NAIC Remarks

Introduction

First, I would like to thank Mr. Nordman and the NAIC for inviting me to contribute to the Future of Mortgage Finance white paper and participate on this panel.

Second, I would like to tell you one more detail about my background. I am one of the few individuals who publicly predicted our current financial crisis.

What lead to my prediction was the realization that the residential mortgage securitization industry was and still is a lemon.

Why is it a lemon? These deals provide no credible investor protections like transparency.

This lack of transparency became well known at the beginning of the current financial crisis when sub-prime mortgage backed securities acquired a first and middle name: opaque, toxic.

When markets are lemons and are known as tilted to protect the sell-side at the investors' expense, they die.

The residential mortgage-backed securities market fits this description as the sell-side has both an informational advantage and has imposed reps and warranties that are impossible for even the US government to enforce.

It is dying.

If the residential mortgage-backed securities market ranging from covered bonds to securitizations is going to be revived--

and I think it should be --it needs to redesign deals so they offer credible investor protections.

And this is where the NAIC and its membership come in and this is why I am here.

You see, you are the only ones representing the investors: in your case, insurers, their policyholders and the state insurance guarantee funds.

During the course of this conference, many of you have told me it is your goal to eliminate the possibility that the insurers will use balance sheet leverage to invest in or guarantee lemons like this again.

I am here today to tell you that achieving this goal requires you to take a simple action: link the amount of risk-based capital that insurers need to hold against any “new” residential mortgage backed security exposure to the security providing credible investor protections.

As several individuals suggested this can be done by making a change in the C-1 instructions.

The change might say, for all structured finance securities purchased after November 30, 2012, if the security provides credible investor protections, multiply by 1. If the security does not provide credible investor protections, multiply by 10 or some other number that you determine will make buying these securities economically unattractive.

Why US?

I know you are very busy and you are probably thinking that there must be someone else who can take this simple action.

After all, there are dozens of other regulators around the world with an interest in structured finance securities that should be pushing for credible investor protections.

You, and you alone, need to take this simple action because all of the other regulators will not do it for you. Your clients, the insurers, the policyholders and the taxpayers are simply not the clients of these other regulators.

I have talked with regulators all over the world. These conversations can be summarized by two observations.

First, while these regulators talk a good game, they have shown in the years leading up to the financial crisis and in the 5 years since that they are not going to protect your clients.

For example, the International Organization of Securities Commissions (think the SEC) recently publicly called for forcing banks to disclose all the relevant documents and data on the underlying collateral so that investors could independently assess the creditworthiness of each structured finance product.

This rhetoric stands in stark contrast to the actions taken by its members to date.

The SEC's latest proposed revision of the structured finance disclosure regulations falls well short of this rhetoric as it does not require disclosure of all relevant documents and data on the underlying collateral.

The second and equally important observation is that all of these regulators will support any rules you put in place and will incorporate these rules into their activities.

They understand that you are the only regulators with both the incentive and the ability to force changes that will credibly protect your clients.

They understand that you have an incentive to make sure that insurers don't buy or guarantee lemons again.

They also understand that insurers are an investor group that cannot be replaced. Insurers buy directly for their own portfolio or indirectly for portfolios they manage a significant percentage of structured finance securities.

As a result, you have a lot of leverage to force credible investor protections.

Your simple action of linking capital to credible investor protections achieves what the International Organization of Securities Commissions says it would like to see accomplished and they would embrace it.

Transparency is first credible investor protection
The first credible investor protection is to require disclosure so that insurers can independently assess the creditworthiness of the underlying collateral for each structured finance product.

Let me show you how this simple protection would turn lemon mortgage-backed securities into lemonade.

Recently, the sell-side announced that its Prime Collateralised Securities initiative is going live in the eurozone. This initiative is the sell-side's effort to demonstrate that they are willing to embrace transparency.

More importantly it is the sell-side's effort to spare these lemon securities from the restrictions of Basel III and Solvency II.

The idea behind PCS is to put a label on a structured finance security to indicate that these securities meet standards for transparency, reporting quality and market best practices.

Of course, this begs the question of do these standards for transparency, reporting quality and market best practices actually provide credible investor protections.

By itself, a label does absolutely nothing to provide credible protections for investors. Even worse, a PCS label is deliberately misleading if the standards behind it do not provide credible protections for investors.

Given their history of creating lemon securities, championing misleading labels is what one would expect from a sell-side led initiative.

So the question is, are PCS labels as currently proposed misleading.

To find out, let's look at transparency. Transparency has two components: what is disclosed and when it is disclosed. I would like to focus on "when" it is disclosed.

Everyone knows that structured finance securities involve taking specific assets, like mortgages, and setting them aside for the benefit of the investor. The physical equivalent of this would be to put them into a bag.

Once the mortgages are in the bag, it is important to know what is in the bag currently. Why?

If an investor does not know what is in the bag currently, and this is true whether the bag has a PCS label on it or not, they cannot take the first step in the investment cycle.

The first step is to independently assess the risk and value the underlying collateral so the investor can know what the investor is buying and, after buying, know what they own.

The second step is to compare this independent assessment to the prices shown by Wall Street.

The third and final step is to make a buy, hold or sell decision based on the difference between the investor's independent valuation of the security and the price shown by Wall Street.

Please note that without the ability to know what is in the bag currently, it is impossible to accurately assess what is going to come out of the bag eventually.

The lack of knowing what is in the bag currently prevents investors from performing their own independent assessment and makes meaningless hiring an expert third party to do the assessment for them.

Simply put, without current information of what is in the bag, investors cannot go through the investment cycle.

Buying securities in the absence of an independent assessment is not investing.

Buying securities that cannot be independently assessed is the equivalent of blindly betting on the contents of a brown paper bag. And, once the securities are purchased, the investor has no ability to know what they own.

In case you doubt this, I invite you to take the Brown Paper Bag Challenge. A challenge which gives me the same informational advantage enjoyed by Wall Street through its ownership of the servicers of the underlying collateral.

On the other hand, if we were talking about a clear plastic bag, the investor would know what is in the bag currently.

As a result, they could independently assess the risk and value the collateral. With this assessment, the investor “knows what they are buying” and "knows what they own".

With this assessment, the investor can make an investment decision to buy, hold or sell based on the prices being shown by Wall Street.

So turning the mortgage market from lemons to lemonade simply requires recognizing that it is a choice between “Paper or Plastic”. With “Paper”, you get lemons. With “Plastic”, you get lemonade.

So how can each of the structured finance securities be put into the equivalent of a clear plastic bag?

This can be easily done as the servicer information systems are designed to track and report on the underlying collateral on an observable event basis.

With observable event based disclosure where all activities like a payment or delinquency involving the underlying collateral are reported before the beginning of the next business day, the investor knows what is in the bag currently.

Observable event based disclosure is associated with a clear plastic bag. All other frequencies of disclosure are associated with a brown paper bag and lemons.

Earlier, I observed that the sell-side PCS initiative was misleading. What makes it misleading is that structured finance securities that have once-per-month disclosure qualify for a label.

This label would suggest that blindly betting on the contents of a brown paper bag is an adequate investor protection.

Clearly blindly betting is not an adequate investor protection.

Your simple action of requiring credible investor protections like observable event based reporting results in insurers only buying structured finance securities where they can know what they are buying and subsequently know what they own.

Call to Action

Currently, you are the only ones who can decide that insurers should only invest in structured finance securities that provide credible investor protections.

However, this window where you alone can decide is closing fast.

First, we have the Federal Housing Finance Agency (FHFA) creating an information platform to support mortgage financing.

This information platform will track hundreds of data fields related to the performance of millions of mortgages.

They are in the process of conducting a public consultation in which they are asking for feedback on the capabilities of this information platform.

Naturally, you would like the information platform to support observable event based reporting rather than leaving the insurers to blindly bet on the contents of a brown paper bag.

In addition, any day now, the US Treasury, which does not have the function of requiring credible investor protections, is going to come out with its proposal for the future of mortgage finance.

By acting before Treasury releases its proposal, credible investor protections are incorporated into the proposal, rather than potentially being at odds with the proposal.

By acting first, if Treasury were to exclude credible investor protections, Treasury would have to explain why blindly betting on the contents of brown paper bags is superior to investing in the contents of clear plastic bags where the insurers know what they are buying and own.

Acting first also allows you to be seen as part of the solution and not an impediment to resolving the US mortgage finance mess.

What needs to be done
Finally, ending the lemons market does not require that you sit down and negotiate with the sell-side. It is highly unlikely to be willing to give up its informational advantages.

Nor does it require that you figure out what data fields need to be disclosed.

Your goal is to make sure that structured finance securities ranging from covered bonds to securitizations have credible investor protections so insurers aren't tempted to buy lemons again.

One of these credible investor protections is observable event based reporting.

Ending the lemons market does not require that you sit down and negotiate with the insurance companies.

After all, we all know the answer to the question of what you should call a portfolio manager who supports blindly betting with the insurers' money? Unemployed.

You can achieve your goal through the use of capital requirements and the instructions to the C-1.

You can reward existing and future structured finance securities that provide credible investor protections including observable event based reporting with significantly lower risk-based capital requirements.

You can penalize existing and future structured finance securities that don't provide credible investor protections including observable event based reporting with significantly higher risk-based capital requirements.

Based on my conversations during this conference, I know it is possible before the conference ends to put in place the process and announce the intent to change the instructions to the C-1 so risk based capital requirements bring credible investor protections and observable event based reporting to all "new" structured finance securities.

Given how important it is to stop insurers from making additional blind bets, I hope that you will take a couple of minutes out of your busy schedule to do this.

I look forward to answering any questions you may have.