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May 26, 2010

Via email: rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule – Asset Backed Securities – File No. S7-08-10

Dear Ms. Murphy:

This comment letter is in response to Release Nos. 33-9117; 34-61858 (the "Proposing Release") in which the Commission solicits comments on proposed revisions to Regulation AB and other rules regarding the offering process, disclosure, and reporting for asset-backed securities.

The Proposing Release is extensive and addresses numerous aspects of the Commission's rules relating to the offering process, disclosure, and reporting for asset-backed securities. This comment letter will respond to certain of the requests for comments contained in Section II.B.3(a) relating to risk retention. In particular, this comment letter will discuss the manner in which the Proposing Release would apply risk retention requirements in the context of the issuance of residential mortgage-backed securities.

Background on Redwood Trust, Inc.

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

Through our Sequoia securitization program, which dates back to 1997, we had securitized, prior to this year, a total of approximately $35 billion original principal amount of residential mortgage loans through 48 transactions. In those transactions, Redwood, as sponsor, generally retained risk through investing in the most subordinate tranches of securities issued in these transactions. To date, none of the triple-A rated securities originally issued in those transactions has incurred credit losses and, through March 31, 2010, losses within these transactions have totaled 28 basis points of the aggregate original principal amount and have only impacted the subordinate tranches of securities issued in these transactions.

In April 2010, through its Sequoia securitization program, Redwood sponsored the first private-sector securitization of newly originated prime residential mortgage debt since 2008 (the "April 2010 Sequoia Securitization"), breaking the ice in the private mortgage securitization market, which has been essentially frozen since the inception of the recent credit crisis. Our April 2010 Sequoia Securitization was well received by investors. Following the distribution of a preliminary term sheet, investor demand was more than five times oversubscribed, allowing us to improve the pricing of the transaction from the preliminary terms. Subsequent to closing, the securities issued in the April 2010 Sequoia Securitization have performed well in the secondary market.

Through the process of conducting the April 2010 Sequoia Securitization, we believe that we have gained valuable experience and perspective with regards to how risk retention requirements are viewed by investors who typically purchase the triple-A rated tranches of residential mortgage securitizations. We believe this experience and perspective should be shared with the Commission as it finalizes the Proposing Release.

Role of the Private Sector in Securitization of Residential Mortgage Loans

Before I proceed, and in order to place our comments in the proper perspective, I will explain the role we believe that private-sector securitization of residential mortgage loans should play in our nation's system of housing finance. While Congress, the Obama Administration, federal and state regulatory agencies, and other stakeholders have all proposed various approaches to reforming the U.S. mortgage markets, one thing most everyone seems to agree on is that the U.S. government cannot continue to support the vast majority of the residential mortgage market. In fact, in the first quarter of 2010, government agencies and government-sponsored enterprises ("GSEs") backed approximately 96.5% of all home loans.

Private sector liquidity needs to return to the U.S. residential mortgage markets in order to reduce reliance on Fannie Mae and Freddie Mac. While private securitization will initially be aimed at prime jumbo (*i.e.*, non-conforming) mortgage loans, the private sector could also provide an alternative to the GSEs for prime mortgages as it has in the past. For example, over one quarter of the loans underlying the $35 billion in Sequoia securitizations we sponsored prior to 2010 met the conforming balance limits of the GSEs in place at the time of origination. In addition, private sector securitization of residential mortgage loans can also help broaden the product set of mortgages by allowing banks to make loans that they might not want to hold on their balance sheets (*e.g.*, 30-year fixed rate mortgages).

While our April 2010 Sequoia Securitization began the process of revitalizing the private sector's participation in the residential mortgage markets through securitization, we think that having the right risk retention requirements in place will be critical to maintaining private sector participation in this important financial market. Setting risk retention requirements properly is important to keeping risk in check and to making credit available to good borrowers at reasonable interest rates. If risk retention requirements are too high, they will unnecessarily choke off credit, while if they are too low, they could fail to discourage overly risky lending.

In our April 2010 Sequoia Securitization we received feedback regarding the risk retention issue from many of the large institutional investors who typically invest in the triple-A rated tranches of residential mortgage securitizations. Based on their feedback, we have concluded that these investors overwhelmingly believe that the sponsor of a securitization should retain "horizontal" risk, by retaining the most subordinate tranches of a securitization – thereby placing the sponsor in the first loss position. As the sponsor of the April 2010 Sequoia Securitization, Redwood responded to these investors and retained significant first loss horizontal risk in the transaction. We believe that it was this horizontal retention of risk that was most persuasive in establishing the alignment of our interests, as sponsor, and their interests, as investors in triple-A rated securities.

Comments on Section II.B.3(a) of the Proposing Release

Against the background provided above regarding the role Redwood plays in the residential mortgage markets and our recent experience in conducting the April 2010 Sequoia Securitization, we offer the following comments regarding the risk retention requirements in the Proposing Release as they would apply to securitizations of residential mortgage loans.

(1) ***Sponsors should be required to retain significant risk.***

We agree with the statement set forth in the Proposing Release that "securitizations with sponsors that have continuing risk exposure would likely be higher quality than those without." Our own experience as a sponsor of securitizations supports this aspect of the Proposing Release. As noted above, we generally retained first loss horizontal risk in the Sequoia program securitizations that Redwood sponsored and, to date, none of the triple-A rated securities originally issued in those transactions has incurred credit losses and through March 31, 2010, losses within those transactions have totaled 28 basis points of the aggregate original principal amount and have only impacted the subordinate tranches of securities issued in those transactions.

(2) ***Sponsors should retain first loss "horizontal risk," not "vertical risk."***

We disagree with the vertical approach to risk retention proposed in the Proposing Release. Instead, we believe that sponsors should be required to retain significant first loss horizontal risk.

- First loss horizontal risk is the strongest method for incentivizing sponsors and aligning the interests of sponsors and investors. As both an investor in, and sponsor of, securitizations of residential mortgage-backed debt, we know that the most basic of the investment fundamentals that investors are focused on is asset quality. A sponsor that is exposed to significant first loss horizontal risk is fully exposed to the weakest assets included within a securitized pool. By contrast, a sponsor that is only exposed to vertical risk may only be exposed to 5%, for example, of losses that may occur with respect to the weakest assets included in a securitized pool. We believe that this is the "investment math" that investors were doing when they exhibited strong demand to purchase triple-A rated securities in our April 2010 Sequoia Securitization. Investors know that a sponsor that retains significant first loss horizontal risk is the most strongly incentivized with respect to selection of the assets to be included in a securitized pool.

- The Proposing Release indicates that there were two principle reasons why horizontal risk retention was not the method of risk retention proposed, namely: (i) "skewed incentive structures" – or inter-tranche conflicts of interest and (ii) "small portions" – or retention of horizontal risk that was not significant enough to achieve the intended effect. We believe that both of these concerns can be addressed without compromising the strong incentive provided by first loss horizontal risk retention, as we discuss further below.

(3) ***Potential inter-tranche conflicts of interest are better addressed through the structure and terms of a securitization – rather than by abandoning the strong alignment of interests that flow from first loss horizontal risk retention.***

The potential conflicts of interests that the Proposing Release intends to address through a vertical approach to risk retention can be addressed through the structure and terms of the securitization – and need not weaken the strong alignment of incentives provided through first loss horizontal risk retention. One potential conflict of interest involves the prevalent use of "over collateralization" structures in securitizations of subprime residential mortgage debt – where conflicts arose when sponsor/servicers could trigger the release of excess collateral amounts to holders of subordinate tranches by repurchasing delinquent loans to eliminate the effect of those delinquent loans on collateral release triggers. Another potential conflict of interest involves the effect that sponsor/servicers can have, through control over loan modifications and repurchases, on the satisfaction of the trigger tests within a securitization that control distributions of cash flows to different tranches of securities.

We believe that these conflicts are better addressed though changes to securitization structures and terms that would mitigate these conflicts – rather than allowing those conflicts to persist and attempting to govern them through vertical risk retention. As an example, private sector securitizations of residential mortgage loans often include performance triggers that were based on stated delinquencies within the collateral loan pool. If delinquent loan balances were below a certain threshold over time, then a greater amount of the principal and interest cash flows generated by the collateral loans would be directed to the subordinate tranches of securities. This type of trigger could potentially be manipulated by modifying the terms of delinquent loans and, thereby, returning them to "current" or non-delinquent status. Regardless of whether the future performance of a modified loan was likely to improve, for purposes of the trigger, the loan would, until any subsequent default, be considered performing – with the result that more principal and interest cash flows would be paid to subordinate security holders.

To address this potential conflict, in our April 2010 Sequoia Securitization, for certain collateral tests that underlie triggers that would increase the principal and interest cash flows directed to subordinate securities, modified loans and loans repurchased by the sponsor will be counted as delinquent for 12 months following the date of modification or repurchase, reducing the immediate impact of these events on the allocation of cash flows between senior and subordinate tranches – thereby disincentivizing servicer/sponsors from utilizing their rights to favor one tranche of a securitization over another. The April 2010 Sequoia Securitization did not include an overcollateralization feature, but the terms of such a structure could quite readily be modified to eliminate the structural incentives that have been the subject of criticism in the market – for example, by adjusting the terms for the release of excess collateral.

(4) ***Sponsors should retain significant risk, but one size does not fit all.***

As noted above, we agree with the statement set forth in the Proposing Release that "securitizations with sponsors that have continuing risk exposure would likely be higher quality than those without." In fact, we believe that sponsors should retain significant risk in the form of first loss horizontal risk. The Proposing Release provides for the sizing of risk retention by proposing a 5% risk retention requirement to be applicable to <u>all</u> asset-backed securitizations. The Proposing Release does not provide any analysis of why 5% is the appropriate amount for all asset-backed securitizations, other than to cite the European Union's recent amendment to its Capital Requirements Directive and to indicate that risk retention by sponsors in the past may not have been effective due to the "small portions" of risk retained.

We strongly support significant risk retention by sponsors, however, we believe that the SEC should engage in a more thorough analysis of whether a flat 5% requirement imposed across all types of asset-backed securitizations compromises the effectiveness of risk retention for the sake of simplicity. While simplicity, where appropriate, is an appropriate goal of the Proposing Release, we strongly believe this approach in the context of risk retention requirements could result in securitization becoming a vehicle for inappropriately distributing credit. In the context of securitization of residential mortgage loans, a fixed percentage for risk retention could, for example, disrupt the flow of mortgage credit to prime borrowers (by making securitization uneconomic for this more conservative asset class) while failing to impact market practice for riskier classes of assets, such as subprime residential mortgage loans. While securitization is but one mechanism for financing borrowers' credit needs, it is a mechanism used across a wide spectrum of asset qualities and risk retention requirements must take into account this variation in underlying credit quality in order to be appropriately structured and effective.

One alternative approach, for example, would be to tie risk retention requirements to rating agency subordination levels. While we recognize that the Commission may choose not to implement a regulation that relies on the work product of the rating agencies, any desire or requirement to disengage regulations from ratings should not, itself, drive an overly-simplistic approach to risk retention. In the paragraph below, we will use rating agency subordination levels as an example of how risk retention requirements could be tailored to the underlying risk of the securitized assets. A similar method could be utilized that did not rely on the work-product of the rating agencies.

The rating agencies' process for rating securitized debt includes the establishment of subordination levels after taking into consideration the quality of the collateral and structure of the securitization, among other factors. These subordination levels dictate the relative sizes (by principal amount) of the various tranches of securities within the securitization. If the Commission were, for example, to set a risk retention requirement at a level equal to 100% of the non-investment grade subordinate securities, then for a securitization backed by prime jumbo mortgages with senior triple-A rated investment grade securities representing 94% of the securitization, mezzanine securities (rated AA, A, and BBB) representing 3% of the securitization, and subordinate or non-investment grade securities (rated BB, B, or not rated) representing 3% of the securitization, the risk retention requirement would be 3%. Alternatively, under the same methodology, for a securitization with lower quality subprime mortgage collateral in a structure in which senior triple-A rated securities represent 70% of the securitization, mezzanine securities represent 10% of the securitization, and subordinate securities represent 20% of the securitization, the risk retention requirement would be 20%.

The variability in the risk retention requirements noted in the above example is a level of variability that we believe would be appropriate and consistent with establishing risk retention requirements that align the interests of sponsors and investors across a wide range of types of securitized assets. Some form of a variable approach to risk retention has been embodied in the financial reform bills recently passed by both the House and Senate (H.R. 4173 and S. 3217) and based on our recent market experience we believe that approach will be more effective than the "one size fits all" approach included in the Proposing Release.

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I appreciate this opportunity to comment on the Proposing Release, and would be happy to discuss any questions with respect to this letter. I can be reached at 415-389-7373.

Sincerely,

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