It's Time to Change the World

by Eric C. Nordman

Since I assumed another leadership role at the beginning of 2012, I have had some amazing things occur. My new title as director of the NAIC Center for Insurance Policy and Research (CIPR) has given me the opportunity to interact with some incredible thought leaders. The white paper *Financing Home Ownership, Origins and Evolution of Mortgage Securitization: Public Policy, Financial Innovations and Crises* published by the CIPR in August has now been downloaded more than 25,000 times—a record, I'm told. What's all the fuss?

Background Information

One of the vexing problems of the recent economic downturn was the performance of the real estate markets. This is important to insurance regulators, as insurers are major investors in real estate, both directly through ownership of their facilities and indirectly as investors. Insurers' investments come in the form of direct lending, but more commonly as investments in both residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). The trouble with investing in either RMBS or CMBS is that it is difficult for an investor to know what the value of the RMBS or CMBS is at any point in time. This difficulty arises because the information needed to evaluate the performance of an RMBS or a CMBS properly is opaque. It is not easily discoverable by the investor.

This was a problem during the economic downturn because nobody could establish a reliable value of RMBS or CMBS securities given the lack of timely information about the performance of the underlying mortgages that made up the package of loans that had been securitized. Casual assumptions that housing values always went up proved inaccurate. Lack of information about creditworthiness of borrowers whose loans were in the packages and lack of information about the lenders' underwriting standards made it impossible to know with any level of certainty what a particular RMBS or CMBS was worth.

Before the economic downturn, there was a robust private market for guaranteeing RMBS. The leverage in the mortgage market surged during the boom years (2001-2007). At the time, the mortgage debt outstanding was greater than any other lending sector. The rate of growth and the amount of outstanding loans were both rapidly increasing. Residential mortgage debt outstanding grew at around 12 percent per year from 2000 to 2007, when it peaked at $11.2 trillion. At the time, this was an amount greater than the total outstanding of the Treasury, non-financial corporate bonds, and credit card debt combined.

The culprit seemed to be the subprime mortgages that lowered lenders' underwriting standards, making it easier for people to borrow. Unfortunately, the ability to borrow did not coincide with the ability and willingness to repay the loan. Before the emergence and proliferation of subprime

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mortgages, the housing finance system was served by the government sponsored enterprises (Fannie Mae and Freddie Mac), a few mortgage insurers, and large lending institutions. These entities knew and understood each other's business practices. Collectively, the system had developed accepted underwriting standards that could effectively eliminate most unqualified borrowers and a working model for setting risk-based premiums for guaranteeing mortgage credit losses. Before the introduction of subprime securitization, things were working pretty well because all the market participants knew and understood each other. In that pre-subprime environment, securitization primarily involved deals backed by conforming prime loans. The consistent quality of government agency RMBS collateral pools allowed a good deal of certainty in predicting future cash flows. Investors only had to worry about prepayment risk and reinvestment risk. In other words, before the introduction of subprime securitization, things were working pretty well because all the market participants knew and understood each other.

The CIPR White Paper

The white paper *Financing Home Ownership, Origins and Evolution of Mortgage Securitization: Public Policy, Financial Innovations and Crises* offers a range of public policy options for insurance regulators to consider. The range of options was suggested by nationally recognized thought leaders who were invited to contribute to the white paper. Three of these authors were also invited to speak at the recent NAIC Fall Meeting at an invitation-only CIPR public policy luncheon. Edward L. Toy, director of the NAIC Capital Markets Bureau, is known as a capital markets expert and innovator and is responsible for the Capital Markets *Special Reports* and a Capital Markets *Daily Newsletter* for regulators. At the luncheon, Mr. Toy focused on recent modeling efforts for both RMBS and CMBS. The NAIC modeling provides insurance regulators with a world-class facility for precise modeling of both RMBS and CMBS. These modeled results are the envy of other financial services regulators who do not have the granular information available to them that insurance regulators have available today.

The other presenters offered suggestions on how to build a better mousetrap. Richard Field is head of TYI, LLC, a consulting and technology firm concentrating on the future of finance. He is a contributor to a variety of publications, including *Fortune Magazine*, *The Wall Street Journal*, *The New York Times*, *Financial Times*, and *Bloomberg*. Mr. Field described how his "Brown Paper Bag Challenge" looked at "observable event reporting" in RMBS. Mr. Field said the RBMS markets do not work because they lack the basic source of investor protection, namely transparency. Mr. Field also observed that insurance regulators are in a unique position to influence the broader RMBS markets because insurance regulators are the only regulators representing investors; in this case, insurers that own $123.2 billion worth of RMBS and $161.9 billion worth of CMBS. The numbers reported by the NAIC Capital Markets Bureau are the holdings in modeled securities. They do not include agency paper and a small amount of non-agency that could not be modeled. Everyone agrees that the RMBS markets are in disarray. Mr. Field's suggested solution to protect insurer investments is for regulators to use capital requirements to encourage the insurers to invest in new RMBS issues from entities providing credible investor protections. Mr. Field defines credible investor protection as timely,

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observable, event-based disclosure so that insurers and other investors can independently assess the creditworthiness of the underlying collateral for each structured finance product.

David M. Rowe is founder and president of David M. Rowe Risk Advisory, a risk management consulting firm focused on risk management support for boards and senior executives of financial institutions (primarily banks and investment banks), with particular focus on capital market activities. Dr. Rowe is a frequent contributor to *Risk* magazine, where he has written the monthly *Risk Analysis* column since late 1999. Dr. Rowe proposed countering housing finance complexity with "Market-Driven Transparency."

Dr. Rowe is a firm believer in the writings of Charles L. Schultz, a senior fellow emeritus in the Economic Studies Program at the Brookings Institution. Schultz wrote in his book *The Public Use of Private Interest* that, "According to conventional wisdom, government may intervene when private markets fail to provide goods and services that society values." He maintains, and I agree, that the private placement market for RMBS is badly broken and in need of repair. The RMBS market is an important one for insurers, as it helps them diversify their asset base. It thereby becomes important to insurance regulators charged with overseeing a healthy and competitive insurance marketplace.

Dr. Rowe has identified a risk predictive technology that he called a "foundational technology for creating healthy and transparent markets." It deploys inducements to market participants to encourage them to update continuously the underlying mortgage-related data needed to value the RMBS. Using a device known as a Transaction Credit™, RMBS aggregators are motivated to disclose pertinent information regarding mortgage performance because they receive an economic benefit from doing so. The Transaction Credit™ provides aggregators and investors with their choice of incentives to induce them to use the transaction platform. The participant can choose a reduced fee on future transactions or gain access to market information to improve sales and market performance.

This methodology need not remain a vision. At the CIPR Luncheon, Dr. Rowe's speech went much further than the way he expressed his thinking in the white paper. He declared that implementation of the "only innovation I have seen that promises to revive the securitized mortgage market and to do so without the benefits of government guarantees" should be made a "national priority." He was talking about resolving as much as roughly $5.35 trillion in government insured debt that the government says it wants to privatize. This is the nation's largest single risk exposure, fully one third of the public and private debt. This "national priority" status is even more the case, as it also applies to the world's largest credit product, roughly $700 trillion in credit derivatives, Credit Default Swaps (i.e. the US is generally thought to have about a 40% market share of financial markets). What is needed to supplement the LEI is to develop a transaction platform within which RMBS can be traded and tracked.

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Implementing Change

Everyone agrees that the RMBS markets are in disarray. Loans are difficult to obtain. Only the government sponsored entities seem to be willing to guarantee mortgage loans and then only prime loans for highly qualified borrowers. What is in question is what to do about the market and its implications for insurers' investment opportunities in RMBS. Given that investments in these markets are a key piece of the investment portfolio of insurers, it is important to them, to consumers, and to insurance regulators that these markets become more functional and reliable.

Immediately after the global financial crisis, politicians were calling for greater transparency, enhanced disclosure, and more regulation as solutions to address the credit crisis. As Dr. Rowe observed in his contribution to the white paper, there was plenty of blame to go around. The solution for many was the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. One of the features of the Dodd-Frank Act was the chartering of the Financial Stability Oversight Council (FSOC) and its research arm the Office of Financial Research (OFR). Together, they were tasked with identifying and documenting risks to the US financial system, promoting market discipline, collecting information needed to assess risks to the US financial system, and coordinating regulatory oversight and information sharing for the financial sector. The housing markets and the related RMBS markets are but one piece of a broader puzzle. So far, the most visible work product of the OFR is creation of the Legal Entity Identifier (LEI). While this is an important first step to a common platform for risk transfers, it is by no means the end. The LEI tells us who is doing something but not what they are doing.

What is needed to supplement the LEI is to develop a transaction platform within which RMBS can be traded and tracked. Accomplishing the task will require a strategic alliance of buyers, regulators, and the general public. The major sell-side firms will not be motivated to develop a solution, as they fear it will reduce what they perceive as a competitive advantage. What sellers fail to realize is that what they lose in narrower margins will be more than made up in volume as the RMBS markets restart and trust is restored.

The transaction platform should start with the lender granting a mortgage. Participating lenders can make information available about their loan underwriting standards, the accuracy of real estate appraisals, and key performance indicators after the mortgage is issued. Indicators might include receipt of a payment, failure of the borrower to make a timely payment, delinquency milestones, changes to the mortgage loan documents, and other agreed upon factors. Aggregators can assemble mortgage packages and tie the information to each loan within a package. Investors will receive access to the transparent mortgage-related information when they purchase an RMBS. If the investor happens to be an insurer, a regulatory portal will give insurance financial regulators access to current transparent information pertinent to the valuation of the RMBS asset. The multiple eyes of the insurance regulators would assist with keeping all parties honest and provide a valuable risk valuation tool for all financial regulators.

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An inventor named Michael Erlanger is the owner of the intellectual property mentioned by Dr. Rowe. Going beyond the Transaction Credit™, Mr. Erlanger has outlined all the businesses processes necessary to add transparency and restore the RMBS markets for the benefit of insurers and other investors. His company, Marketcore, should be included as part of the solution. The business processes described on the Marketcore website (www.marketcore.com) involve the electronic "trading" of risk-detailing disclosures in exchange for more efficient, better-functioning financial markets. The transaction platform would be both optional and voluntary. His recommended processes go beyond the RMBS markets and would potentially cover all of structured finance.

The suggested business process can quantify and reduce risk to help restore financial markets to good health. The reason this invention works for capital markets products like RMBS is twofold. First, if an electronic system is developed to enable the transactions and capture the transaction data, the administrative costs to all parties to the transaction would be reduced over the current business processes. Second, there is always a cost of risk associated with a financial product that is related to uncertainty. The greater the uncertainty, the greater the cost of the element of the capital markets product associated with the transfer of that risk between the parties. If the uncertainty surrounding the risk is reduced, then the cost of risk is reduced and the overall cost of the product is reduced. The Marketcore invention is designed to reduce uncertainty and enable a more complete identification of risk in financial products. All parties to the transaction benefit from the reduced transaction costs.

As an important first step, insurance regulators are in a position to lead. They can be the catalyst for convening the necessary strategic alliance of investors, regulators, and the public. It's time to change the world—or at least this part of it.

Eric Nordman is the director of the NAIC's Center for Insurance Policy & Research. He is a long time member of IRES and currently serves on the board of directors.

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