REDWOOD TRUST

One Belvedere Place
Suite 300
Mill Valley, CA 94941

Phone 415.389.7373
Fax 415.381.1773

October 12, 2016

Honorable Melvin L. Watt
Director
Federal Housing Finance Agency
400 7th Street, S.W.
Washington, D.C., 20219

Dear Director Watt,

On behalf of Redwood Trust, Inc. ("Redwood"), we respectfully submit this response to the Federal Housing Finance Agency's (the "FHFA") Single Family Credit Risk Transfer Request for Input (the "RFI").

Credit Risk Transfer ("CRT") transactions represent one of the most important innovations in the housing finance system since the financial crisis. We applaud the efforts of the FHFA, along with Fannie Mae and Freddie Mac ("Enterprises"), in creating the CRT programs that are becoming a regular part of the Enterprises' business.

Redwood, a nationally operating Real Estate Investment Trust ("REIT"), has a long and successful history in the business of taking mortgage credit risk in various forms, both in the agency and non-agency space. That history includes participation in both front-end as well as back-end CRT transactions issued by each of the Enterprises, so we believe we are highly qualified to offer these comments on how to improve the CRT initiatives of the GSEs. We urge you to consider the following three key recommendations, and our commentary on the FHFA's principals for CRTs.

RECOMMENDATIONS

1. Remove Barriers That Prevent REITs from Investing in All CRT Transactions

All forms of Enterprise CRT transactions (including front-end transactions) should be fully REIT-eligible investments given their core nature as investments in residential mortgage credit, and mortgage REITs' important position as capital markets investors that support the availability of mortgage credit to homeowners.

A REIT is a company that owns or finances income-producing real estate. Many REITs are public companies traded on major stock exchanges, but there are also non-listed and private REITs. This allows for a wide range of investors, including individual investors as well as institutions, to provide capital to invest in and support the U.S. housing market. Mortgage REITs generally hold mortgages and mortgage backed securities ("MBS") on their balance sheets, funding these investments with equity and debt capital. REITs typically use less borrowing and more equity capital to finance their acquisitions of mortgages and

MBS than do other large mortgage investors, making REITs a stable source of financing for mortgage loans in the secondary market.[1]

REITs are important investor participants in agency and non-agency MBS markets, but remain limited participants in back-end CRT markets such as Freddie Mac's Structured Agency Credit Risk transactions ("STACR") and Fannie Mae's Connecticut Avenue Securities ("CAS"). According to the FHFA, REITs make up only 2% of the investor base for CAS and STACR, primarily due to the tax treatment applicable to REITs for investments in the most subordinate tranches of these transactions under the Internal Revenue Code ("Code").

REIT participation in the markets for back-end CRT transactions is also limited due to technical restrictions that apply under the Investment Company Act of 1940 (the "'40 Act") that generally govern the nature and amount of investments eligible to be held by REITs. For example, because STACR and CAS are debt securities of the Enterprises, they are not considered to be "real estate assets" nor to represent "interests" in mortgages or other real estate, as defined under the '40 Act, thereby limiting REIT participation.

Risk-sharing investments such as CAS and STACR are consistent with the mortgage-focused investment activity of Redwood and other REITs. We believe that such investments by a REIT are also consistent with a common sense understanding of the underlying policy rationales of the '40 Act and Code provisions that apply to REITs. However, the '40 Act and the Code long predate the Enterprises' CRT programs. Those legal provisions should not now be so strictly interpreted and applied so as to thwart their purposes and restrict REIT investments in CRT transactions that are truly real estate assets that represent interests in mortgages. If the legal barriers were corrected, Redwood and other REITs would be able to invest significantly more in these back-end transactions.

Similarly, certain front-end CRT transactions, including those that are generally referred to as having an "L-Street" structure, have raised technical interpretive questions that relate to their eligibility to be held by REITs and their status under the '40 Act. Ensuring that the market for these emerging transaction structures allow for robust participation by REITs should be a common goal of Federal policymakers and regulators.

Expanding the investor base for CRT transactions by making these investments fully REIT-eligible will increase liquidity in the securities and further the government's goal of shifting more mortgage credit risk to private capital and away from taxpayers. There are several factors influencing a security's liquidity, one of the most important being creating a broad 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

[1] At June 30, 2016, the asset-weighted average equity capital ratio of all stock exchange-listed Mortgage REITs was 13.8%, compared to 9.6% for the commercial banking industry and 7.5% for the investment banking industry. Mortgage REITs were also typically better capitalized than other mortgage investors in the period before the 2008 financial crisis. Source: NAREIT – Guide to Mortgage REITs (https://www.reit.com/investing/reit-basics/guide-mortgage-reits).

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. The Enterprises and the FHFA both want as broad and deep a base of investors in their CRT transactions as possible, as it would bring greater competition and thus a better and less volatile execution for them. Increasing the ability of REITs to participate will not only increase the amount of the actual investable capital available to invest in CRT transactions but will also bring an additional type of investor, thereby broadening the investor base as well. Because REITs are generally monoline businesses backed by equity, they are a stable funding source with a focus on housing and, therefore, more available in all market conditions to support housing finance, including CRT transactions.

We understand that the FHFA does not have control over the regulations that limit REIT investments in back-end CRT transactions. However, we urge the FHFA to encourage the other government regulators and policymakers with appropriate jurisdiction to address this matter.

2. Maximize the Unique Advantages of Front-End CRT Transactions

Front-end CRT transaction have unique advantages in comparison to back-end transactions that should be maximized in the broader risk sharing program. We do not advocate a cessation of back-end transactions, rather we urge the FHFA to develop a more robust front-end CRT program to at least match the volume of the back-end transactions. To date, back-end CRT structures have been the predominate means of credit risk transfer for the Enterprises.

Front-end CRT transactions provide a promising balance of the many principles and concerns outlined in the FHFA's "Principles of Credit Risk Transfer" enumerated in the request for input. Front-end transactions can be structured to reduce taxpayer risk by covering both "Expected Losses" and "Unexpected Losses", each as defined in the RFI. We anticipate that front-end structures can transfer those categories of loss with execution equal to or better than back-end transactions, such as STACR and CAS. The reason is due to the fact that front-end transactions can be created with pools of loans aggregated or selected by the party taking the risk. This allows the party taking the risk to tailor the transaction to match its risk appetite and more accurately price the risk it is taking. Potential front-end participants such as lenders, mortgage insurers and REITs are experts in loan level credit analysis, and when they are allowed to more precisely pick and create the risk they prefer, each is able to pay the highest price for its particular risk set. Additionally, because these parties work closer to the production of the loans they can use the information they glean during production to better price this risk and thereby pass this cost savings and efficiency on to the consumer and the taxpayers.

Additionally, back-end CRT transactions require that the Enterprises assume several months' worth of market risk as they must accumulate and warehouse loans in preparation for structuring a transaction. Front-end risk sharing structures with committed mortgage market participants, including stable monoline businesses devoted to residential finance such REITs and mortgage lenders, can reduce that market risk to the Enterprises while providing many of the same benefits as the CAS and STACR programs.

Another added benefit of front-end CRT transactions is that many of the parties most likely to participate in them are long-term participants in the mortgage market with business models focused on originating mortgage credit and/or assuming mortgage credit risk, unlike the majority of the investors in back-end CRT transactions. Therefore, while individual mortgage loans and mortgage pools may price differently at any time, there would be less volatility over time because the investor base would largely remain stable and committed to the mortgage market through various market cycles. This would lend stability to the housing market, ensure consumers see more consistent mortgage rates and stable risk pricing regardless of when they choose to purchase a home.

Back-end risk sharing transactions to date have primarily relied on money managers and hedge funds as investors. In the current market environment, these investors view housing as a relatively cheap risk compared to corporate bonds and other investments. When the risk/reward view of these investments versus the myriad choices offered to these investors shifts, the cost of back-end risk sharing for the Enterprises will increase significantly as there is not another source of capital standing by to purchase these investments at similar prices. As noted above, this risk can be mitigated by expanding the investor base for back-end transactions to more fully include equity-backed investors who are focused on a long-term presence in the market, such as REITs and insurance companies. It can also be mitigated by balancing this form of risk sharing with other front-end transactions, giving the Enterprises multiple outlets that can be used when one outlet is unavailable or uneconomical.

Front-end transactions with REITs, mortgage insurers, and lenders, are least subject to market swings. These institutions are in the long-term business of taking mortgage credit risk, so they will not raise their pricing as much in bad times or lower it as much in good times. Additionally, asset managers, hedge funds, and other capital market participants in back-end transactions are more likely to use debt to finance their participation. By passing risk off to these back-end counterparties, the Enterprises are increasing leverage in the system and with it the overall systemic risk to the housing market. This risk is further exacerbated by the lack of transparency into the sources of, and the total amount of, that leverage. In times of stress, back-end investors would demand a much higher return to cover the risk. As a result, the Enterprises would pass the added cost on to borrowers, or pull back on their volume of risk sharing transactions when it is most critical for them to be engaging in them in order to transfer risk.

3. **Keep Innovating and Improving**

While we address several specific concerns in our response, we believe that in these still relatively early stages of the credit risk transfer market, the FHFA and the Enterprises should not seek to anticipate and decide on a final outcome for a permanent form and structure for these programs and other innovative structures that may yet emerge. This market is still new and far from a mature market one could use to judge which structures are most efficient. Capital is still being raised and business models are still being developed to participate in and respond to these burgeoning efforts. Capital and businesses available to support various risk transfer structures today may not be reflective of capital that can be raised over time and businesses that can be developed to support existing and new risk transfer structures. The U.S. secondary mortgage market was developed over many decades, and we think it prudent, as the FHFA and Enterprises build a new system for addressing credit risk, to allow for continuing innovation and flexibility that will allow market forces to shape a robust credit risk transfer market that will endure over time.

COMMENTARY ON PRINCIPALS OF CRT

a) Continuity of Core Business

Front-end risk sharing transactions can be structured in ways that do not interrupt the to-be-announced market (the "TBA Market"), which the FHFA has rightfully noted to be part of the Enterprises' core businesses. Aggregators such as Redwood can create pools that meet TBA requirements and with respect to which they would take front-end risk. Further, this can be done at a loan level, similar to the way that mortgage insurance is purchased, which has had no impact on the functioning of the TBA market over the years.

b) Repeatable and Scalable

Redwood and all those seeking to participate in risk sharing transactions need them to be repeatable and scalable if they are to be economically viable. The Enterprises have executed only a small number of front-end transactions to date, all of which have been opaque, customized transactions. Because these transactions have not been transparent, scalable, or available to a wide range of lenders, we have not seen a market develop for them. We recommend that these transactions be made more transparent, standardized and accessible to lenders of all sizes. The consistency, size and transparency of the CAS and STACR programs has encouraged investors to dedicate the time and resources needed to support these markets. Front-end risk sharing transactions would benefit the same way from the transparency and consistency offered in back-end risk sharing transactions such as STACR and CAS.

c) Counterparty Strength

In regards to counterparty strength, many of the front-end risk sharing structures proposed to date are cash bond transactions for the Enterprises. They are fully collateralized at closing and all risk proposed to be transferred is transferred to the investor on day one. We fully understand and appreciate the FHFA's concerns in regards to non-fully collateralized transactions. We recommend that the Enterprises and the FHFA consider scaled collateralization based on loan and counterparty performance as a mitigant to "Reimbursement Risk" as defined in the RFI. This concept of scaled collateralization should also consider the natural leverage inherent in the counterparty itself and the correlated risk taken by that counterparty. Without taking these factors into account, REITs will not be able to compete with other more levered participants and, just like current back-end risk sharing, will not be able to effectively contribute to the depth and diversity required to make a liquid market for mortgage credit risk in all market environments.

d) Broad Investor Base

Front-end risk sharing transactions will bring in a whole new suite of investors that are not currently participants (or are only *de minimis* participants) in back-end risk sharing transactions. Additionally, front-end risk sharing transactions can be easily varied to create easy to administer, scalable programs with slight tailoring to appeal to various market participants ranging from hedge-funds, to REITs, to mortgage insurance companies.

e) Stability Through Economic and Housing Cycles

Creating stability through economic cycles should be addressed on multiple fronts. The combination of front-end and back-end risk sharing structures, coupled with various forms of each, will ensure capital is drawn from numerous parties with varied structures and interests. This will result in a housing market that is supported through all but the most extreme economic cycles. While correlated business risk must be managed, it is important to ensure participation from monoline businesses that invest in the housing market and take risk on mortgages. While monoline business do pose correlated business risk, this risk can be mitigated by having other risk-sharing alternatives available and by monitoring counterparty stability. Further, many front-end CRT options are fully collateralized, which eliminates this risk.

f) Transparency

Redwood, in all its endeavors, supports transparency. Redwood and many other mortgage REITs are public companies that are held to stringent disclosure requirements by the SEC. We appreciate and support the FHFA's goal to ensure that all risk sharing arrangements are transparent. This protects the Enterprises, investors, borrowers and taxpayers. While many transactions to date have been proprietary and therefore private, Redwood supports the release of information on these transactions so all may benefit from what we have learned to date and what we will learn. This will also facilitate companies looking to raise capital to enter these transactions. It will further allow public policy and housing advocates transparency into the cost to consumers. It will allow all possible participants to understand the economics of these transactions, thus increasing the investor base and liquidity, as well as the diversity and safety and soundness of the system. Finally, it will provide the means for a level playing field for all participants.

g) Level Playing Field

As mentioned earlier in this letter, we ask that the FHFA consider the natural leverage inherent in each counterparty to a CRT transaction, as well as the risk their particular pools of mortgage loans pose. The FHFA rightly points out its concerns with discounts for volume, and rightfully points out concerns that certain CRT transactions require scale to be economically viable. Redwood and other non-banks have successfully run aggregator conduits that enable smaller originators to gain access to the capital markets without surrendering their customers to their larger competitors. There are numerous front-end risk sharing structures that provide smaller lenders with a meaningful way of participating in the CRT initiative. Redwood has and will continue to propose innovative front-end CRT structures specifically targeted to the needs of community banks and to promote a level playing field and notes that the Federal Home Loan Banks are a good example of FHFA-regulated institutions that can provide smaller lenders with level access to participate in front-end CRT structures.

We hope our recommendations and comments play a very constructive role in the ultimate success of a balanced and robust CRT program.

Sincerely,

Redwood Trust, Inc.

Marty Hughes
Chief Executive Officer

Christopher J. Abate
President and Chief Financial Officer