

Perspectives on Private Capital and the "QM Patch"

May 2019

REDWOOD TRUST

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A Voice for the Private Sector

- As policymakers consider reducing the federal role in housing finance, there remains a powerful constituency in the housing market that unnecessarily pits affordable homeownership against the interests of taxpayers in an effort to preserve **status-quo government subsidies**

- In spite of this, the non-subsidized **private sector** of the mortgage market **continues to grow,** financing an increasing share of GSE-eligible loans

- Redwood Trust has led the private sector resurgence in housing finance since issuing the first post-crisis securitization in 2010, and is the **most prolific issuer** outside of the GSEs

- Through a nationwide network, Redwood finances a diverse array of loan products covering a broad spectrum of homebuyers, offering a proven framework for broader **private sector competition** to the GSEs

FHFA's Renewed Focus on Safety and Soundness

- New FHFA Director Calabria recently reminded stakeholders that *"if an institution is leveraged 1,000 to 1, as are the GSEs, it's a recipe for failure…no supervisor is good enough to fix that."*

- Calabria also addressed GSE charter-creep (i.e., taxpayer-backed initiatives at the GSEs traditionally suited for the private sector), citing *"a very clear-lined approach that if it's not in the (GSE) charter, then you're not doing it"*

- In reference to the "crowding out" effect on private sector capital that could otherwise shield taxpayers from losses at the GSEs, Calabria noted:

  — *"If you level the playing field regulatory-wise, other players will start to come into that market. My view is there's a tremendous amount of interest among investors, a tremendous amount of balance sheet capacity, not just among banks but insurers and other players in the marketplace."*

Private Capital Continues to Gain Traction

- A strong emphasis on safety and soundness at the FHFA coincides with the private sector's capacity to finance an increasing share of overall mortgage production

- Recent data indicates there is ample room to continue "crowding in" private capital without a meaningful (if any) impact on rates available to most borrowers

- A gradual leveling of the playing field can happen safely and expediently, but will require a commitment to transition milestones for *both* the public and private sectors

- One logical way to begin such a transition is to address the current state of non-QM lending and the "QM Patch" expiration in a way that creates opportunities for private markets, rather than locking that segment into the GSE market

The QM Patch

- Ability-to-repay (ATR) rules that took effect in 2014 created a "non-qualified" mortgage (non-QM) designation that encompasses a variety of loan characteristics
- Acquiring and securitizing non-QM mortgages requires significant compliance procedures, introducing increased litigation exposure and capital inefficiencies for private market participants such as Redwood
- Conversely, the GSEs were afforded a blanket exemption for non-QM loans (the "QM Patch") to accommodate existing automated workstreams, resulting in a significant compliance and capital subsidy to the GSEs that is not available to the private sector
- Today, approximately **25-30%**[1] (est. **$185 billion** annually) of single-family mortgages purchased by Fannie Mae and Freddie Mac would be considered non-QM but for the QM Patch, which is set to expire in 2021 or upon the GSEs exiting conservatorship

1. Estimate based on publicly-available GSE credit risk transfer offering documents.

The QM Patch Expiration is an Opportunity for Private Capital

- Advocates for the status quo argue that the QM Patch impact is “too big”, and that a taxpayer backstopped exemption from consumer protection rules should be permanently extended for the GSEs

- In fact, the expiration of the QM Patch represents an excellent opportunity for policymakers to shrink the government mortgage footprint and begin shifting market share to the private sector in a **safe and measured approach**

- Our analysis breaks down QM Patch loans into manageable cohorts, based on underwriting and credit risk metrics

  - ***The results show that approximately 65-70% of production currently covered under the Patch could be reliably funded through the private sector with very little impact to borrowers***

- Implementing a well-reasoned transition with clear line of sight for market participants can deepen private capital’s presence while preserving the consumer protections established under the QM Rule

Non-QM Issuance: Public vs Private Sector

- The following chart shows certain features of non-QM loans recently securitized by Redwood (the top private-label non-QM issuer) and the GSEs:

Features of Non-Qualified Mortgages by Issuer[1]			
	Redwood	FNMA	FHLMC
FICO	760	734	741
CLTV	69	76	75
DTI	42	47	47
Investment Property	7%	7%	9%
DTI>45	49%	67%	64%
CLTV>80 & DTI>35	2%	31%	27%

Two viable and growing portions of PLS market

- The data shows that private-label investors are comfortable with properly-underwritten non-qualified mortgages, including loans with higher debt-to-income ratios (*highlighted in green*)

- However, the private sector remains uncompetitive for loans with extreme layered risks, particularly loans with both high DTI and high LTV (*highlighted in yellow*)

1. Redwood: Flow purchases between Q115 and Q418; FNMA: Purchases between Q4 2015 and Q4 2017; FHLMC: Q4 2018 first payment date

Collateral Attributes of Recent Securitizations

- The following chart details collateral attributes of recent Redwood securitizations, including:
  - Overall percentage of GSE-eligible loans
  - Percentage of GSE-eligible loans with DTI ratios over 43% (i.e., non-QM)

			As a % of GSE-Eligible Loans	
Deal Name	Gross Coupon	% GSE-Eligible	DTI>43	% Self-Employed
SEMT 2019-1	4.72	30	46	25
SEMT 2018-8	4.62	22	40	23
SEMT 2018-7	4.54	33	54	19
SEMT 2018-6	4.50	31	57	24
SEMT 2018-5	4.24	29	50	29

The percentage of GSE-eligible loans included in private-label RMBS is the most since the financial crisis and continues to grow

QM Patch / Non-QM – Technical Exceptions

- Many non-QM loans do not qualify for QM status for reasons that do not reflect the borrower's true ability to repay; these borrowers see a minor increase in available rates when the loan is financed through the Redwood network rather than through the GSEs

CRITERIA	QM REQUIREMENTS	AGENCY REQUIREMENTS	IMPACT IF AGENCY HELD TO QM STANDARDS/APPENDIX Q
Self-Employed	➢ Signed, dated individual tax returns, with all applicable tax schedules for most recent 2 years ➢ Personal and business returns required	➢ For certain casefiles, Agency criteria permits only 1 year of personal and business tax returns ➢ Criteria may not require business returns for borrowers self-employed >5 years	➢ Missing second year of tax returns would likely cause the loan to be ineligible for QM status
Rental Income (Income from existing Rental)	➢ Analysis of current lease(s)/rental agreement(s) (among other documentation) required to verify all consumer rental income ➢ Consumer can provide a current signed lease or other rental agreement for a property that was acquired since the last income tax filing, and is not shown on Schedule E	➢ Borrower's most recent year of signed federal income tax returns, including Schedule E, or copies of the current lease agreement(s) if the borrower can document a qualifying exception	➢ Missing lease could cause the loan to be ineligible for QM status. Many landlords with long term tenants don't have a current lease agreement
Gaps of Employment	➢ Explain any gaps in employment that span one or more months; gaps spanning more than 6 months require the borrower to be on the job for 6 months ➢ Must document a 2-year work history prior to an absence from employment using employment verifications; and/or copies of IRS Form W-2s or pay stubs	➢ Do not address any specific time period for employment gaps ➢ Do not require any specific verification when gaps exist	➢ Most meaningful for borrowers with job gap of greater than 6 months that recently found new employment
Signatures on Tax Returns	➢ Required on or before consummation	➢ Not required	➢ Missing signatures at closing cause loan to be deemed non-QM, even if signatures provided day after closing

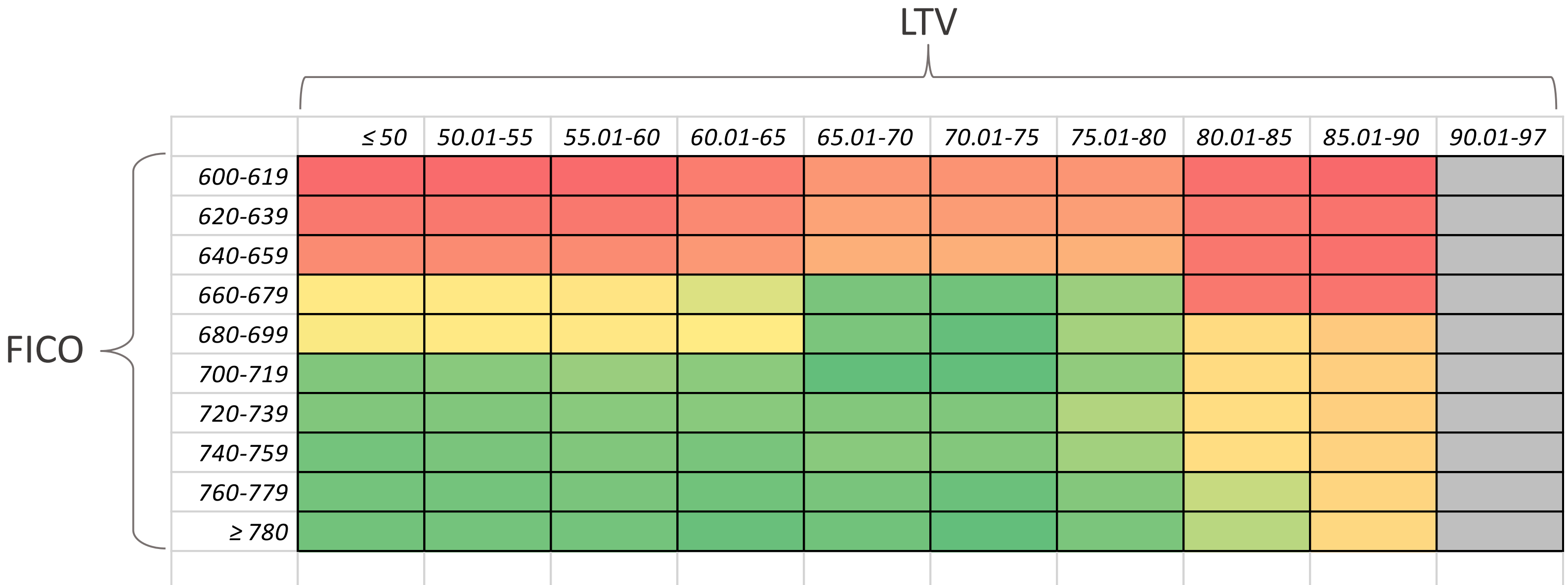
QM Patch / Non-QM –
Price Comparison to Private Sector

Heat maps on the following slides illustrate:

- Qualified consumers offered loans supported by private capital receive similar rates to what the GSEs provide today
- The loans private capital can fully support represent a majority of what the GSEs are currently buying
- Private capital stays away from extreme layered risk (i.e., high DTI coupled with very high LTV)

Note: Heat maps are displayed in the same increments, so they can be overlaid with one another

GSE versus Redwood Rate Comparison: Non-Agency “QM” & Agency “QM”



Consumer in same or better rate in Non-Agency loan

Consumer in 25-50 bp higher rate in Non-Agency loan

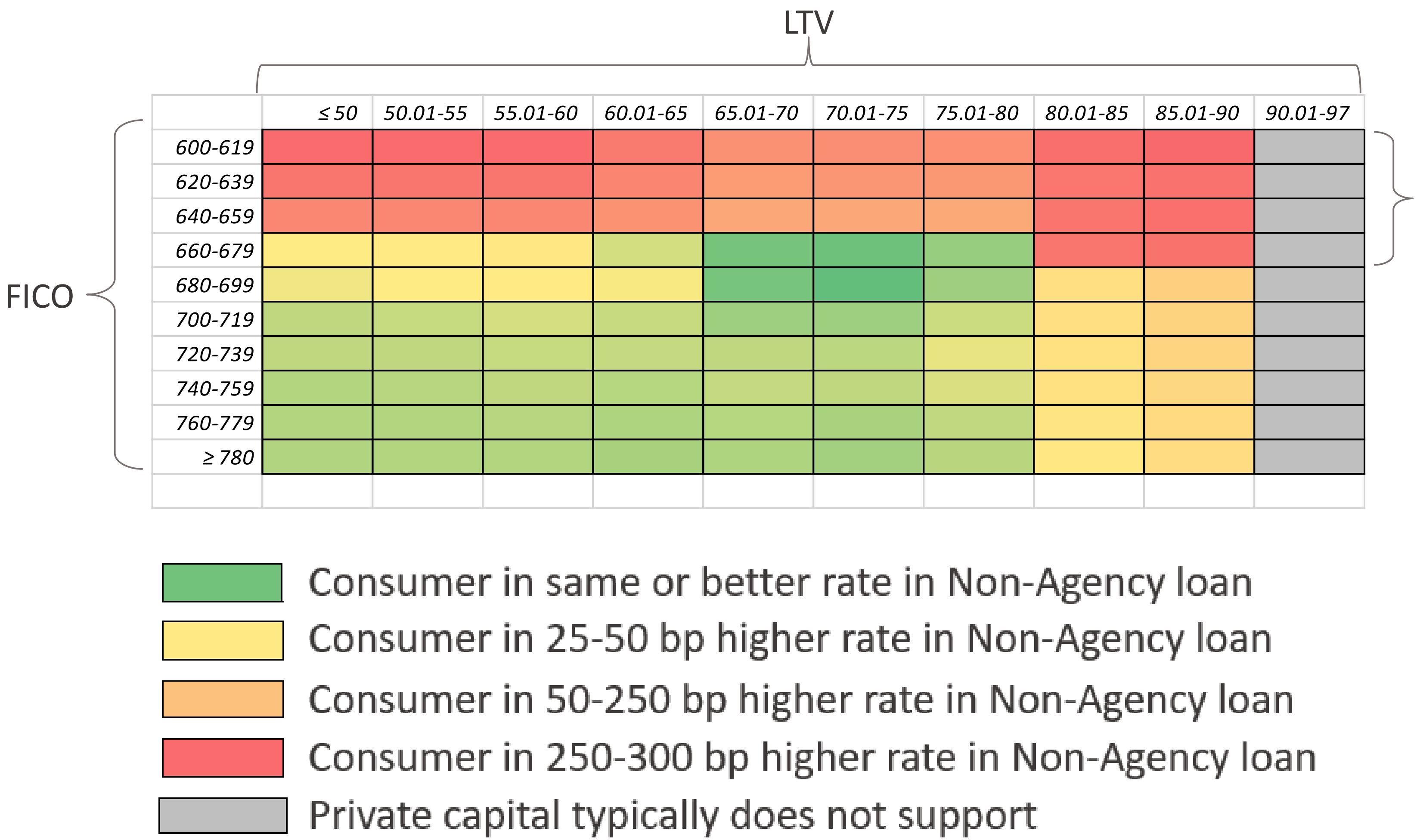
Consumer in 50-250 bp higher rate in Non-Agency loan

Consumer in 250-300 bp higher rate in Non-Agency loan

Private capital typically does not support

Disclaimer: GSE versus Redwood rate comparisons and agency production distributions are based on aggregated observations, estimates, and assumptions, including observations of residential mortgage loan market pricing, estimates of loan pricing derived from Fannie Mae and Freddie Mac "TBA" securities, and other industry data. Pricing inputs and loan characteristics were obtained, estimated, or derived from sources which we believe are reliable, but we do not warrant or guarantee the completeness or accuracy of this information. This information involves many assumptions and limitations, and you are cautioned not to give undue weight to these estimates. The information displayed regarding Redwood is not a solicitation or an offer to buy or sell securities and is not investment advice or a recommendation to purchase or sell any security.

GSE versus Redwood Rate Comparison: Non-Agency "Non-QM" & Agency "Non-QM"



In both the QM and non-QM space, the far end of the credit spectrum is less supported by private capital

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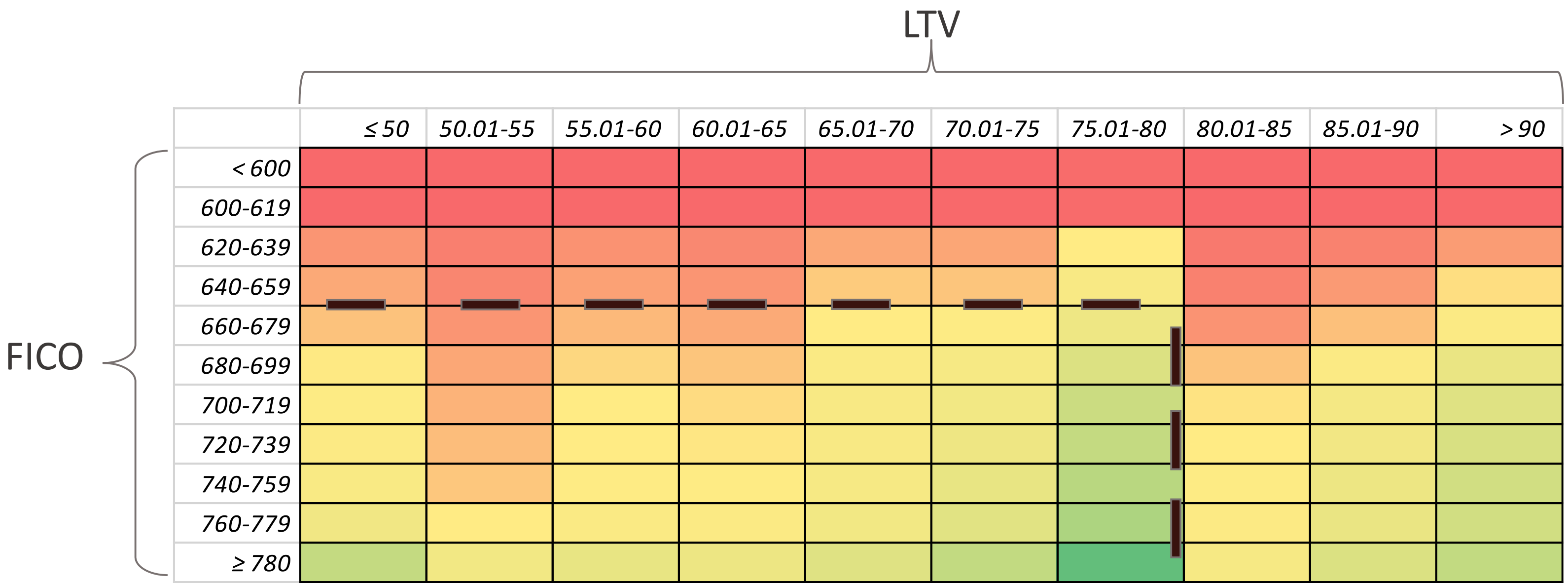
Agency Production Distribution – Aggregate (“QM” & “Non-QM”)



- Overlaying the prior slides shows that the areas of green where the private market is able to effectively serve the consumer at the same rate aligns with the majority of GSEs purchase volume
  - The etched area represents more than 65% of GSE purchase volume

Cells represent 4.5%-7.0% of Agency production

Cells represent 3.0%-4.5% of Agency production

Cells represent 1.5%-3.0% of Agency production

Cells represent 0.0%-1.5% of Agency production



Appendix

REDWOOD TRUST

Who is Redwood Trust?

We are a specialty finance company that plays a key role in the housing finance market

Durable Track Record through Cycles	▪ 25-year track record providing liquidity to the housing market
Aligned with Shareholders	▪ Internally-managed, $1.6 billion market cap with incentive compensation directly tied to shareholder returns
Scalable Operating Model	▪ Unique mortgage banking platform purchasing loans from almost 200 discrete sellers
Organic Investment Creation	▪ Source majority of our portfolio investments from our Sequoia platform and strategic partnerships
Focus on Human Capital	▪ Experienced and disciplined team with approximately 240 employees in Mill Valley, Denver, Irvine, Chicago and New York

Redwood is Prepared to Broadly Compete with the GSEs

	GSEs	Redwood
Homogeneous Pools	✓	✓
Deep Investor Base	✓	✓
Market Standard	✓	✓
Alignment of Interest	✓	✓
Government Backed	✓	X
Private Capital Sole Source of Funds	X	✓
Proven Track Record	✓	✓
Provide Liquidity for Originators of All Sizes	✓	✓
National Footprint	✓	✓
Neutral Counterparty (not an originator)	✓	✓
Cash Window	✓	✓
Originator Approval and Counterparty Risk Management	✓	✓
Servicing Oversight	✓	✓

Strong Culture of Risk Management

A naturally evolving approach to risk, underpinned by consistent core principles

- ✓ **Controlling production quality**
- ✓ **Centralized decision-making**
- ✓ **Rigorous liquidity management**
- ✓ **Modest financial leverage**
- ✓ **Culture of transparency and integrity**

Overview of Redwood's Loan Programs

Overview of Redwood's Loan Programs

- Redwood Choice, our expanded-prime program, was launched in April 2016 to complement our original prime jumbo Select program
  - Loans typically included in Redwood's Expanded "CH" transactions have represented 36% of our 2018 lock volume, versus 28% in 2017 and 9% in 2016
- Redwood Core ("SEMT") securitizations have recently averaged approximately 24% Agency-eligible loans[4]
- Redwood "CH" securitizations have recently averaged approximately 8% Agency-eligible loans, which has been increasing[4]
- Our platform offers 3 main channels with program guideline ranges of:
  - Debt-to-income ratio: up to 49.9% and 43%
  - LTVs: up to 90% and 80%
  - FICO: minimums of 600 to 700

2018 Lock Volume Statistics

	Select[1] Programs	Choice[2] Programs	Agency[3] Eligible
Avg. FICO	770	730	762
Avg. LTV	71	74	68
Avg. DTI	33	37	38
Avg. UPB	$729K	$780K	$537K
% Non-Qualified Mortgages	7%	32%	N/A
% Investment Property	3%	12%	10%
% FICO <700	<1%	29%	4%

1. "Select Programs" include our Select QM, Select Non-QM and Select 90 branded mortgage loan programs
2. "Choice Programs" include our Choice QM and Choice Non-QM branded mortgage loan programs
3. "Agency Eligible" are loans underwritten and approved to GSE guides and eligible for GSE delivery.
4. SEMT securitizations include mortgage loans from our Select QM and Select 90 mortgage loan programs as well as Agency Eligible mortgage loans. CH securitizations include mortgage loans from our Select Non-QM, Select 90, Choice QM, Choice Non-QM mortgage loan programs as well as Agency Eligible mortgage loans.

Redwood is the Leader in Private-Label RMBS

- Redwood was the first private-label securitization issuer post-crisis and is credited for restarting the market
- The platform has sustained its market leadership position
  - #1 purchaser of non-QM and expanded credit loans in the market[1]
  - Redwood's prime and expanded prime programs are the gold standard in their respective categories
- In addition to securitizations, Redwood has executed over $17 billion[2] in whole-loan sales

Prime/Expanded Prime Securitization ($ in billions)				
Issuer		Issuance Volume	No. of Deals	No. of Issuers
Redwood	**$**	**21**	**55**	**1**
Others[3]		63	149	32
Total	**$**	**84**	**204**	**33**

1. Source: Inside Mortgage Finance 2018 Ranking
2. As of 3/31/19
3. As of 3/31/19 Includes depositories such as banks, bank holding companies, and their affiliates and non-depositories such as mortgage REITs, and non-bank originators and aggregators. Source: Bloomberg and public records

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CELEBRATING

25 YEARS