difficult challenge facing the PLS market is a bit of a Catch-22. Investors and issuers are much more inclined to participate in a PLS market that is active and liquid, with ample investment opportunities and tight bid-ask spreads, but the current market has none of these characteristics. The Catch-22 is that we can't get to a healthy and liquid state while both investors and issuers remain on the sidelines, waiting until the market is healthy and liquid.

This guide primarily addresses the interests of triple-A investors, who typically acquire 90% or more of the securities issued in a PLS transaction. But we have also endeavored to offer ideas that we believe balance the interests of all stakeholders, including the government, mortgage originators, servicers and borrowers. From our perspective, the ultimate goal should be the restoration of a healthy and robust PLS market that benefits homeowners and is able to function without government support.

We thank you for your leadership and interest in this effort. You have a unique platform for generating discussion, bringing together stakeholders, airing different views, and most importantly, facilitating consensus and compromise. Redwood Trust shares your commitment and we urge you to continue this initiative.

As this discussion proceeds, Redwood will continue to do its part to rebuild the PLS market. While our post-crisis Sequoia transactions have already demonstrated nearly perfect credit performance, we are planning to adopt many of the reforms contained in this document in our future PLS issuances, to ensure an even higher level of structural safety for investors.

We hope our ideas and recommendations play a very constructive role in your ultimate success.

Sincerely,



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



Brett D. Nicholas
President
Redwood Trust, Inc.



Matthew J. Tomiak
Managing Director
Redwood Trust, Inc.

Executive Summary

Issues

The mortgage financing provided to homeowners through the PLS market is vital to the long-term health of our nation’s housing market and must be restored. To accomplish that, we must address many issues, some of which are interdependent. We group these issues into three broad themes.

- ***PLS structural flaws that have caused a lack of trust among triple-A investors has resulted in insufficient demand,***
- ***A lack of financial incentive, coupled with unfinished litigation and regulation, has made large banks hesitant to reenter the PLS market, and***
- ***Insufficient PLS market volume and liquidity deters participation of both issuers and investors.***

This Guide discusses all three in greater detail and provides a very practical and actionable roadmap for reforming the PLS market and rebuilding investor confidence.

Solutions

PLS Structures

PLS transaction documents must be much more prescriptive, clearly assign responsibilities, and limit the need for subjective decision making by servicers and trustees. This Guide proposes structural reforms that will increase transparency, reduce documentation ambiguity, promote standardization, prevent conflicts of interest, ensure the integrity of underlying loan collateral, and align all counterparties’ financial incentives with those of investors.

We also firmly believe that adding an independent Transaction Manager or “traffic cop” to oversee servicers, the resolution process for representation and warranty breaches and the application of monthly cashflow mechanisms would address many of the investor concerns that are causing them to not participate in the PLS market. The Transaction Manager must be empowered to compel corrective action.

Bank Participation

Drawing banks back into the PLS market may be accomplished if two developments occur. First, pending litigation and unfinished regulation needs to be finalized. The financial and reputational risk of noncompliance with laws and regulations is now so high that some banks have made a decision not to reenter the PLS market until regulations and enforcement standards are very clearly established. Second, a rise in short-term rates or a flattening of the yield curve may make banks reconsider their current practice of holding longer duration mortgages on their balance sheets, making them more apt to sell mortgages through the PLS market.

Market Volume and Liquidity

The first step to enticing more investors to return to the PLS market would be to implement the structural reforms we are recommending. The next step would be to increase the size of the PLS market by lowering the GSE loan limit on a safe and measured basis. In addition, there are two other ideas that we believe would be very effective ways to increase market liquidity, but we fully recognize these ideas are likely to be politically unpopular. Firstly, the government could facilitate the creation of more efficient and attractive borrowing facilities for triple-A securities to increase demand and yield. Secondly, the government could authorize an existing agency, such as the Federal Home Loan Bank (“FHLB”) System, to serve as an anchor buyer of PLS securities, thus increasing demand and liquidity.

I. Our Thoughts and Observations

The purpose of this section is to offer our thoughts and observations on issues that impact PLS transactions. It is intended to provide the background and context for our recommendations, as well as our views on some of the reform ideas being advanced by other stakeholders.

Redwood Trust’s Approach to this Guide

In preparing this Guide, we have purposely compartmentalized our analysis and proposals. We believe this will best enable the different stakeholders to take what they want and utilize those portions that are most relevant to the particular aspects of reform on which they are focused. This Guide is not a single “take it or leave it” proposition. Instead, it consists of discrete proposals that need not be adopted or put in place at the same time.

It is not our intention to anger stakeholders or appear to be “pointing fingers.” In suggesting these reforms, however, we believe it is necessary to acknowledge and address issues with clear eyes.

What Should I Read First?

For readers unfamiliar with the issues facing the PLS market, the reforms detailed in Section II will likely require additional background. For the necessary background and context, we suggest you skip ahead and first read pages 22-32 before reading Section II. If you require more information on securitization structures and industry terminology, we suggest you read the Appendices of the first version of this Guide dated November 2010, which can be found on Redwood Trust’s website (www.redwoodtrust.com) in the Investor Information section under “Policy Proposals.”

Mandatory First Step: Address the Concerns of Triple-A Investors

Triple-A securities comprise 90% or more of any PLS issuance, making triple-A investors the most important investors in PLS securitizations and the drivers of that market as a whole. If they do not invest in the asset class, there is effectively no asset class. Many of the triple-A investors who supported the buildup of the PLS market in the past are now limiting the amount of capital they are willing to risk in this asset class; others no longer invest at all. We understand the rationale for their decision. Triple-A investors have borne much of the ultimate financial cost of misalignment of financial interests, government interventions, and in certain instances, poor servicing practices and poor underwriting, as well as rating agency failures, and almost everything else that went wrong in the mortgage-backed securities market.

Triple-A investors have felt powerless to protect their interests, except by simply opting out of new PLS transactions altogether. Furthermore, the vast majority of new mortgage regulation and reform enacted in the aftermath of the crisis has been targeted toward better protecting borrowers' interests, while little has been done to enhance protections for PLS investors. Even the highly touted "skin-in-the-game" provision under the Dodd-Frank Act appears headed toward being significantly weakened.

A full and robust PLS market will not return unless the concerns of triple-A investors are completely addressed. We recognize that other interests need to be considered when evaluating reforms, but the outcome must be investor-interest driven. That is the overriding objective of the suggested reforms contained in this Guide, and we urge you to give that objective the same level of priority.

Restart PLS Around High-Quality Prime Loans, then Expand

In our opinion, triple-A investors' initial return to the PLS market will happen only when appropriate reforms are in place and when they can invest in PLS backed by the most conservative and creditworthy collateral. This will allow investors to test the adequacy of new structural reforms, with the fail-safe that if the structural reforms are inadequate, investors will still be protected by very conservatively underwritten loans carrying minimal credit risk. That is a natural part of the recovery process and should be built into plans and expectations. It is highly unlikely that a restructured PLS market will be able to serve all segments of the mortgage market from the outset.

We believe that we must first rebuild a strong core PLS market centered on high-quality, well-underwritten prime loans, securitized via simple structures. Then, as we regain the trust of triple-A investors, the PLS market can expand to serve other segments of the mortgage market.

If it were up to us, we would place a temporary moratorium on high-risk PLS transactions, defined as those backed by low-quality loan collateral and utilizing complicated securitization structures. It is just too difficult to develop adequate investor protection mechanisms for these transactions, as there are simply too many ways to divert cashflow away from senior investors. Further, the reemergence of risky PLS transactions will spoil the market opportunity for all parties and retard the return of an active PLS market. Unfortunately, there is no easy structural mechanism to put such a moratorium in place.

Potential Changes to the Trust Indenture Act (“TIA”)

A number of investors have advocated for changes in the TIA to impose fiduciary duty obligations on securitization trustees. Certain trustees have opposed the changes and have noted the possibility of substantially increased costs of transactions, and ultimately for borrowers, if such changes were to be made. The objective, we believe, should be to have a well-recognized institution looking after the interests of investors. We don't believe that trustees have the ability or resources to serve this function. This is a new role, requiring expertise in several fields. The importance of this role necessitates a new industry participant, rather than simply piling significant new responsibilities on an unprepared current market participant. An appropriately selected Transaction Manager (described later in this Guide) charged with specific responsibilities for oversight, enforcement and reporting to investors, and that may be removed by investors at any time, may be better able to resolve investors' underlying concerns.

Manage Expectations and Measure Success Incrementally

All parties to reform must recognize that rebuilding the PLS market will take time and will happen incrementally, and will likely include the occasional setback. We should not be deterred by this reality. Instead, we should build it into our expectations and into how we periodically measure success.

Impact of Government Intervention and Litigation on Investors and the New Issue PLS Market

In the wake of the financial crisis, the Federal government adopted many policies and programs in an effort to stabilize the mortgage market, bolster housing, and mitigate the social impact of foreclosures. The key components of that agenda were foreclosure moratoriums, loan modifications, and higher GSE and FHA loan limits. The beneficiaries of those policies were borrowers, especially distressed borrowers. In addition, the Federal government has used its investigative and enforcement powers to force originators, servicers and other parties to agree to large financial settlements on claims of misconduct. The primary recipients of the settlement funds were not investors. The scope of government intervention also included the actions of State regulators, and local governments' attempts to use eminent domain to seize mortgages.

For the sake of moving forward, we do not intend to question the legitimacy or effectiveness of the government's agenda. In fact, we will posit that the government was well intentioned in its actions. However, the government has to realize that because of its primary focus on channeling benefits to distressed borrowers, the government inflicted significant damage to triple-A mortgage investors.

Triple-A investors suffered losses at the hands of the same parties that the government has claimed harmed borrowers. Investor losses were further compounded by government interventions that helped borrowers at the expense of investors. We believe the structural reforms presented in this Guide will begin to alleviate some of the understandable investor mistrust, but it would help if government policy makers also demonstrated an appreciation for investor rights and interests. Without investors' money, there will be no PLS market.

Government litigation has chilled not just investor interest in the PLS market, but has also chilled the interest of the major banks and Wall Street firms who had been historically large PLS issuers. The massive settlements and seemingly endless claims and negotiations related to pre-crisis PLS transactions have made historically large issuers extremely hesitant to reenter the new issue PLS market in any meaningful way. Regardless of differing views of the merits, we do believe that having truly final and all inclusive settlements that cannot be reopened will encourage issuers to reenter the market.

GSE Guarantee Fees (“g-fees”) and Loan Limits

Early discussions about bringing private capital back into the mortgage market centered on the creation of a “level playing field” to allow private capital to compete against the GSEs in the mortgage market. The primary tool for trying to accomplish that objective has been an increase in the g-fee so that the private market could compete with the GSEs on loan pricing. A level playing field remains a sound policy objective. However, we are now convinced that a further g-fee increase will not achieve this goal until structural issues in the PLS market have been fully addressed. Without structural reforms, higher g-fees will do little to crowd-in private capital, and could in fact result in a counterproductive increase in borrowing costs for average homeowners at a critical juncture in the housing cycle.

A reduction in the GSE loan limit is the only immediate and viable step that can be taken to bring more private capital back into the mortgage market. GSE loan limits should be rolled back from the current \$625,500 to the pre-crisis limit of \$417,000, on a safe and measured basis. Private capital, primarily in the form of bank balance sheets, has demonstrated a strong demand for mortgage assets. The loan limit was reduced from \$729,750 to \$625,500 in October of 2011, and private capital has filled the space. Those borrowers are getting loans at very competitive rates, even if most of the loans are not entering the PLS market. The portion that does get pooled into PLS transactions still helps to increase the market share opportunity and liquidity for PLS transactions. These loans will likely move off of bank balance sheets and into the PLS market when the reforms we have described in this Guide are adopted.

Do Servicers Deserve All the Bad Press They Received?

It's a complicated issue and the bottom line is that there was plenty of blame to assign to various parties. Certain servicers clearly had serious performance issues and inherent conflicts of interest, but there were three other factors that compounded the servicing problems during the financial crisis:

- Few people in industry or government understood that the problems that initially surfaced in early 2007 in the subprime segment of the mortgage market would quickly engulf all segments of the mortgage market, leading to a deluge of delinquencies of epic proportions. As a result, the servicing industry was vastly understaffed and unprepared to deal with the issues that ensued.
- As it related to the PLS market, which accounted for about 20% of outstanding mortgages in 2007, servicers were forced to deal with vague contractual provisions in pooling and servicing agreements ("PSAs") that never contemplated a high level of defaults, nor the complexity of resolving those defaults.
- Finally, servicers were forced to quickly implement, on a mass scale, the constantly evolving, government-directed HARP and HAMP programs, without having the opportunity to adequately reengineer their processes and procedures, all while being understaffed and under extreme pressure.

Will These Changes be Implemented?

We have endeavored to find solutions to concerns we have heard from investors, issuers and other industry participants. While we believe we have found solutions for many voiced concerns, the solutions are not free. Certain solutions (such as the Transaction Manager which will require an entirely new and highly sophisticated industry participant to be developed) come with potentially significant costs. As noted in our letter to Mr. Lew, we will endeavor to implement many of the changes described in this Guide. It is important to remember that while we want to offer investors as much protection as possible, if investors do not see the value in such protections, we will not insert costs and frictions into the PLS market unnecessarily. Further, while we believe we have found workable solutions, there are many market participants (rating agencies, investors, regulators, servicers, trustee, etc) and we have not fully vetted these concepts with all parties. We will continue to work through our ideas with these counterparties but we cannot guaranty that we will be able to implement each of the concepts because they are not unilateral decisions.

II. PLS Structures: PLS structural flaws that have caused a lack of trust among triple-A investors resulting in insufficient demand

The financial crisis revealed multiple structural deficiencies in many PLS transactions that contributed to triple-A investors bearing significant losses on their investments. Until structural improvements are made, many large traditional triple-A investors will continue to boycott the new issue PLS market. The absence of these players makes it difficult for the PLS market to reach the size and liquidity needed to gain traction, grow and flourish. The clear first step is to address these structural issues and restore triple-A investor confidence.

The structural deficiencies in many pre-crisis transactions existed on two levels. First, the key investor protection mechanisms built into the underlying governing documents for PLS transactions often lacked clarity and were subject to much interpretation and, in some cases, manipulation. Second, and equally detrimental, was the fact that when things went awry, the PLS trusts had no “traffic cop” empowered to compel action to protect senior investors from conflicts of interest, losses arising from inadequate servicing practices, breaches of representations and warranties and the misallocation of cashflows based on vague and misunderstood guidelines.

In order to address these issues, we propose the following structural reforms that will increase transparency, ensure contractual compliance, reduce documentation ambiguity, promote standardization, prevent conflicts of interest, ensure the integrity of underlying loan collateral, and align all counterparties’ financial incentives with those of investors.

Proposed Structural Reforms

Appoint a Transaction Manager to each PLS Transaction

- At issuance, the sponsor should appoint a competent and independent third-party “Transaction Manager” to oversee servicers, the process for the resolution of representations and warranty breaches and the application of cashflow mechanisms and triggers. The Transaction Manager would be empowered to compel compliance and corrective action. The Transaction Manager would have a prescribed role and would not take direction from any particular class of security holder. This role would be greatly expanded from the traditional “credit risk manager” seen in certain pre-crisis securitizations and is described in greater depth in Appendix A.

Create a Self-Regulatory Organization (“SRO”) to Promote Standardization and Best Practices

- Establish an SRO (similar to FINRA) to:
 - Create and maintain a set of standard securitization terms and features;
 - Categorize PLS transactions by certain defined features (similar to the TBA market); and
 - Establish best practice standards for representation and warranties (the GSEs provide a good model) and sunset terms.

Establish Clear Cashflow Mechanisms and Triggers

- Establish clear and unambiguous contractual language governing cashflow mechanisms and triggers.
- Require that once a loan becomes 120 days delinquent, servicer principal and interest advances automatically stop and the lowest subordinate bond or bonds cease to receive cashflow in an amount equal to the balance of the delinquent loan. After the loan default is resolved, normal trigger mechanisms would resume and the lowest subordinate bond(s) would be written down or reinstated depending on loan performance and actual losses.
- Require the Transaction Manager to review the monthly cashflow waterfall payments for compliance with the contractual terms.

Establish Better Standards and Controls over Servicing

- Establish clear standards for servicer functions and responsibilities including performance metrics and consequences for poor performance.
- Provide oversight of servicing by the Transaction Manager, who would be empowered to remove the servicer for poor performance.
- Require a servicer firewall to eliminate conflicts of interest.
- Require that once a loan reaches 120 days delinquency, the primary servicer must transfer the loan to a special servicer and principal and interest advances to the trust stops. (See also the corresponding cashflow mechanism above.)
- Define the list of acceptable special servicers in the PSA.
- Align the financial incentives of the primary and special servicer with the interests of investors.
- Establish clear, prescriptive procedures for default resolution, including a hierarchy of loss mitigation actions, the key drivers of net present value calculations, and requisite disclosure to the Transaction Manager.

Greater Clarity and Better Enforcement of Representation and Warranties

- Require prominent disclosure of any deviation from the SRO best practice standard.
- Establish clear criteria for what is deemed a breach and require binding arbitration for dispute resolution.
- Require oversight of the dispute resolution process by the Transaction Manager.

Improve Transparency

- SRO should create best practices for PLS loan performance disclosure.
- Encourage the newly formed SRO to create a “hot sheet” for prominent disclosure of key PLS contractual provisions.
- Expand GSE data disclosure (loss severity, foreclosure timelines, etc.) to support PLS pricing and the reentry of private capital.
- Disclose itemized expenses in trustee reports for recovery proceeds.

Limit Assignee Liability under the CFPB’s Ability-to-Repay (“ATR”) Rule

- Modify the ATR Rule to clearly provide that securitization trusts (and therefore triple-A PLS investors) do not have liability under the ATR Rule. Triple-A PLS investors have no control over and do not have the information required to make judgments regarding whether a loan was made in accordance with the ATR Rule. Even if such information were to be made available, the rule is quite technical and triple-A PLS investors generally do not have the ability to make the judgments required by lenders.

Complete Unfinished Regulations

- Complete and issue all unfinished rulemaking that impacts PLS transactions including Regulation AB II and those required by the Dodd-Frank Act.

Reform Second Lien Mortgages and Home Equity Lines of Credit (“HELOCs”)

- Adopt minimum standards and restrictions on second lien mortgages and HELOCs, including the possible requirement that second lien mortgage loans and HELOCs must be approved by the first lien holder/investor.
- Subject all second lien mortgages and HELOCs to the Ability-to-Repay regulation issued by the Consumer Financial Protection Bureau (“CFPB”).

Establish a Bond Registry to Facilitate Security Holder Communication

- Develop a centralized clearinghouse or bond registry to enable security holders to locate and contact each other and take collective action when necessary.
- The Depository Trust Company (“DTC”) could expand its role as bond registrar and create the capability for investors to contact each other.

III. Bank Participation in the PLS Market: A lack of financial incentive, coupled with unfinished litigation and regulation, has made large banks hesitant to reenter the PLS market

Balance Sheet Funding by Large Banks Trumps PLS Execution

Since all mortgages are generally fungible from the consumer prospective, mortgage lenders compete on price and customer service. To do so, lenders seek the lowest cost of funding, which they then pass through to borrowers. Lenders constantly compare the relative costs of: (a) balance sheet funding; (b) whole loan sales; (c) PLS; and (d) GSE execution (when applicable).

Historically, major banks were the predominant sponsors of PLS transactions, especially for 30-year jumbo fixed-rate loans, which are not a good asset/liability match for their balance sheets. As a result of recent monetary policy, major banks are saturated with record levels of excess reserves, their cost of funds is extremely low, and they are looking for loan growth. This has made holding jumbo mortgage loans on their balance sheets a more attractive option than selling them or financing them via securitization. The decision to hold loans on balance sheet is aided by a loan accounting standard which, unlike securities accounting, does not require mark-to-market adjustments.

High Front-End Costs

Participation in the PLS market comes with significant front-end costs. For issuers, this includes the cost of compliance with new regulations, setting up a securitization shelf, hiring specialized staff, and retrofitting systems and technology. In addition, costs have increased due to the significant time spent reconciling and conforming transactions to (a) investor requirements, (b) divergent and sometimes irreconcilable rating agency criteria, and (c) accounting standards. Each of these factors has been and continues to evolve, making each potential securitization a significantly different transaction that requires significant cost and time and limits economies of scale. For banks, this ongoing friction has added greatly to the cost of re-entering the securitization market.

Without confidence that there will be an ongoing market for a regular stream of securitization transactions to amortize front end costs, the “break-even” cost of opening these financial channels becomes prohibitively high.

Regulatory Uncertainty

Issuers are willing to invest in the securitization market and bear the high front-end costs; however, without certainty around the viability of the market under various proposed regulations and potential accounting changes, these cautious market participants are waiting for certainty before they incur front-end costs in building PLS programs.

There are current uncertainties around various rule-makings such as (a) risk retention/QRM, (b) QM and ability-to-repay interpretation and implementation, (c) Basel III implementation, (d) national servicing standards, (e) Regulation AB II, and (f) the Franken Amendment. This uncertainty, plus the compounding effect of current regulations, makes the future economics of PLS somewhat unpredictable.

Further, given the GSEs' current percentage of the market and the uncertainty around their future, spending capital on the development of a PLS market is an uncertain investment with an unknown and potentially short horizon.

Protracted Litigation and Liability

The protracted litigation and liability relating to securitizations issued in the years leading up to the financial crisis has kept issuers on the sidelines. This litigation has resulted in the reinterpretation of contractual provisions regarding risk transfers that issuers had relied on. Belief that the liability and costs associated with the continuous inquiry, investigation and litigation from investors, regulators, borrowers and other parties can never be settled has made securitization look like an unattractive funding source. Without an end to the litigation surrounding previously issued securities, issuers are unable to measure their potential liability when issuing new securities or know what to fix to avoid future litigation.

Issuers also fear that regardless of the level of detailed disclosure, investors are seeking a "free put" in the instance a loan defaults. Additionally, investor demands for loan file access and other information put the issuer in the precarious position of balancing transparency with consumer protection and privacy laws. Without clarity from appropriate regulators, some issuers see this as a "no win" situation.

Proposed Solutions

Unfortunately, there are no magic bullets that will resolve the issues holding back major banks from once again becoming regular issuers of PLS. These issues may resolve themselves gradually over time or potentially more quickly if there is a change in circumstances, such as a change in the dynamic between short-term versus long-term interest rates or in the amount of liquidity (deposits) in the banking system.

A Potential Movement in Interest Rates

A rise in short-term rates or a flattening of the yield curve (should it occur) may make banks reconsider holding longer duration mortgages on their balance sheets, as either would create a more acute asset/liability mismatch. Additionally, if the high level of deposits were to significantly decrease, (which in our opinion is unlikely), banks may then look to sell more jumbo loans through PLS as an alternative to holding these loans on their balance sheets.

Finalize Litigation and Regulation

Pending litigation and regulation needs to be finalized. The financial and reputational risk of noncompliance with laws and regulations is now so high that banks have made a prudent decision not to reenter the PLS market until regulations and enforcement standards are clearly established.

Further, common sense would dictate that one should not reenter a market that resulted in what appears to be endless litigation. Coming to final terms would allow wounds to heal and parties to move forward. While we believe that culpable parties should be held accountable, we also believe that protracted and outstanding litigation is a major deterrent to restoring the PLS market.

IV. PLS Market Volume and Liquidity: Insufficient PLS market volume and liquidity deters the participation of both issuers and investors

There are several factors influencing a security's liquidity:

- **Size of Market:** Generally, the larger the market and the more depth it has, the more liquid it is. This allows large transactions to occur without significantly impacting the security's price.
- **Investor Base:** A broad investor base improves liquidity for two reasons. First, a broad investor base means there are more investors to buy or sell securities on any given day. Second, a broader and more diverse investor base tends to smooth out any market shocks. When many different investors are buying and selling, the diversity of opinions creates both buyers and sellers at reasonable prices on any given day.
- **Credit Quality:** The credit quality of a security impacts its liquidity. A security with a low risk of delinquency or default is generally more liquid than a riskier security.
- **Market Conditions:** Market conditions and industry stability can influence liquidity as well. The more favorable the conditions, the more liquid the security.
- **Financing:** The ability for investors to safely and attractively finance the securities.

In order to incentivize a broad investor base to participate in the PLS market, the factors that impact liquidity must be addressed. Healthy markets need willing and active buyers (investors) and sellers (issuers), but neither is consistently present in the current PLS market. Insufficient market volume and liquidity deter both issuers and investors. Small, thin markets suffer from wide bid-ask spreads and substantial price volatility that investors must consider when they purchase PLS.

Large institutional investors cannot justify spending significant resources on an asset class with limited investment opportunity, yet the asset class cannot achieve sufficient critical mass without large institutional investor participation. These inefficiencies harm the overall securitization execution (as well as the certainty of execution) for originators relative to other funding sources such as balance sheet lending, GSE execution and whole loan sales. Diminished liquidity causes a reduction in the incentive to create more PLS, which perpetuates the lack of volume and lack of liquidity.

Furthermore, investors price a lack of liquidity into their initial purchase price. This liquidity discount harms the overall securitization execution for originators relative to other funding sources. Therefore, the lack of liquidity once again perpetuates a lack of volume and lack of liquidity.

There are two other factors affecting PLS market liquidity. As a result of the increase in the GSE loan limit in high cost areas from \$417,000 previously to \$625,500 today, the jumbo market share available to PLS is significantly smaller than before the increase was put in place. Additionally, the PLS market lost three very large anchor investors (Fannie Mae, Freddie Mac, and the FHLBs) when their ability to acquire new securities for their portfolios was terminated.

Proposed Solutions

The current supply/demand equilibrium can either be resolved passively or proactively. Passive solutions include: (a) waiting for the market to find its legs and hoping issuers put out an increasing volume of PLS each year; or (b) waiting for a change in the yield curve that would make it less attractive for banks to hold mortgages on their balance sheets as opposed to securitizing them. These solutions will take many years to resolve the current market problems. The uncertainty and delay associated with a passive approach is unacceptable. We favor the following proactive solutions:

Adopt Structural Reforms

- Complete the previously discussed structural reforms to bring more triple-A investors back to the market.

Lower GSE Loan Limits

- Reduce the GSE loan limits on a safe and measured basis over time.

Create a Borrowing Facility

- To increase institutional demand, investigate options to provide more attractive triple-A financing through the Federal Reserve Bank, the FHLB System, or a TALF-like program. Such a facility would increase yield and therefore increase demand.

Establish an Anchor Buyer

- Create an anchor buyer that will provide a supporting bid for recently issued PLS at any point in time. We suggest allowing the FHLBs to acquire and hold the highest rated, highest quality triple-A securities as categorized by the industry SRO. This would decrease volatility and reduce the bid/ask spread on any given day.

We fully recognize that after several rounds of quantitative easing, the political appetite for creating another government buying or financing program is probably non-existent, but we mention it nevertheless because it would be an effective solution.

Appendix A. Structural Reforms Explained in Greater Detail

Proposed Structural Solutions

As noted above, it takes both buyers and sellers to produce a healthy market. Solving only issuer or only investor problems will not result in a robust, revived PLS market. The following proposed solutions are not in this appendix because they deserve any more or any less attention, but merely because they are more nuanced and may benefit from a deeper discussion than the highlights noted above.

Appoint a Transaction Manager to each PLS Transaction

We recommend the appointment of an independent third-party “Transaction Manager” to conduct ongoing surveillance on all of the servicer’s activities and to report to the trustee and investors the results of the review. The securitization documentation should provide for the Transaction Manager to have the same access to loan information and original files as the servicer and trustee to ensure that the Transaction Manager has the information necessary to perform the prescribed surveillance. The Transaction Manager would also oversee the process for the resolution of representations and warranty breaches and the application of cashflow mechanisms and triggers.

The Transaction Manager would be empowered to compel compliance with the terms of the transaction and take corrective action. The Transaction Manager would be an unbiased third-party with a clearly prescribed role and would not take direction from any particular class of security holder. The creation of this position could be a key component to creating orderly PLS transactions with a much needed administrative infrastructure that protects investors by placing better controls on the management of the transaction. We don’t believe that trustees have the ability or resources to serve this function. This is a new role, requires expertise in several fields. The importance of this role necessitates a new industry participant, rather than simply piling significant new responsibilities on an unprepared current market participant.

Create a Self-Regulatory Organization to Promote Standardization and Best Practices

As noted above, industry best practices need to be established and key securitization terms and provisions should be presented in a short form for easy investor reference. These features and provisions could be determined by an industry SRO.

The SRO would serve a purpose similar to the group within the Securities Industry and Financial Markets Association (“SIFMA”) that determines the To-Be-Announced (“TBA”) market Good Delivery Guidelines.

The Good Delivery Guidelines cover a number of areas surrounding the TBA trading of agency mortgage-backed securities, and are promulgated by and maintained by SIFMA, through consultation with its members. The purpose of the guidelines is to standardize various trading and settlement related issues to enhance and maintain the liquidity of the TBA market. Many of the guidelines are operational in nature; however, other guidelines deal with qualitative aspects of the loans that underlie the securities, as well as the structure of the securities themselves. Mortgage pools, which are not eligible for TBA delivery may be traded in what is called the “specified pool” market. Many products which do not fit into the TBA guidelines are traded as specified pools.

We believe the process we suggest is similar to the TBA Good Delivery Guidelines process, as the proposed group would not determine the total universe of possible PLS offerings, but could instead determine what is “market” and what is not.

While we do not believe that all terms can or should be standardized due to the various types of collateral, structures and other requirements that will evolve over time, we do believe certain deal terms could be noted on this short form along with any deviation from standard terms.

Establish Clear Cashflow Mechanisms and Triggers

In order to mitigate perceived and actual abuses, we recommend adding provisions in securitization documents that restrict the ability of servicers to direct cashflow in ways contrary to the interests of investors.

Performance Triggers: In many pre crisis deals the payment of a large distribution was allowed if certain conditions were met. If loan delinquencies and cumulative losses were below set amounts (referred to as “performance triggers”), principal payments that would otherwise go to triple-A investors would be distributed to the residual holders. In some cases, the servicer could manage delinquencies and losses to affect the performance triggers. As an example, a servicer could modify a severely delinquent loan and thus remove its impact on the delinquency calculation. Or, foreclosure proceeding could be delayed to push cumulative losses further down the line (past the trigger date) and thus not be included in the calculation.

We recommend examining solutions that are less susceptible to abuse, such as requiring the inclusion of modified and repurchased loans in the calculation of triggers which redirect cashflows among various tranches of securities for a period after the repurchase or modification. Additionally, the transfer of certain delinquent loans to a special servicer could also remove potential conflict.

Advances: In the past servicers were given unilateral discretion in determining when to stop advancing and determining when their prior advances were no longer recoverable from proceeds on the related mortgage loan (a “non-recoverable advance”). Securitizations provide that once an advance is deemed non-recoverable the servicer is allowed to recoup these advances from proceeds on all the mortgage loans in the securitization. Therefore, servicers were allowed to make unilateral decisions to prioritize themselves over bondholders. This standard not only allowed for potential abuse, but also did not permit investors to predict servicer advance behavior with any certainty.

Further, principal and interest advances during the first 25% of a loan's life are primarily interest, and because investors must primarily look to proceeds from the sale of the house in the event of a foreclosure for recovery, advanced interest effectively just raises the LTV of the loan and the ultimate loss severity. The net effect can be extremely harmful to triple-A investors because the servicer advanced interest typically goes to pay subordinate bonds which would have been written down and have no entitlement if the advances were stopped or a foreclosure took place. In a normal environment and in the instance of low LTV loans, this is not an issue. However, when foreclosure timelines are greatly extended and/or LTVs are high, the sum of these facts is that cashflows that should go to triple-A investors are redirected to subordinate bonds which should already be written off due to losses. Additionally, when the losses are finally recognized, the increased loss severity caused by the advances further erodes the subordinate bonds that represent triple-A securities protection from losses.

We therefore suggest that securitization transactions adopt a rule that once a loan becomes 120 days delinquent, servicer principal and interest advances automatically stop and the lowest subordinate bond or bonds cease to cashflow in an amount equal to the loan balance. After the loan default is resolved, normal trigger mechanisms would resume and the lowest subordinate bond(s) would be written down or reinstated depending on loan performance and actual losses. Therefore, while subordinate bonds would not lose their rights to cashflows on the collateral until the loan is resolved, during an extended period of non-payment, advances do not redirect cashflow to subordinate bonds at the expense of the triple-A securities they protect. This would also eliminate the ability for servicers to manipulate foreclosure timelines in order to benefit one tranche of securities over another and remove the need for investors to speculate on servicer advance decisions and the impacts on the securities they own.

Net Present Value Test: Net present value ("NPV") tests compare the expected cashflow from a modified mortgage loan with the expected cashflow from the same loan with no modification (such amount usually based on proceeds from foreclosure) to determine which option is likely to be more valuable to the investor. NPV tests require a large number of subjective inputs and assumptions such as discount rate, cure rate, foreclosure costs and home price decline. Even minor changes to any one of these inputs can greatly skew results. In the past, NPV tests have been proprietary and in the sole discretion of the servicer. This lack of transparency has resulted in investors not being able to predict when a modification will be used and when a loan will go to foreclosure without any certainty. Further, because mortgagors are bank customers and many large servicers are associated with banks, there is potential for abuse whereby servicers will modify loans to please the consumer despite a foreclosure being in the best interests of the investor. Additionally, the decision to modify or foreclose directly impacts servicer compensation and the timing of advance recovery, which creates conflicts of interest and the potential for abuse.

We therefore suggest the establishment of clear, prescriptive NPV tests that are written into the PSA related to the securitization. We also suggest disclosure related to how the servicer will make determinations surrounding the key drivers of NPV tests that must remain subjective and determined at the time the test is applied. In order to ensure contractual compliance and that the servicer is acting in the best interests of investors, the servicer should be required to disclose the exact application of any NPV test to the Transaction Manager, who can then evaluate the reasonableness of the test on behalf of the trust.

Better Standards and Controls over Servicing

The servicer works for the investors in the securitization, yet historically, investors have had no real way of ensuring the servicer is actually doing so because there are few objective standards for performance and servicer compensation structures did not always align the interests of servicers with the interests of investors.

First, we should examine what potential servicer performance triggers could be incorporated into PLS transactions. Examples of such triggers could include: average loss severity (taking loan characteristics into account), adherence to foreclosure timelines, and average REO liquidation timelines. If a servicer fails a trigger, escalating action could be taken (rather than only having the extreme option of servicer removal altogether).

Second, we believe the servicer's compensation could be more closely aligned with the performance of a pool and therefore the interests of investors. It is much less expensive to service a performing loan than a defaulted one. A more closely aligned compensation scheme would help servicing return to profitability and protect investors without excessive cost to borrowers.

For example, a possible system would provide for a servicer to service current loans at one fee and then transfer all 120 day delinquent loans to a special servicer who would then work on remediating the delinquent loan at a greatly increased servicing fee. To ensure that the special servicer has a public policy goal of helping the borrower stay in the home (limited by the requirement to maximize NPV to the trust), should the loan cure and begin performing again the special servicer would remain on to service the loan for the life of the loan at the stepped up servicing fee. Further, under this proposal the servicer is incented to take the lowest cost and fastest route to curing the delinquent loan and balances the best interests of the borrower and the investor.

Third, we recommend rules that define and prohibit servicer conflicts of interest. Such regulations could address considerations related to disclosure, servicer surveillance and elimination of conflicts and could require and provide for the following:

- Clearly define what constitutes a servicer conflict of interest and which conflicts would be prohibited in private sector securitizations.
- In the event of a default on a loan requiring the servicer to determine whether to modify or to foreclose, the Transaction Manager could investigate the conduct of the servicer.
- Require that servicing of a 120 day delinquent loan be transferred to a special servicer. This would remove the potentially conflicted servicer at the time an actual conflict could have adverse consequences.

Greater Clarity and Better Enforcement of Representations and Warranties

Both investors and issuers have cited concerns with both consistency and the enforcement of representations and warranties. As a potential solution, we recommend that the SRO (recommended previously) create a uniform definition of standard best practice loan-level representations and warranties.

- We believe the representations and warranties of the GSEs (with some modifications) could serve as a strong benchmark.
- We do not believe that any standard would need to be mandatory, but each securitization should clearly disclose any material variation from the standard.
- We believe the inclusion of so-called “best of knowledge” qualifiers could be abused and their use should be examined and limited.

While many investors believe no representations and warranties should ever sunset, and many issuers would like all representations and warranties to sunset at the earliest possible date, we believe a compromise can be found. A solution exists whereby issuers can effectuate a real risk transfer and investors can have confidence the party closest to the origination process takes responsibility for compliance with proper underwriting.

We believe that representations and warranties that go to the quality of the mortgage loan and loan origination process could sunset after a reasonable period of time and positive borrower performance. Any issues related to the quality of underwriting of the loan should generally reveal themselves before an extended period of continuous timely borrower payments.

Further, we believe representations and warranties that run to the enforceability of the lien should not sunset as they are needed at all points in the life of loan, regardless of cause of default and are solely in the control of the originator and determined at the time of origination.

Further, by having industry standards on certain terms and requiring disclosure of deviations, investors would have easy-to-navigate and readily available information for making investment decisions, thereby decreasing the time needed to review a PLS securitization and increasing the liquidity of the asset class.

The issues with representations and warranties go further than just the content of the contractual provision. An additional issue is the enforcement of those representations and warranties.

The process for determining what constitutes a breach needs to be very clear and fully disclosed. This will allow (a) issuers to have the clarity and certainty that a risk transfer has taken place, (b) investors to understand what is and what is not a breach of a representation and warranty, and (c) both issuers and investors to understand their risks.

We recommend that a clear description of causation and materiality be developed for the various representations and warranties to give: (1) investors certainty that representations and warranties can and will be enforced, (2) clear guidance to those involved in the arbitration process, and (3) certainty to issuers that a risk transfer has taken place and that insignificant and technical violations completely unrelated to a loan's performance are not the basis for a repurchase claim.

Further, we recommend requiring a formal dispute resolution process with a regular panel of arbitrators who will be required to have specific training in mortgage origination and the arbitration of mortgage-related representations and warranties. This would provide certainty and consistency in dispute resolution. The FHFA could establish such a panel and utilize it for disputes between the GSEs and their respective loan sellers. The industry could then utilize this panel and process for PLS. If FHFA does not establish such a panel, an SRO (recommended previously) could facilitate its development in conjunction with the standardization work described above.

Data Disclosure to Support Private Capital Taking Mortgage Credit Risk

In order to invest in mortgage credit risk, it is critical that investors understand the relationship between a loan's inherent characteristics (ex. LTV, borrower FICO, borrower debt-to-income ratio, etc.) and its actual performance. Since 2007 there has been little to no information on loan performance as almost all mortgages have been funded by the GSEs or bank balance sheets and neither of these entities have been required to disclose such information to the market. As evidenced by the recent performance of the few post crisis PLS transactions, loans originated since 2010 have evidenced little credit risk. Despite this performance, investor appetite for mortgage exposure remains muted and rating agency assumptions related to mortgage performance is extremely conservative. In addition to the other concerns noted herein, much of the hesitance of both investors and rating agencies relates to a lack of information on recent loan performance and the loan characteristics that are driving it.

As part of their larger effort to increase transparency, the GSEs have developed templates for loan-level disclosures, (i.e. the Fannie Mae and Freddie Mac Uniform Loan Delivery Dataset initiative) and released certain loan-level credit performance data on a portion of fully amortizing 30-year fixed-rate mortgages that they purchased or guaranteed. Currently, this collective information includes disclosure relates to loan origination characteristics with some limited information on loan performance. We suggest that the GSEs expand these efforts to include more granular loan performance information as well. Data points such as pay strings, delinquency, prepayment, foreclosure, modification, foreclosure timeline and loss severity data should be included as these data points are critical in evaluating mortgage credit risk. These efforts must be coordinated with Reg AB II to ensure consistency, clarity and prevent conflicting standards and duplicative reporting. Further, the GSEs, or their regulator the FHFA, should provide a one-time release of the aforementioned enhanced data on a loan level basis, by vintage year, so private investors can enhance/develop their models correlating loan characteristics to performance; similar to the one-time Regulation AB static pool information release in January 2006.

Once released, these data sets should be updated monthly and the FHFA should implement standardized loan disclosure reporting using the same data fields as provided in the historical release for new issuances as well. These enhanced disclosures will provide for the buildout of investor and rating agency credit models and allow for the transparent pricing of credit risk and create pricing discipline for both the GSEs and the private market. The pricing discipline created results from the fact that once investors better understand the credit risk of GSE insured loans, they can determine whether the GSEs are over or under charging (via g-fees) to take this risk and private capital can begin to step in to replace the GSEs.

Reform Second Lien Mortgages and Home Equity Lines of Credit

A borrower having equity in a property is akin to the borrower having “skin in the game”, thus better aligning the interests of the borrower and the lender/investor. The more equity a borrower has in the property the more “skin in the game” he/she has and the higher the incentive for the borrower to continue to make timely payments. The creation of a second lien mortgage that substantially erodes the borrower’s equity and/or substantially increases a borrower’s monthly debt payments may increase the likelihood of default on the first mortgage and may significantly alter the risk profile of the initial investor in the first lien mortgage.

To prevent the layering of additional leverage and risk, it is common in other forms of secured lending (including commercial and corporate lending) to require either the consent of the first lien holder to any additional leverage or to limit any new borrowing based on a prescribed formula approved by the first lien holder at the time the first lien loan is originated. We recommend the extension of this concept to residential mortgages.

Because second lien mortgages can be obtained from the lender that provided the first lien mortgage or from different lenders either at the time the first lien mortgage is originated or later, we recommend the examination of a potential Federal law prohibiting any second lien mortgage on a residential property unless the first lien mortgage holder gives its consent.

- If the holder of the first lien mortgage fails to consent, the second lien mortgage lender could still issue a loan to the borrower by refinancing the first lien mortgage.
- Alternatively, a second mortgage could be subject to a formula whereby the new combined loan-to-value (based on a new appraisal) does not exceed 80%.
 - This would allow investors to price risk to a worst case scenario and would ensure a minimum of borrower “skin in the game” and incentive to make timely payments.

We believe that these concerns on second liens are much more than academic. Second lien lending is once again on the rise and given that most borrowers have locked in a first lien at a historically low rate, there is a high probability that second lien lending will continue to rise as borrowers look to access the equity they have built while keeping the rate on their current first lien mortgage loan. We think it would be prudent for the CFPB to reexamine the reduced scrutiny and protections for HELOCs versus closed end mortgage loans given that they will likely be a significant source of second lien lending.

Additionally, to deal with the conflicts of interest between first-lien loans and second-lien loans, owners of first-lien loans should get repaid before the owners of second-lien loans are repaid by the same borrowers and should control any modification, short sale or restructuring process. Property-level losses should be allocated properly among creditors based on legal priority and junior creditors should be impaired before more senior creditors in all instances including modification and short sale.

Establish a Bond Registry to Facilitate Security Holder Communication

We recommend the development of a centralized clearing-house or bond registry to enable security holders to locate each other even where the securities are held on behalf of investors by the Depository Trust Company (the “DTC”). Because it is far more practical to work within the system we have as opposed to creating a large platform from scratch, we recommend the DTC expand its role as bond registrar and create the capability for investors to contact each other and take collective action when necessary. It is important to note that this will require modification of the current DTC system in which investors may hold securities under multiple subaccount names which represent the various funds they oversee. We suggest each DTC participant list a single, centralized contact for its various subsidiaries in order to make it less expensive and easier for investors to find each other and take collective action.