



National Association of
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POLICY
and RESEARCH

CIPR STUDY

Private-Label Securitization Market Challenges and the Implications for Insurers and Insurance Regulation

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Prologue

This Center for Insurance Policy and Research (CIPR) study presents independent research the purpose of which is to inform and disseminate ideas to regulators, consumers, academics and financial services professionals. CIPR studies are available at no cost on the CIPR website:

http://www.naic.org/cipr_special_reports.htm.

This study would not have been possible without the valuable contributions by members of the CIPR, the NAIC Structured Securities Group (SSG) and the invited authors noted for their expertise in mortgage securitization. All the contributors are listed on page ii.

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Foreword

By Dimitris Karapiperis, Research Analyst, NAIC Center for Insurance Policy and Research and Eric Kolchinsky, Director, NAIC Structured Securities Group

The primary purpose of this study, a follow-up to the 2012 Center for Insurance Policy and Research (CIPR) study,¹ is to discuss the challenges still facing mortgage securitization. Specifically, this study focuses on the private-label/non-agency² residential mortgage-backed securities (RMBS) market to detail U.S. insurers' continuing investment participation in that market and to present how state insurance regulators, through the National Association of Insurance Commissioners (NAIC), analyze and evaluate insurance companies' investments.

The 2012 study explored the history of mortgage securitization and home ownership, traced the shift from agency to private-label securitization describing the characteristics and dynamics of the market, and discussed its central role in the eruption of the global financial crisis. This earlier study also detailed insurers' exposure to mortgage securitization and presented how state insurance regulators responded to the crisis by developing a new method for a more precise assessment of the value of the private-label RMBS and determination of the appropriate NAIC designation for reserving purposes. A key feature was the inclusion of articles by five select authors who offered their views on the problems and challenges of residential mortgage securitization.³ The authors also provide a glimpse into the future of residential mortgage securitization.

With the knowledge of what has transpired in the last four years, this study brings together seasoned mortgage securitization professionals and NAIC experts to provide an update on the continuing efforts to reinvigorate the private-label securitization market and examine the persistent challenges in addressing the structural deficiencies that have severely eroded the trust of all market participants.

As it was well-documented in the 2012 study, private-label securitization before the global financial crisis was one of the main propelling forces for the housing finance market helping to generate the lending capital required to support and expand homeownership.⁴ The bursting of the housing bubble, which was partly fueled by poorly underwritten subprime mortgages,

¹ Dimitris Karapiperis, 2012. "Financing Home Ownership: Origins and Evolution of Mortgage Securitization, Public Policy, Financial Innovations and Crises" National Association of Insurance Commissioners (NAIC) Center for Insurance Policy and Research (CIPR), August 2012,

www.naic.org/documents/cipr_120812_white_paper_financing_home_ownership.pdf.

² "Private-label" and "non-agency" are interchangeable terms to denote mortgage-backed securities issued by private institutions such as commercial banks, savings and loans institutions, and mortgage bankers and not guaranteed by governmental or quasi-governmental agencies such as Ginnie Mae, Fannie Mae and Freddie Mac.

³ Ibid.

⁴ Ibid.

exposed a number of weaknesses and deficiencies in the underwriting and packaging of private-label RMBS. The rising defaults and loss of value of RMBS erased investors' confidence in these securities and their credit ratings. Nearly eight years after the crisis, the new issuance of private-label RMBS remains at practically nonexistent levels.

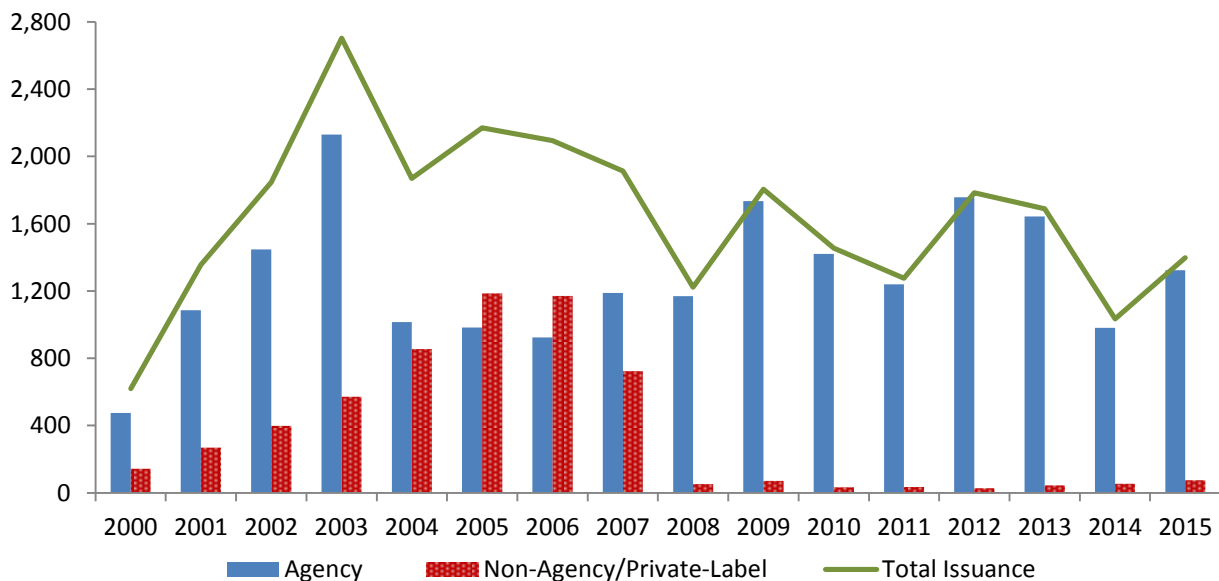
The existing environment of persistent low interest rates and solid job growth has supported the gradual improvement of the housing market and has contributed to a steady supply of new mortgage issuance. However, with the housing market being far from fully recovered to pre-crisis levels and mortgage volume coming primarily from new purchases, total mortgage-related security issuance is still well below peak levels (Figure 1.)

Furthermore, with the memory of the massive losses experienced by subprime non-agency RMBS still fresh in the minds of most investors, the vast majority of post-crisis securitizations are underwritten and backed by the government-owned agency Ginnie Mae and the two government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. The relative stabilization of the overall mortgage market following the financial crisis has extended only to agency RMBS, with private-label securitizations still at historic lows (Figure 1.)

Private-label RMBS issuance all but disappeared after 2007 compared with being a substantial portion of new issuance in the 2001–2007 period. In 2006, private-label RMBS was more than 56% of the total new issuance of \$1.17 trillion. By 2008, private-label securitizations had shrunk to \$52.6 billion or a mere 4.3% of new issuance. At the end of 2015, private-label RMBS issuance had managed to record only a marginal increase to a still very modest \$75.9 billion, or just 5.4% of all new issuance in 2015 (Figure 1.)

Figure 1: Residential Mortgage-Backed Securities Issuance (\$ Billions)

Source: SIFMA



During the nadir of the financial crisis, the NAIC made a crucial and courageous decision to forego using nationally recognized statistical rating organization (NRSRO)⁵ credit ratings to set capital requirements on RMBS. Since then, the NAIC has provided RMBS analysis for seven annual reporting periods. The process begins every year in August with the setting of the macroeconomic scenarios and concludes with a two-phase delivery of results: mid-December and mid-January. The analytical burden has remained roughly the same; for year-end 2015, the NAIC Structured Securities Group (SSG) analyzed roughly 22,000 CUSIP⁶ numbers evidencing \$124.6 billion of par value of securities.

One of the biggest changes for the 2015 reporting year has been the change of a vendor from Pacific Investment Management Company (PIMCO) to BlackRock Solutions. Consistent with its business practices, the NAIC periodically submits third-party contracts to competitive rebidding. In February 2015, the NAIC issued request for proposal (RFP) 1758 (commercial mortgage-backed securities—CMBS) and 1759 (RMBS) seeking firms to model expected losses of securities owned by U.S.-domiciled insurance companies. After a multiphase, in-depth selection process, the NAIC selected BlackRock Solutions as the vendor for both RMBS and CMBS. The BlackRock Solutions inaugural year-end process was in 2015.

This study helps serve a dual purpose regarding the work of the SSG: 1) describe the philosophical and operational process the SSG follows to analyze RMBS; and 2) describe how this process has changed over the years.

The following sections of the study detail the analytic landscape for RMBS, the current state of the private-label market, its many challenges and its future prospects:

- Eric Kolchinsky of the NAIC/SSG provides an overview of the NAIC analytical process.
- Hankook Lee of the NAIC/SSG details some of the changes in the RMBS market the SSG has seen and discusses the use of credit risk transfer transactions by the GSEs to sell a certain amount of mortgage credit risk to private investors.
- Azar Abramov of the NAIC/SSG presents insurer private-label RMBS holdings and describes the results of the NAIC analysis.
- Dimitris Karapiperis of the NAIC/CIPR provides a brief account of the RMBS 3.0 initiative and presents the progress made in reviving private-label securitization.

⁵ A nationally recognized statistical rating organization (NRSRO) is a credit rating agency recognized by the U.S. Securities and Exchange Commission (SEC) allowing other financial firms to use their credit ratings for regulatory purposes.

⁶ CUSIP stands for Committee on Uniform Securities Identification Procedures. Formed in 1962, this committee developed a system (implemented in 1967) that identifies securities, specifically U.S. and Canadian registered stocks, and U.S. government, municipal and corporate bonds.

Forward

- Chris Katopis of American Mortgage Investors discusses the current state of the private-label RMBS market and presents the investors' views and concerns.
- Mark Adelson of *The Journal of Structured Finance* explores the need to strengthen investor protection and discusses legal actions brought by investors against private-label RMBS issuers and underwriters in an attempt to recover some of their losses.
- Richard Field of the Institute for Financial Transparency discusses the paramount need for transparency in the private-label securitization market and presents his innovative idea of a transparency label to provide sufficient disclosure.

Overview of the NAIC Analytical Process

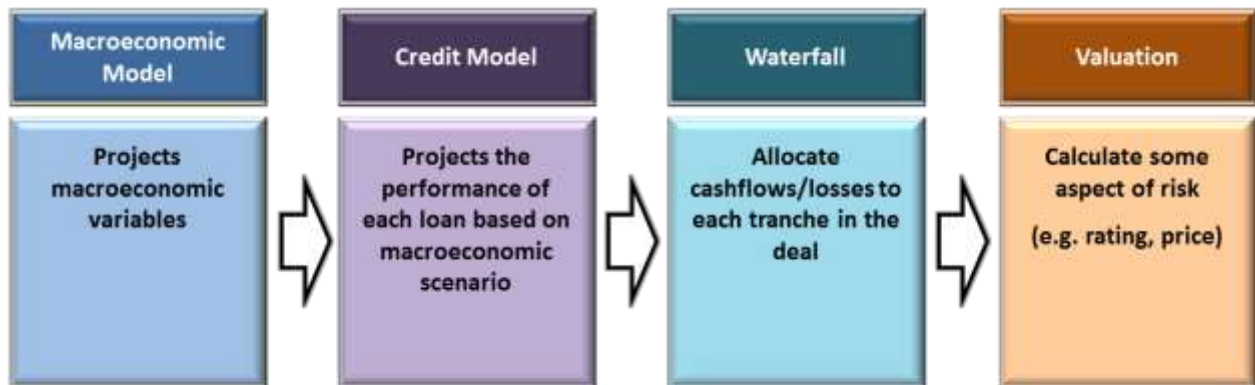
By Eric Kolchinsky, Director, NAIC Structured Securities Group

Introduction

Insurer-owned private-label residential mortgage-backed securities (RMBS), once largely eligible for filing exempt (FE) status⁷ relying on ratings assigned by NAIC-approved credit rating providers (CRPs),⁸ are no longer FE as a result of the mass downgrades during the global financial crisis and the loss of market confidence on CRPs' credit ratings. The need for a massive ratings correction and, therefore, an alternative approach ending the reliance on credit ratings led to the decision to develop a new valuation methodology to allow for a more robust and regulator-focused assessment of the credit of private-label RMBS in insurer portfolios. The new National Association of Insurance Commissioners (NAIC) methodology called for the financial modeling of each insurer-owned security, starting with filing year 2009 and continued each year since. The results of financial modeling provide the basis for price grids, which are used to determine the NAIC designations for private-label RMBS used to calculate insurers' capital requirements.

The financial modeling process is based on the selected vendor's proprietary financial model providing the basis for the following analytical steps. The NAIC Structured Securities Group (SSG) considers this process as flowing through four analytical tasks: 1) macro-economic model; 2) loan credit model; 3) waterfall; and 4) valuation (Figure 2.)

Figure 2: The Analytical Tasks of the Financial Modeling Process



⁷ Filing exemption (FE) is a rule adopted by the NAIC in 2004 granting an exemption from filing with the NAIC Securities Valuation Office (SVO) for bonds and preferred stock that have been assigned a current, monitored rating by an approved nationally recognized statistical rating organization (NRSRO).

⁸ Credit rating providers are NRSROs, recognized by the U.S. Securities and Exchange Commission (SEC) and whose credit ratings are approved by the NAIC for regulatory use.

Macroeconomic Model—*What do we think will happen in the future?*

Description

At the initial stage, the NAIC SSG wants to determine what sort of economic scenario it foresees. There are a number of decisions to make—the number of scenarios to be run and their relationship with current conditions.

The decision regarding the number of scenarios is a trade-off between capturing as much probability space as possible versus being able to create relevant scenarios and computability. For example, running 10,000 Monte Carlo simulations would not be computationally feasible when applied to hundreds of thousands of loans nor represent an economically accurate description of future states of the world. On the other hand, a single scenario would miss the leverage build into structured securities.

The other decision involves cyclicity. Will the scenarios be pro-, counter- or acyclical? For example, most nationally recognized statistical rating organizations (NRSROs) subscribe to the “through the cycle” acyclical approach. However, the NAIC SSG believes this is a policy decision best left for the relevant financial regulators.

NAIC SSG Process

Currently, the NAIC SSG uses four probability weighted scenarios (Table 1.) The Baseline scenario is generated each year by a third-party economic forecaster, while the Optimistic, Conservative and Most Conservative scenarios are generated by the SSG and Blackrock Solutions off the Baseline. Because the Baseline scenario is the forecasters’ best opinion of future events, the SSG process is currently pro-cyclical.

Table 1: Probability Macroeconomic Scenarios

Source: NAIC SSG

RMBS Scenario	Probability	Current to Trough	Time of Trough	3-Year HPA Growth	5-Year HPA Growth
2015 Scenarios and Forecasts					
Optimistic	10%	N/A	N/A	24%	43%
Baseline	50%	N/A	N/A	11%	18%
Conservative	25%	-8%	Q1 2019	-6%	-8%
Most Conservative	15%	-43%	Q1 2027	-15%	-23%
2014 Scenarios and Forecasts					
Optimistic	10%	N/A	N/A	25%	42%
Baseline	50%	N/A	N/A	11%	17%
Conservative	25%	-10%	Q4 2025	-1%	-4%
Most Conservative	15%	-44%	Q4 2026	-11%	-20%

Changes

Because the economic forecast is pro-cyclical, technically the actual scenarios change every year. However, the mechanical process of generating the scenarios has stayed fairly constant. Major changes included moving from five scenarios to four in 2010 and adopting a slightly negative bias (in terms of probability weights of various scenarios) in 2011.

In 2016, the Valuation of Securities (E) Task Force considered changing the process for setting annual macroeconomic scenarios. Specifically, the SSG proposed a study to create a more consistent year-to-year macroeconomic framework. The framework will need to meet the following criteria:

- Be based on historical and publically available data: e.g. Case-Shiller for RMBS.
- The model must be able to generate several forecast “paths” which can statistically represent various percentiles (e.g. 5th, 50th, 75th and 95th).
- Qualitatively, we would expect extreme scenarios to approximately mimic historical extremes (e.g. the RMBS Most Conservative scenarios should approximate the recent financial crisis).
- Be “memoryless” (i.e. possess the Markov property). This is the key criterion which ensures consistency and acyclicity.
- The resulting paths / scenarios would be converted into periodic percentage changes to be applied annually to then current value (e.g. HPI).

Such an approach would be similar to “through-the-cycle” methodologies used by credit rating agencies. As of August 2016, no decision has been made to move forward with the change.

Loan Credit Model—*What will happen to the loans in the pool in the future?*

Description

The Loan Credit Model (LCM) takes the macroeconomic scenarios as well as loan characteristics as inputs and determines the performance of a loan in the given economic environment. The LCM is the most critical part of the process. While the form of the LCM varies from vendor to vendor, they may be deterministic or stochastic, and vary in the number of parameters which are used. They are also typically updated every four to five years based on prior experience, data availability and computation power.

NAIC SSG Process

At its core, the LCM is what the NAIC outsources to BlackRock Solutions. As a result, the focus of the SSG quality assurance process centers on the outputs of the model. The NAIC SSG

Overview of the NAIC Analytical Process

focuses on reviewing principal and interest payments and losses for the portfolios backing the RMBS. A number of statistical queries are run, as well as deep-down dives into selected securities.

Changes

The greatest change in the year-end process has been the switch of vendors from Pacific Investment Management Company (PIMCO) to BlackRock Solutions. Because the LCM is unique to each vendor, a switch could have meant a change in portfolio outcomes. A great deal of time was spent by the selection team in order to measure the potential impact.

Waterfall – What will happen to our securities in the future?

Description

In the context of structured finance, the waterfall refers to each transaction's priority of payments. These rules meticulously describe how much each investor is paid and when. They also describe how losses on the pool are allocated to each tranche. The output is a series of time-series vectors for each tranche evidencing principal payments, interest payments and losses.

A number of third-party software vendors supply the market with programs which already have converted the legal language into computer code. For all intents and purposes, all financial participants outsource this aspect of the analysis to third-party software vendors.

NAIC SSG Process

Both vendors use the same market-leading software to model the waterfall.

Changes

There have been no changes in the modeling software due to the move from PIMCO to BlackRock Solutions. However, the NAIC SSG has acquired an independent capability to model waterfalls—on existing or new transactions. The NAIC SSG has taken advantage of this capability to model several pre-closing transactions which it was asked to model through the NAIC Regulatory Treatment Analysis Service (RTAS).

Valuation – *How do we measure the performance?*

Description

The last step of the process appears deceptively simple. While the cash flows produced by the waterfall model completely describe the performance of a given tranche (in a given scenario), they are rarely useful in their raw form.

The valuation step seeks to distill the cash flows into one (or, rarely, more) useful statistic(s). A number of crucial decisions need to be made: 1) which cash flows are used (principal, principal and interest); 2) is a discount rate applied and what the discount rate is; and 3) what the losses are compared to (par or carrying value). Finally, how is this result communicated—in its raw form or mapped to a rating/designation? These choices could produce wildly varying results from the same set of waterfall results.

NAIC SSG Process

The result step is wholly within the NAIC control, and the process was set by regulators in 2009 and 2010. A price is calculated as 1 less the discounted principal losses at the effective coupon rate for each macro-economic scenario. The four prices are probability weighted to derive the final intrinsic price. The resulting number (bounded by 0 and 100) is then mechanically mapped to five “breakpoints,” which are then used by individual insurers to determine individual positions. The latter process is dictated by the NAIC’s *SSAP No. 43R—Loan-Backed and Structured Securities* sections 24-6.

Changes

There have been no changes in the result for ordinary RMBS since 2009.

However, beginning with 2014, the NAIC SSG was empowered by the Valuation of Securities (E) Task Force to analyze credit risk transfer (CRT) securities issued by Fannie Mae and Freddie Mac. As described more fully in the following section by Hankook Lee (p. 11), CRTs are securities which do not meet the requirements of SSAP 43R. Instead, *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities* requires insurers to use designations directly. In order to fulfil our obligations, the NAIC SSG modified the valuation step for these securities. An intrinsic price is derived as before, but is mapped directly to a designation.⁹

⁹ See www.naic.org/documents/svo_guidelines_filing_designation_assignment.pdf.

NAIC Analytical Process Conclusion

It has been said with regards to real estate, economic cycles last about eight years, but memories last only five. As we have now reached beyond the eight years of the economic cycle and memories clearly have not improved, the NAIC SSG stands ready with an independent capacity to analyze complex private-label RMBS securities.

Post-Crisis Housing Finance and Related Securities Market

By Hankook Lee, Senior Structured Securities Analyst, NAIC Structured Securities Group

Introduction

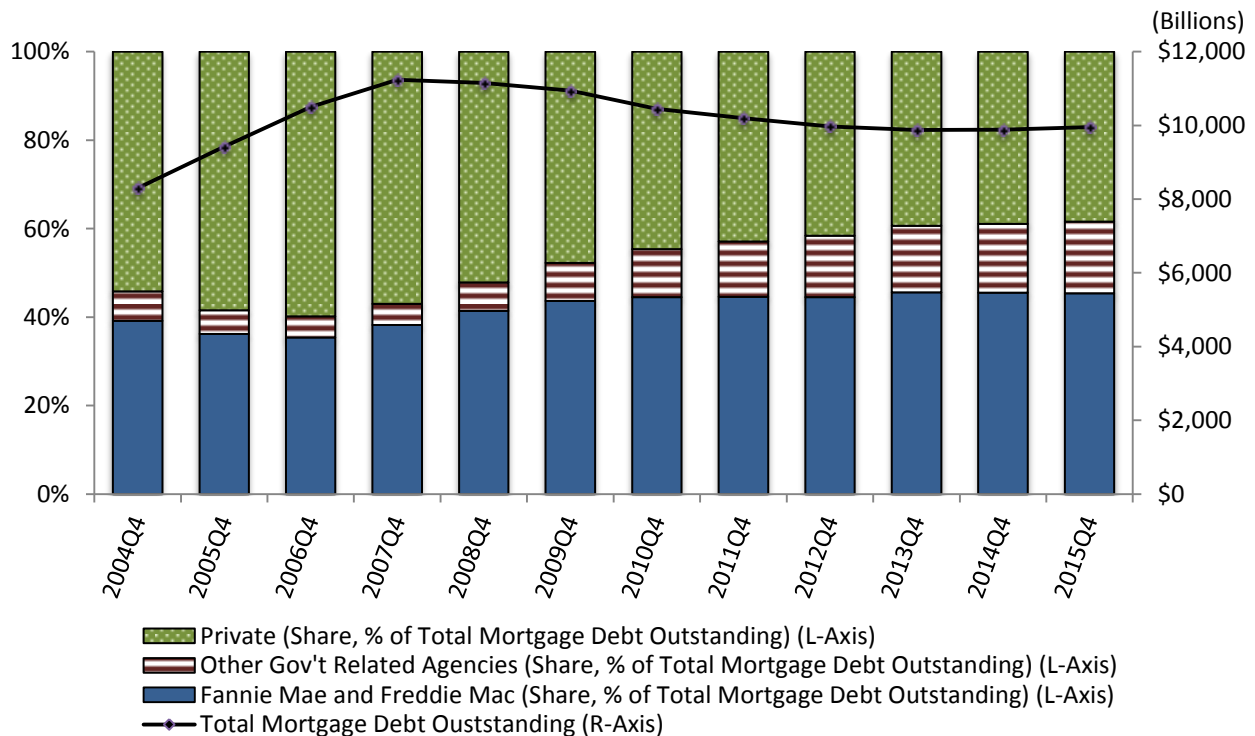
The collapse of the private-label residential mortgage-backed securities (RMBS) market has resized and reshaped the U.S. housing finance market, as well as the overall mortgage-related securities market. Since the onset of the global financial crisis, the federal and related agencies have stepped up their activities in housing finance amid a scarcity of private capital.

Breakdown of Residential Mortgage Market

At the end of 2015, the federal and related agencies accounted for 62% of nearly \$10 trillion mortgage debt outstanding (for one- to four-family houses), up from 40% at the end of 2006. Over the same period, the combined share of Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), two government-sponsored enterprises (GSEs) currently under the conservatorship of the Federal Housing Finance Agency (FHFA), also climbed 10 percentage points from 35% to 45%. Figure 3 shows the trends of total mortgage debt outstanding and the market share by type of holder.

Figure 3: Total Residential Mortgage Debt Outstanding and Market Share by Type of Holder

Source: Federal Reserve Bank of St. Louis



The role of the federal and related agencies in the residential mortgage securitization market has also been more prominent than ever. Fannie Mae and Freddie Mac, together with the Government National Mortgage Association (Ginnie Mae), have been responsible for the unprecedentedly high share of RMBS issuance volume since 2008 as the market for non-agency RMBS dried up, remaining practically dormant to this day. Table 2 shows the increased combined share of Fannie Mae, Freddie Mac and Ginnie Mae in the annual RMBS issuance volume.

Table 2: Composition of Mortgage-Backed Security Issuance by Issuer Type

Source: Freddie Mac and Inside Mortgage Finance

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Fannie Mae, Freddie Mac & Ginnie Mae	44%	62%	95%	97%	96%	98%	99%	98%	96%	96%
Private-Label Securities	56%	38%	5%	3%	4%	2%	1%	2%	4%	4%

Credit Risk Transfer of Fannie Mae and Freddie Mac

During the ongoing dominance of the GSEs in the housing finance markets, the FHFA—through the Conservatorship Scorecards¹⁰—has encouraged Fannie Mae and Freddie Mac to embrace the strategic single-family credit risk transfer programs. While remaining supportive of the stability in the housing finance markets, Fannie Mae and Freddie Mac have increased their overall risks, which can be potentially transferred to the taxpayers.

To address such concerns, the two GSEs have developed and used several credit risk transfer products to share a portion of the associated credit risk with private capital. Among them, the type of structured debt known as Fannie Mae’s Connecticut Avenue Securities (CAS) and Freddie Mac’s Structured Agency Credit Risk (STACR) has been the principal form of credit risk transfer by the two GSEs to date. The other main forms of credit risk transfer that have been used include the pool-level insurance/reinsurance transactions¹¹ known as Fannie Mae’s Credit Insurance Risk Transfer (CIRT) and Freddie Mac’s Agency Credit Insurance Structure (ACIS) and

¹⁰ Annual Scorecards have been used by the Federal Housing Finance Agency (FHFA) to outline specific priorities for Fannie Mae and Freddie Mac while in conservatorship.

¹¹ Pool level insurance coverages are acquired and paid by the government-sponsored enterprises (GSEs) after the acquisitions of the mortgage loans.

the senior-subordinate securitization of whole loans¹² known as Freddie Mac’s Whole Loan Securities (WLS).

Currently, credit risk transfer has become a recurring operation of both the GSEs. The annual issuance volume, measured by unpaid principal balance (UPB) of mortgages associated with these risk transfer programs, reached \$417.1 billion in 2015, of which \$311.2 billion UPB represented the reference mortgages for \$12.6 billion of issued structured debt notes of the GSEs. Table 3 provides the annual amount of credit risk transfer.

Table 3: Single-Family Credit Risk Transfer Transaction Issuance Volume (\$ Billions)

Source: FHFA

Year	Enterprise	Structured Debt Notes		Non-Debt CRT Forms		Total	
		UPB ^[1]	Note Size ^[2]	UPB ^[1]	RIF ^[3]	UPB	Note Size ^[2] or RIF ^[3]
2013	Fannie Mae	25.0	0.7	5.2	0.1	30.2	0.8
	Freddie Mac	41.9	1.1	2.9	0.1	44.8	1.2
	Total	66.9	1.8	8.1	0.2	75.0	2.0
2014	Fannie Mae	209.6	5.8	10.2	0.3	219.8	6.1
	Freddie Mac	105.6	4.9	20.5	0.7	126.1	5.6
	Total	315.2	10.8	30.7	1.0	345.8	11.8
2015	Fannie Mae	179.1	5.9	49.7	1.4	228.8	7.3
	Freddie Mac	132.0	6.7	56.3	2.9	188.3	9.5
	Total	311.2	12.6	106.0	4.3	417.1	16.8
Total 2013-2015	Fannie Mae	413.7	12.4	65.1	1.8	478.8	14.2
	Freddie Mac	279.5	12.7	79.7	3.6	359.2	16.3
	Total	693.2	25.1	144.8	5.4	837.9	30.6

^[1]Unpaid principal balance (UPB) of related mortgages

^[2]Issued amount of structured debt notes (CAS and STACR) to transfer losses on UPB

^[3]Risk-in-force (RIF), predominantly the amount of insurance/reinsurance coverage to transfer losses on UPB

Structured Debt Notes of Fannie Mae and Freddie Mac (Known as CAS and STACR)

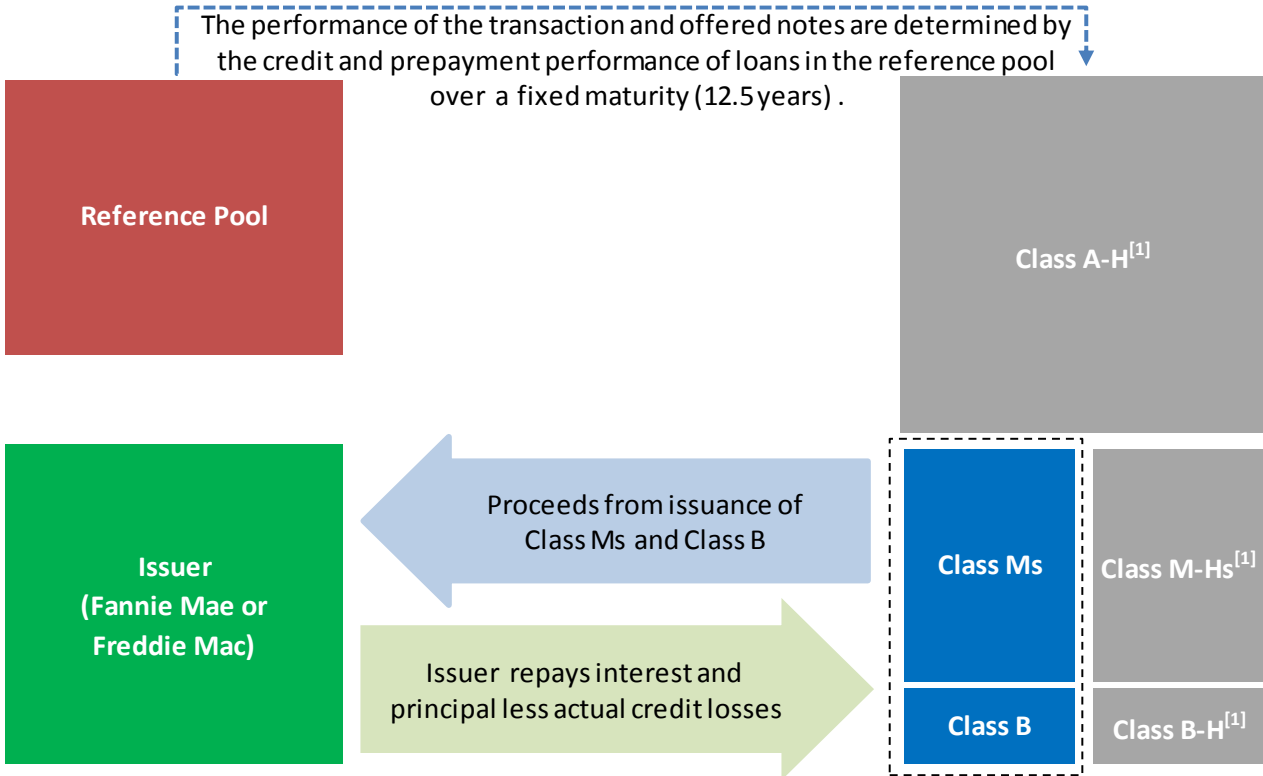
The structured debt securities, accounting for about 83% of the UPB with risk transferred by Fannie Mae and Freddie Mac to date, are structured as unsecured general obligations of the issuers. These notes are issued in synthetic transactions where the performance of the transactions is determined by the credit and prepayment performance of a corresponding

¹² Unlike the structured debt deals of the GSEs that are structured as synthetic credit transfers, Freddie Mac’s Whole Loan Securities (WLS) deals are created using a traditional securitization method. While the senior tranches are credit guaranteed by Freddie Mac, the subordinated tranches lack the GSE’s guarantee.

reference pool consisting of well-diversified residential mortgage loans owned or guaranteed by either Fannie Mae (for CAS transactions) or Freddie Mac (for STACR transactions). They carry fixed legal final maturities typically either 10 years (for transactions structured with fixed severity schedules) or 12.5 years (for transactions structured with actual loss) at issuance.

Since the first execution of this type of transaction in 2013, the market has seen three notable changes in the structured debt issuance. First, in addition to the loans satisfying the original loan-to-value (LTV) requirement of 60% to 80% (Lower LTV), mortgage loans with original LTV ratio greater than 80% (High LTV) were brought to the market. Second, in addition to the mezzanine class (known as Class M), the first loss pieces (known as Class B) structured without any credit enhancements have been offered to investors. Third, instead of risks estimated by fixed severity schedules, the latest structured debt transactions offload the risk of actual losses. Fannie Mae and Freddie Mac have expressed their intention to issue the CAS and STACR securities solely under the actual loss framework going forward. Figure 4 provides the hypothetical structure of the current structured debt issuance.

Figure 4: Hypothetical Structured Debt Transaction



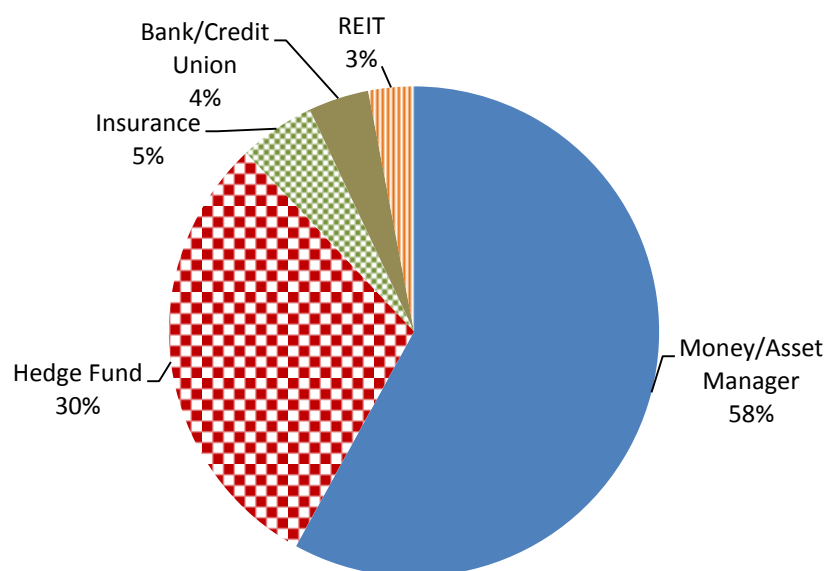
^[1] Reference tranches retained by the issuer

The securities offered in this form of credit risk transfer are referred to as mortgage referenced securities,¹³ a category of a structured note,¹⁴ for the purpose of insurance regulation and currently fall under *SSAP No. 26—Bonds, Excluding Loan-Backed and Structured Securities*, instead of *SSAP No. 43R—Loan-Backed and Structured Securities*. This statutory accounting treatment is based on the following characteristics of the GSEs’ structured debt: 1) the performance of the transaction and offered notes are determined by the credit and prepayment performance of mortgage loans in the reference pool; and 2) the interest and principal payments associated with the offered notes are unsecured general obligation of the issuer, either Fannie Mae (for CAS transactions) and Freddie Mac (for STACR transactions).

Along with many large money managers, the insurers have invested in the structured debt issued by the GSEs. Although the insurance industry has not been the primary investor, its holdings of CAS and STACR securities have grown to about 5% of the total issuance as of year-end 2015. Figure 5 shows the composition of CAS and STACR securities by types of investors.

**Figure 5: Share of Structured Debt by Type of Investor
(CAS and STACR Securities Purchased, 2013-2015)**

Source: FHFA



¹³ *The Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual)* summarizes the characteristics of Mortgage Referenced Security: “A mortgage Referenced Security’s coupon and/or principal payments are linked, in whole or in part, to prices of, or payment streams from, real estate, index or indices related to real estate, including, but not limited to, mortgage loans.”

¹⁴ For the definition of “structured note,” please refer to Part Three, Section 3 (b) (vi) of the P&P Manual.

Private-Label RMBS Market Environment

Despite the housing market recovery and the favorable credit quality of post-crisis mortgage loans—including relatively low LTVs, high borrower credit scores and full documentation—the revival of the private-label RMBS market has not taken place due to a number of market and regulatory impediments.

The persistently low level of market activity in the private-label RMBS market is at least in part attributable to a loss of investor confidence in this asset class and the lack of clarity in the evolving regulatory environment. Also, the unresolved common standards for RMBS securitization as discussed in more detail in the following sections have contributed to investors' skepticism. Moreover, the current origination economic and regulatory dynamics are seen as more favorable for portfolio loans (retained on lender's balance sheet) and agency mortgage-backed securities than private-label securitization.

Even eight years after the crisis, the market for securitization backed by new mortgage loans remains stagnant, solely driven by a limited amount of jumbo collateral. Despite the return of subprime securitization in 2014, the relevant issuance volume has been negligible. Bank of America Merrill Lynch estimated the 2015 total private-label issuance backed by new mortgage loans to be at around \$12 billion¹⁵ (year-to-date total issuance of about \$10 billion as of October 2015), a fraction of the \$1.2 trillion in 2005.

By contrast, two types of RMBS backed by seasoned mortgage loans have seen relatively constant issuance volume, responsible for much of the private-label RMBS issuance volume since the financial crisis. These types are resecritizations, also known as re-REMICs, and transactions backed by non-performing loans (NPL) and re-performing loans (RPL).

¹⁵ This figure excludes the issuance volumes of GSE's Credit Risk Transfer (CRT), Single Family Rental (SFR), and securitizations backed by seasoned residential mortgage loans such as re-REMICs and NPL/RPL.

Table 4: RMBS Annual Issuance by Asset Type, Excluding CRT and SFR (\$ Millions)

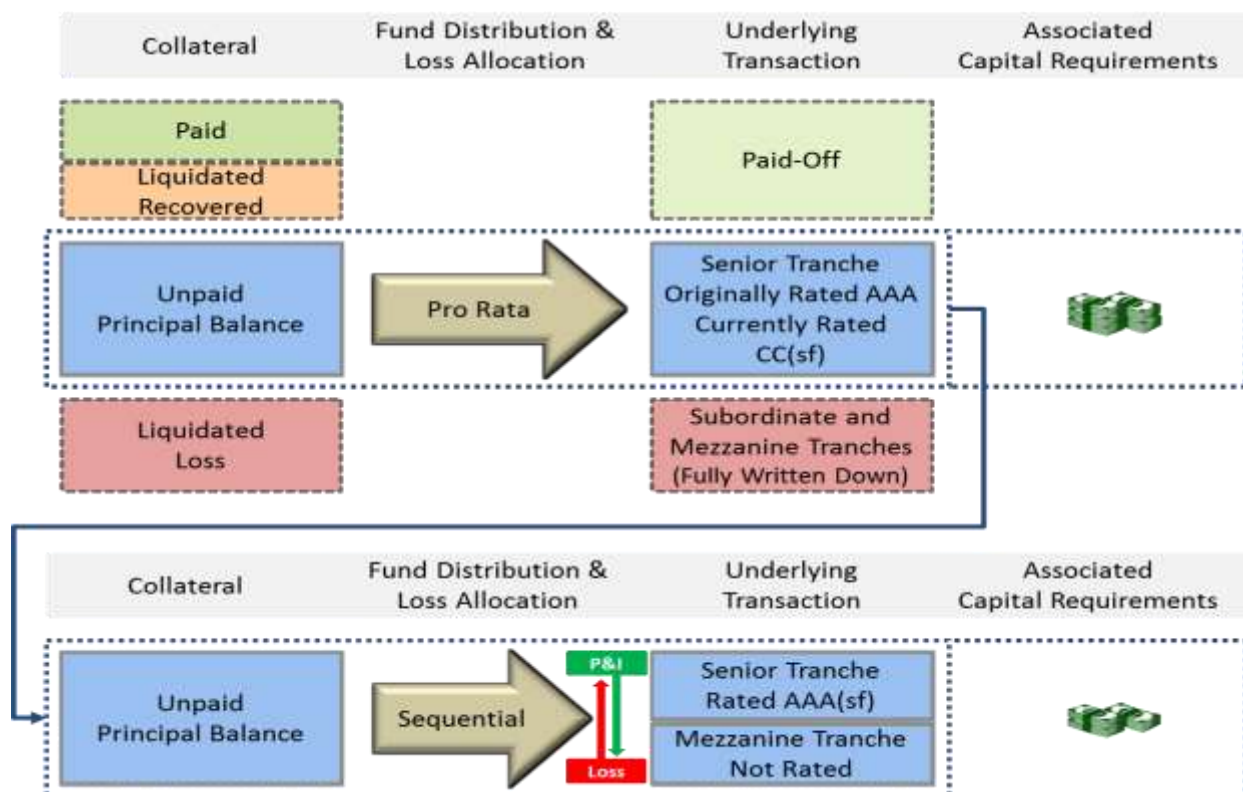
Source: BofAmerica Merrill Lynch Global Research, Intex, and Bloomberg

Date	Jumbo	Alt-A	Option ARM	Subprime	Re-REMIC	NPL/RPL
Oct. 2015	10,287	-	-	72	15,586	23,266
2014	8,792	-	-	10	15,107	23,387
2013	12,830	-	-	-	11,989	12,100
2012	3,469	-	-	-	14,164	4,634
2011	671	-	-	-	23,827	3,536
2010	273	-	-	-	60,238	4,303
2009	-	-	-	-	58,453	7,131
2008	14,941	9,433	371	4,421	14,656	397
2007	153,641	188,214	91,893	247,762	21,192	8,169
2006	145,756	279,290	157,514	534,389	20,203	12,862
2005	183,140	278,846	147,948	530,438	36,214	12,134
2004	195,602	164,702	40,187	427,155	9,684	22,430
2003	238,245	86,393	3,362	239,690	6,207	6,909
2002	178,665	46,584	4,624	184,006	7,746	1,710
2001	118,269	27,458	2,584	110,667	2,885	629
2000	46,597	12,336	7,336	72,944	1,669	493

Resecuritization (Re-REMIC)

Resecuritization of RMBS has been a significant source of post-crisis volume in the private-label RMBS market. Although the resecuritization of RMBS is not a new asset type recently brought to the market, it appears the motivation behind the resecuritization transactions has broadened. The traditional use of re-REMIC has primarily been to serve investors' specific cash-flow needs without any material impact on the credit risk aspect of the securities. However, the market has made use of post-crisis re-REMICs to address the massive rating downgrades of the pre-crisis-era private-label RMBS. As a significant number of RMBS with investment-grade credit ratings (often triple-A-rated) at issuance experienced dramatic credit deterioration and steep credit rating downgrades, many investment managers and regulated institutions have stayed away from these legacy RMBS. The resecuritization of such legacy RMBS is usually structured to enhance their appeal for investors with different levels of credit risk appetite. Figure 6 illustrates a hypothetical resecuritization transaction and how the credit risk shift is achieved through a re-REMIC transaction.

Figure 6: Hypothetical Resecuritization Transaction



This particular example takes in an underlying senior tranche—currently rated CC(sf)¹⁶—with completely exhausted subordination support and creates a senior tranche supported by a mezzanine tranche. The principal and interest payment distributions are sequential, starting first with the senior tranche of the re-REMIC transaction. The mezzanine tranche of re-REMIC transaction would not receive any principal payments until the senior tranche is fully paid off. The realized loss allocation is in the exact reverse order. The senior tranche would not take any realized losses until the mezzanine tranche is completely written off. The products of this hypothetical transaction are the triple-A-rated senior tranche and the unrated mezzanine tranche. The mezzanine tranche of the re-REMIC transaction, providing credit enhancements to the senior tranche of the re-REMIC transaction, allows the senior tranche holders to invest in the underlying pre-crisis private-label RMBS with a cushion to absorb a certain level of losses. This resecuritization results in a reduction in total capital requirements associated with the underlying security without any total credit risk reduction.

¹⁶ The credit rating scale of CC (or Ca) indicates highly speculative credit quality and generally implies highly probable default. The special symbol “sf” was first applied to structured finance ratings in 2010 to satisfy the requirements under the European regulation on credit rating agencies. The special symbol distinguishes structured finance ratings from the ratings of other types of instruments.

Despite the structural benefits described earlier, this retranchment of RMBS can expose the investors to additional risks such as transaction and legal structure. The legal structure and complex structural features of re-REMICs can potentially complicate the credit risk review scopes. For these reasons, it is crucial to ensure all relevant collateral, cash flows and loss allocations at both underlying transaction and re-REMIC levels are well identified and secured.

NPL and RPL Transactions

Another RMBS asset type which has contributed to the post-crisis volume growth is securitization backed by seasoned mortgage loans that are, when bundled to be securitized, either NPLs or RPLs as a result of modifications or self-curing from serious delinquency. These transactions are usually structured with substantial credit enhancement and primarily take a sequential-pay structure although often accompanied by other structural features. A rise in the issuance volume for RMBS backed by NPLs and/or RPLs was expected as the housing market bottomed out in 2012 following the severe housing downturn. The issuance volume, which had remained below \$5 billion in each of the preceding three years, picked up in 2013 to \$12.1 billion and subsequently increased further to \$23.4 billion in 2014. The first 10 months of 2015 saw a record level issuance volume totaled \$23.3 billion, nearly matching the full 2014 issuance volume.

The credit risk evaluation of these seasoned NPL and RPL pools requires additional considerations such as current, updated loan and borrower credit attributes and the assurance of executable asset liquidation. Provided NPLs are already in default or near default and RPLs have high default likelihood, the adage “garbage in, garbage out” applies more to the NPL and RPL transactions than for any other RMBS asset types. The credit quality of mortgage loans at origination becomes less relevant, and special attention should be given to updated risk attributes and their integrity, appropriate recording and documents, and regulatory compliance to enhance the predictability of the model. The third-party due-diligence largely serves a crucial role in verifying packaging of valid loans and accurate data associated with these types of seasoned loans.

NAIC Response to the Post-crisis RMBS Market Developments

As the housing market recovers and the performance of the pre-crisis RMBS stabilizes, the Structured Securities Group (SSG) of the NAIC has developed and implemented a framework to cope with various issues discovered in the pre-crisis-era mortgage securitization. In the aftermath of the collapse of the private-label RMBS market, the NAIC SSG highlighted the critical importance of data accuracy, appropriate collateral recording and compliance, and

adequate transaction and legal arrangement in the credit evaluation of RMBS.¹⁷ Effective in 2014, any insurer-owned RMBS issued on or after Jan. 1, 2013, must satisfy the initial information and ongoing information requirements to be eligible for the year-end modeling of the NAIC. While enhancing the overall accuracy and relevance of the NAIC RMBS analysis, the information, documentation and data meeting the utmost integrity requirements mitigate the aforementioned risks and concerns pertaining to the securities issued in resecuritization and NPL and RPL transactions.

The NAIC SSG has also established the analytical methodology and procedures in response to the emergence of the GSEs' credit risk transfer products. Its operational and analytical procedures were ready in time for the 2013 year-end statutory reporting of the inaugural CAS and STACR deals issued in 2013. The NAIC continues to closely monitor the performance and evolution of the Fannie Mae and Freddie Mac's structured debt transactions and other credit transfer programs.

¹⁷ The more comprehensive view of the NAIC on data integrity can be found in [CIPR Newsletter Vol. 10: Data Integrity in Financial Modeling](#).

Overview of Insurance Industry Holdings of Private-Label RMBS

By Azar Abramov, Structured Securities Analyst, NAIC Structured Securities Group

Introduction

The U.S. insurance industry has historically been and still is an important institutional investor in the residential mortgage-backed securities (RMBS) market. This section of the study focuses on insurers' holdings of modeled private-label RMBS. Additionally, it discusses the impact on National Association of Insurance Commissioners (NAIC) designations¹⁸ derived from financially modeled intrinsic prices (IP)¹⁹ instead of the previous methodology, which relied solely on the credit ratings published by NAIC-approved rating agencies.

The decision to end regulatory reliance on nationally recognized statistical rating organization (NRSRO)/credit rating provider (CRP) credit ratings followed the mass downgrades of RMBS at the height of the 2008 global financial crisis. These aggressive downgrading actions and other than temporary impairments greatly affected insurers' investment portfolios and their risk-based capital (RBC) charges, which were derived by NAIC designations directly mapped to CRP credit ratings.

The current methodology, in accordance with statutory accounting instructions provided in *SSAP No. 43R—Loan-Backed and Structured Securities*, financially models each RMBS transaction held by insurers to determine its intrinsic price, which drives the breakpoint carrying prices.²⁰ The estimated expected losses, discounted at the security yield, are used to calculate each security's IP. The IP is then applied to translate expected loss ranges into carrying price ranges for each NAIC designation. Insurers use these breakpoint carrying prices by reference to their book/adjusted carrying value (BACV) for that security to determine the appropriate designation and the corresponding RBC factor.

As it was noted earlier in the study, in 2015 a noteworthy change of modeling vendor from Pacific Investment Management Company (PIMCO) to BlackRock Solutions took place. This section of the study draws a comparison to the year-end 2014 IP under the previous vendor and the year-end 2015 modeled securities' IP from the new vendor.

¹⁸ Financial model-based designations and risk-based capital (RBC) calculations are estimated based on insurers' reported book/adjusted carrying value (BACV) matched against the breakpoint carrying prices, which results in a National Association of Insurance Commissioners (NAIC) designation. For further reference, see *SSAP No. 43R—Loan-Backed and Structured Securities*.

¹⁹ The modeled intrinsic price is defined as difference between remaining par value and expected principal losses, which are generally discounted at the coupon rate of the security.

²⁰ Breakpoint carrying price is the intrinsic price (IP) divided by 1 minus the expected loss for each NAIC designation.

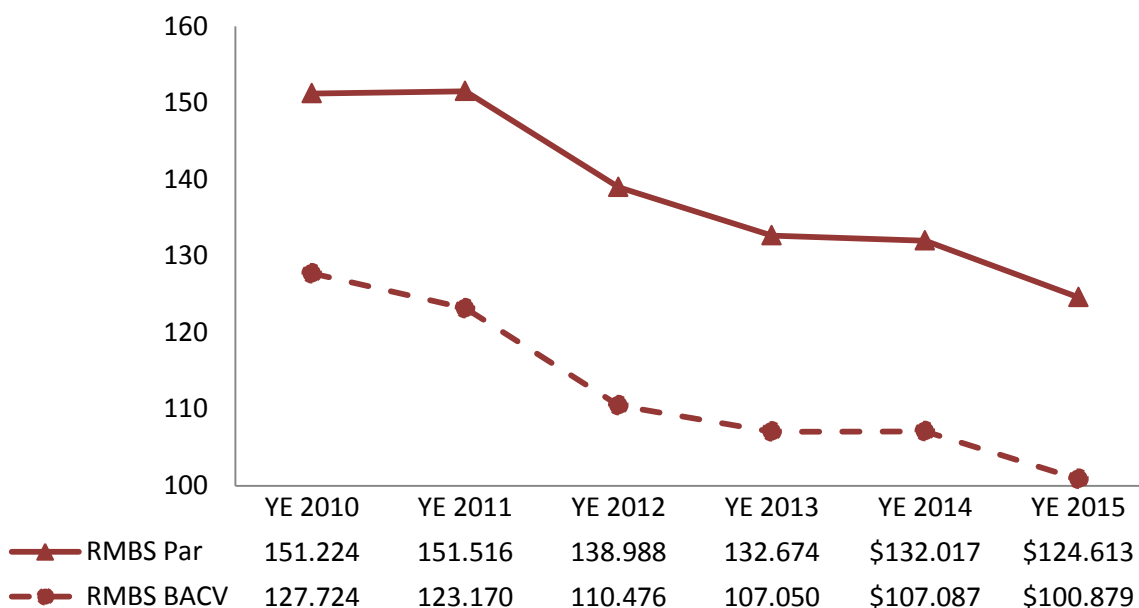
Insurer RMBS Investments

Insurance companies' holdings of non-agency RMBS have gradually declined since 2010. Repayments of existing loan balances, realized losses and extremely low new issuance have led to substantial declines in the outstanding balance of the U.S. private-label RMBS market.

The holdings of modeled private-label RMBS as of 2015 year-end were \$124.6 billion (par value), or 14.2% of total RMBS outstanding (Figure 7.) Additionally, the insurance industry held about \$253 billion of agency RMBS, representing 4.2% of outstanding agency market at year-end 2014. It is important to note agency RMBS are not modeled by the NAIC.

Figure 7: Par Value and BACV for Private-Label RMBS Holdings (\$ Billions)

Source: NAIC



Life insurance companies are collectively the largest industry holders of private-label RMBS, representing 82.03% of the total insurance industry private-label RMBS investments, followed by property and casualty (PC) insurers at 16.16% (Table 5.) Furthermore, the top five insurance company groups in terms of private-label RMBS holdings accounted for 52% of the aggregate industry RMBS investments.

Table 5: Year-End 2015 Insurer Private-Label RMBS Holdings by Industry Type

Source: NAIC

Industry	BACV (\$ Billions)	Industry %
Life	82.76	82.03%
P/C	16.30	16.16%
Fraternal	1.11	1.10%
Health	0.709	0.70%
Grand Total	100.88	100.00%

Zero loss bonds represented 38.72% of the total insurance industry private-label RMBS investments at year-end 2015, a marked improvement from 30.29% at year-end 2014 (Table 6.) These securities have no expected loss under any of the modeling scenarios and were, therefore, modeled at an IP of 100%, thus rendering them automatically equivalent to an NAIC 1 designation regardless of insurers' reported carrying values.

Furthermore, 61.28% of private-label securities were modeled with an expected loss at an average IP of 87%, which is also an improvement over year-end 2014 non-zero loss portion, which had an average IP of 86.45%. There were gradual improvements in the IP and zero loss portions over the past four years.

Table 6: Insurer Private-Label RMBS Holdings with Modeled Loss and Zero Loss Year-End 2015 Versus Year-End 2014

Source: NAIC

Loss	2015			2014		
	IP	BACV Price	% of RMBS BACV	IP	BACV Price	% of RMBS BACV
Non-Zero Loss	87.04%	74.32%	61.28%	86.45%	76.11%	69.71%
Zero Loss	100.00%	94.28%	38.72%	100.00%	95.59%	30.29%
Grand Total	91.35%	80.95%	100.00%	89.93%	81.12%	100.00%

The IPs of insurer-owned private-label RMBS have been on the rise since year-end 2012, while the BACV price²¹ has stabilized. Following the global financial crisis, insurers recognized impairments and newly acquired securities are trading at discounted prices to par, which led to lower BACV. The higher NAIC designations based on SSAP No. 43R are partially attributable to IP increasing at a faster pace than the BACV price, as depicted in Figure 8.

²¹ IP and BACV price are dollar-weighted averages based on insurers' actual holdings.

For year-end 2015, IPs increased to 91.35% from 89.93% in the previous year, while BACV prices did not record significant increases. As the gap between IPs and BACV prices widened, the estimated SSAP No. 43R designations improved. This trend is consistent with positive market dynamics and increases in the Home Price Index (HPI).

Figure 8: RMBS Intrinsic Price, BACV Price and Home Price Index²²

Source: NAIC

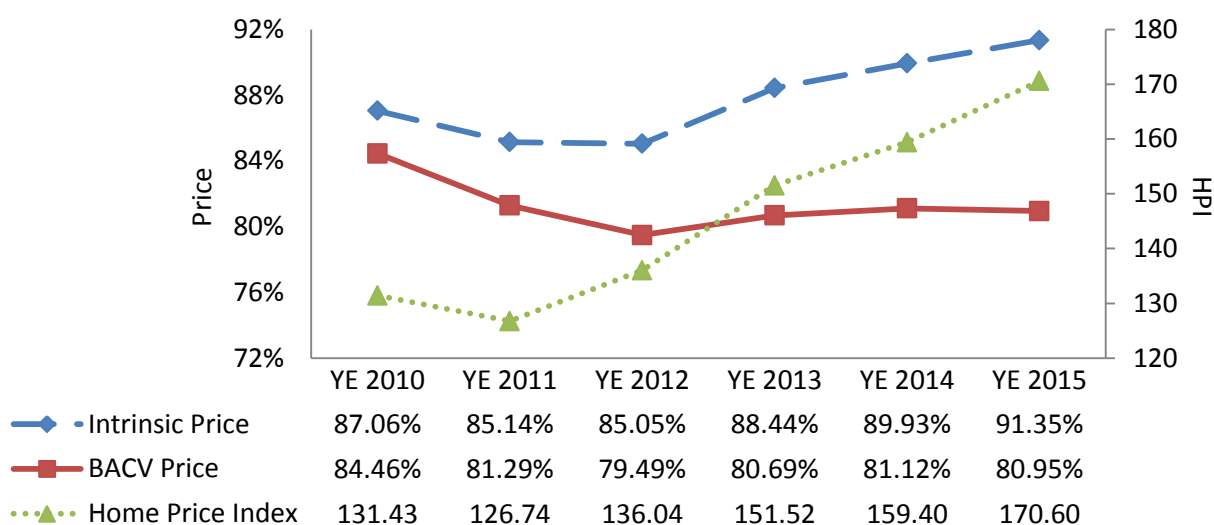


Table 7 shows 79.6% of modeled private-label RMBS experienced an upgrade based on SSAP No. 43R designations compared to CRP-equivalent designations. The upgraded portion has a favorably higher average IP of 90.42% versus insurers' more conservative average BACV price of 78.79%. Securities with no change in designations represented 20.3% and were mostly zero loss bonds. The downgraded securities represented a negligible amount. There was not much of a difference from the previous year.

Table 7: RMBS SSAP No. 43-Based Designation Upgrades and Downgraded Year-End 2015

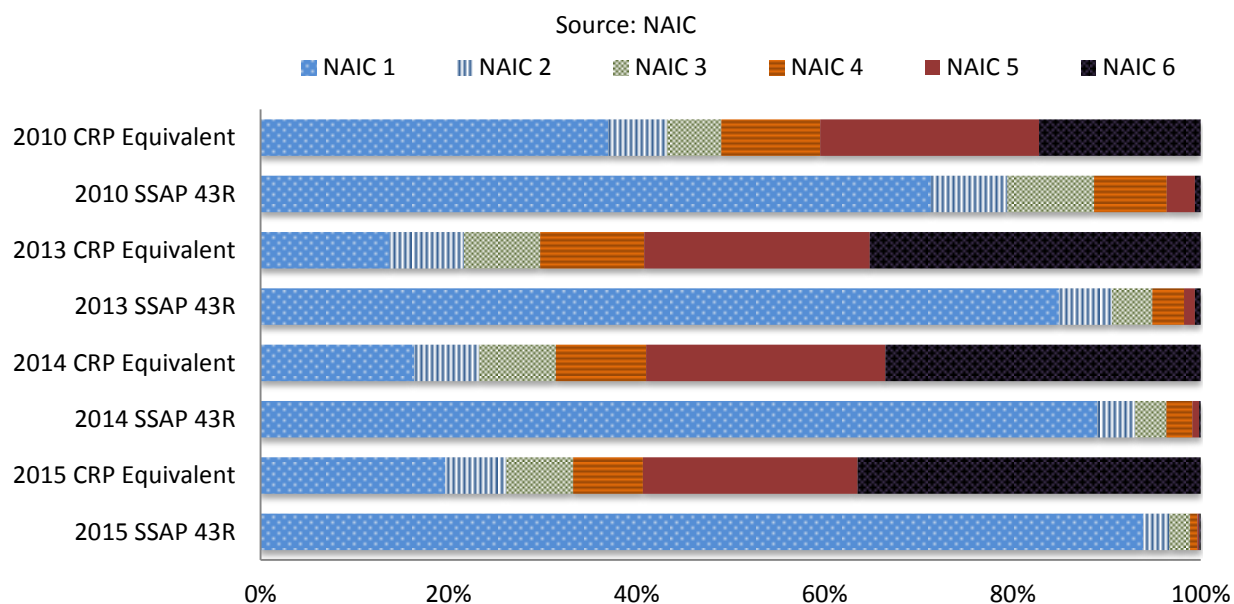
Source: NAIC

Designation	IP	BACV Px	BACV (\$ Billions)	% of BACV
Upgrade	90.42%	78.79%	80.28	79.6%
No Change	95.54%	90.66%	20.49	20.3%
Downgrade	85.51%	91.42%	107.59	0.1%
Grand Total	91.35%	80.95%	100.88	100%

²² Case-Shiller Home Price Index (HPI): Single-Family Aggregate Index (Index 2000Q1=100, SA) for United States Source: Moody's Investors Service; CoreLogic, Inc. (right-hand side).

In Figure 9, we show the RMBS breakdown by estimated SSAP No. 43R-based designation and compare it to CRP-equivalent designations. At year-end 2015, SSAP No. 43R-based NAIC 1 category makes up most (93.9% of BACV) versus CRP-equivalent NAIC 1 designations of 19.7%. In contrast, the previous year RMBS portfolio consisted of 89% SSAP 43R-based NAIC 1 designation and 16.3% CRP-equivalent 1 designation. Looking further back at year-end 2010, the SSAP 43R-based NAIC 1 made up a smaller portion—71.3% versus CRP-equivalent designation at 37%.

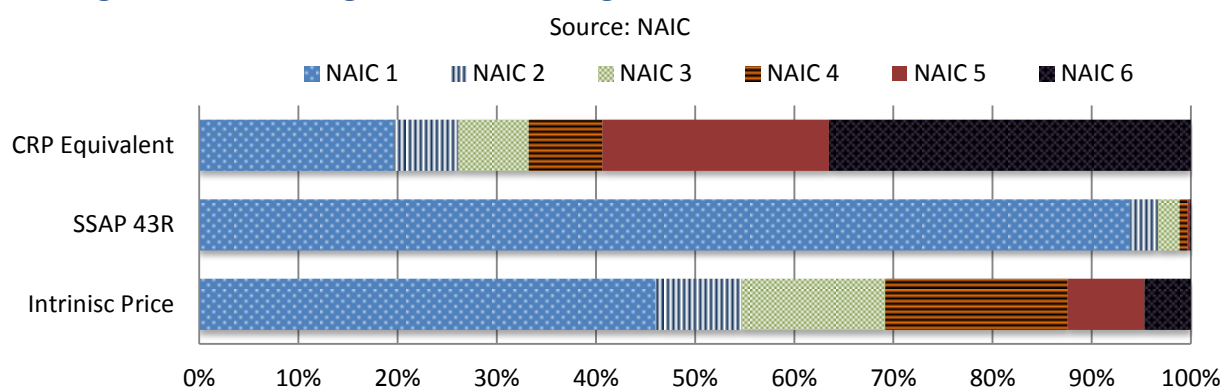
Figure 9: RMBS SSAP No. 43R Designation Versus CRP-equivalent Designation



The main driver of NAIC designation change is from the BACV being materially lower than the modeled IP. As noted earlier, almost 80% of the designations were upgraded based on the SSAP 43R methodology, which compares the higher IP of 90.42% to a lower reported BACV price of 78.79%.

If consideration for BACV was to be removed and instead designations were derived directly from the modeled IP, the NAIC designation distribution would be different. Figure 10 compares the three methods based on year-end 2015 private-label RMBS holdings. IP-based NAIC 1 designation declines to 46% of total RMBS holdings from 93.9% SSAP 43R-based NAIC 1 and 19.7% CRP-based NAIC 1 designations.

Figure 10: NAIC Designation Methodologies for Private-Label RMBS Year-End 2015



This IP-based designation is the methodology used for assigning designations to the mortgage-referenced securities,²³ which are also financially modeled but are treated under the SSAP No. 26. The IP is mapped to a single NAIC designation, employing five midpoints between two adjoining asset valuation reserve (AVR) charges (pre-tax), as in Table 8. The midpoints are then used as the threshold minimum IP for determining the designation. This method does not factor carrying value for assigning designations.

Table 8: Mapping of Intrinsic Price to Designation

Source: NAIC

Asset Class	AVR (Pre-Tax) Factor	AVR (Pre-Tax) Factor Midpoint	Minimum Final Intrinsic Price
NAIC 1	0.4%	0.85%	99.15%
NAIC 2	1.3%	2.95%	97.05%
NAIC 3	4.6%	7.30%	92.70%
NAIC 4	10.0%	16.50%	83.50%
NAIC 5	23.0%	26.50%	73.50%
NAIC 6	30.0%		

Insurance Industry Holdings Conclusion

The implementation of SSAP No. 43R with financial modeling for insurers' year-end reporting of private-label RMBS has had a large impact on NAIC designations and in turn on RBC requirements. The overall profile of RMBS holdings continues to improve and is consistent with positive market dynamics. The insurance industry's average BACV price of RMBS is conservative relative to the financially modeled intrinsic price. Additionally, the portion of zero loss bonds and IP continue to increase.

²³ [1] Part Seven, Section 6, b) of the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) defines the mortgage-referenced securities. A detailed description for [designation assignment to Mortgage-Referenced securities](http://www.naic.org/documents/svo_guidelines_filing_designation_assignment.pdf) is available on www.naic.org/documents/svo_guidelines_filing_designation_assignment.pdf.

Private Mortgage Capital in the U.S. Market: Past and Present

By Chris Katopis, Executive Director, Association of Mortgage Investors

Introduction

The housing crisis remains one of the most vivid narratives surrounding the financial collapse of the late 2000s. This section of the study will focus on the issues and concepts regarding the current impediments for private capital in the housing finance system, the concerns of investors and some proposed legislative solutions. A key goal of the financial system is the flow of mortgage credit and capital from investors to borrowers—and then back again. At its essence, the present situation limits the availability of housing credit and the reach of the American Dream of home ownership.²⁴ In response, organizations such as the Association of Mortgage Investors (AMI) have advocated for some common-sense legislation to have an impact on the critically important topic of returning private capital to the U.S. mortgage market.

The renewed investment of private capital returning into the U.S. housing finance system and increasing future investor demand in the mortgage market will require addressing a number of current market problems which are presently obstacles for private label securitization. The current mortgage investors suffer from market opacity, an asymmetry of information between investors and originators or arguably, a thorough lack of transparency. Moreover, additional issues include:

- Poor underwriting standards.
- A lack of standardization and uniformity concerning the transaction documents.
- Numerous conflicts-of-interest among servicers and their affiliates.
- Antiquated, defective, and improper mortgage servicing practices.
- An absence of effective legal remedies to investors for violations of residential mortgage-backed securities (RMBS) contractual obligations and other rights arising under state and federal law.
- Unwarranted federal and state government intervention in the mortgage market (e.g., the use of eminent domain as a foreclosure mitigation tool).

Background

The AMI is a leading unconflicted policy and legal advocate for mortgage investors. The AMI was formed to become the primary trade association representing investors in residential

²⁴ The “American Dream” is often equated to a 30-year fixed rate mortgage, pre-payable without a penalty.

mortgage-backed securities (RMBS), along with life insurance companies, state pension and retirement systems, and university endowments. It has become the sole unconflicted buy-side investor group and developed a set of policy priorities it believes contribute to achieving the goal of restoring private market securitization. The AMI was founded to play a primary role in the analysis, development and implementation of mortgage and housing policy that keep homeowners in their homes and provide a sound framework to promote continued home purchasing.

In practice, only three sources of residential mortgage capital exist in the U.S.: 1) balance sheets of financial institutions such as banks; 2) the government (currently including Fannie Mae, Freddie Mac and the Federal Housing Administration [FHA]); and 3) private securitization, which is effectively shut down for the reasons described herein.

At its height, today's U.S. mortgage market consisted of approximately \$11 trillion in outstanding mortgages. Of the \$11 trillion, approximately 50% or \$5.4 trillion is held on the books of the government-sponsored enterprises (GSEs) as agency RMBS (issued by one of the agencies) or in whole loan form. Another \$4 trillion is on the bank balance sheets as whole loans or securities in their portfolios, of which \$1 trillion are second liens (i.e., home equity loans/lines of credit or closed end second mortgages). Of the \$1.1 trillion outstanding second mortgages, only about 3% to 4% of the total (or approximately \$40 billion) is held by private investors in securitized form. The remaining \$985 billion in first lien mortgages resides in private-label RMBS.²⁵

As it was shown earlier in the study, private capital has virtually left the U.S. mortgage market. This trend is uncontested. The future is likely to reflect a similar situation unless the U.S. Congress helps establish the necessary systems, structures and standards for private capital to return.

Investors are prepared to invest private capital into the mortgage market, hence increasing housing availability and affordability. However, investors seek the government's development and deployment of these enhanced securitization standards and safeguards to restart the virtuous circle of private capital into the market and to borrowers. These will promote the certainty, transparency, uniformity, enforcement, recourse and other criteria which will contribute to improving the functioning of capital markets for all investment asset classes, especially those pertaining to a necessity of life—namely housing.

²⁵ In point of fact, the AMI's members have held a significant portion of these mortgages through their individual investments.

As many observe, Washington's efforts contribute to helping to keep Americans in their homes, making credit available, and the development of effective tools to counteract this challenging housing and foreclosure environment. However, after almost a decade, across the spectrum many remain frustrated as more needs to be done to improve the climate around the private mortgage and housing markets.

Mortgage investors share that frustration with the slow restoration of the housing market and the need to assist homeowners who are truly hurting. In fact, the markets for private-label securitization have virtually ground to a halt since the financial crisis for reasons we will explore.²⁶ Investors hope meaningful solutions can be implemented more quickly, and believe their interests are aligned with responsible homeowners.

As difficult as it may be to believe, many of the most sophisticated mortgage investors were as victimized by the servicers and their affiliates as were many consumers. Investors are essential in order to rebuild the private mortgage market. However, investors and their private capital will only return to a market which is transparent, has non-conflicted stakeholders and the protection of contract law.

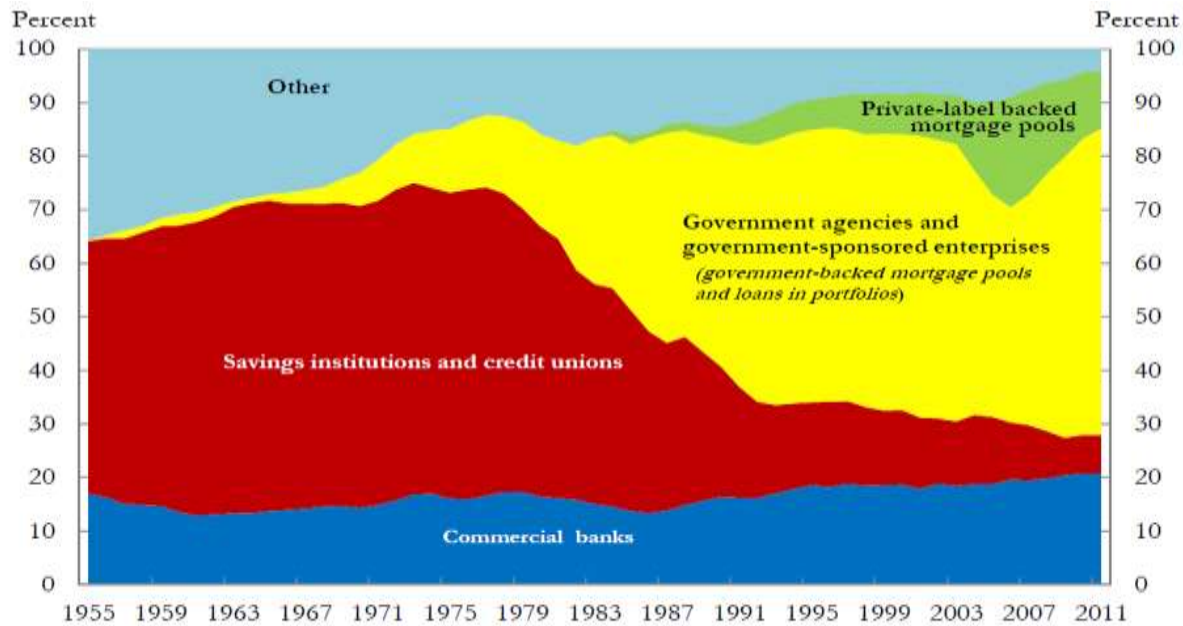
The Role of Mortgage Investors in the Marketplace

Mortgage investors, through securitization, have for decades contributed to the affordability of housing, made credit less expensive and made other benefits available to consumers. Today, in contrast, as it can be seen in Figure 11, mortgage investors are continuing to exit the market. As Figure 11 illustrates, the government's dominant market share—as shown in yellow—can only be transitioned back to the private sector—as shown by the blue and green—by fixing the asymmetry of information, poor underwriting and conflicts-of-interest by key parties in the securitization process, as well as the inability to enforce rights arising under contracts, securities and other laws. This list is by no means intended to be exhaustive. Accordingly, the U.S. economy in general is hurt by the decreasing availability of mortgage credit. Figure 12 illustrates the practical disappearance of private capital as a funding source for mortgage loans after the global financial crisis by contrasting mortgage originations by credit source before the crisis in 2006 with those of 2012.

²⁶ The exceptions to this include a small number of private-label securities (PLS) securitizations, which are very limited in size and scale: www.bloomberg.com/news/2012-09-10/redwood-to-sell-securities-backed-by-313-2-million-of-mortgages.html.

**Figure 11: The Mortgage Market Needs Diverse Capital Sources
Exposure to Residential Mortgages Outstanding**

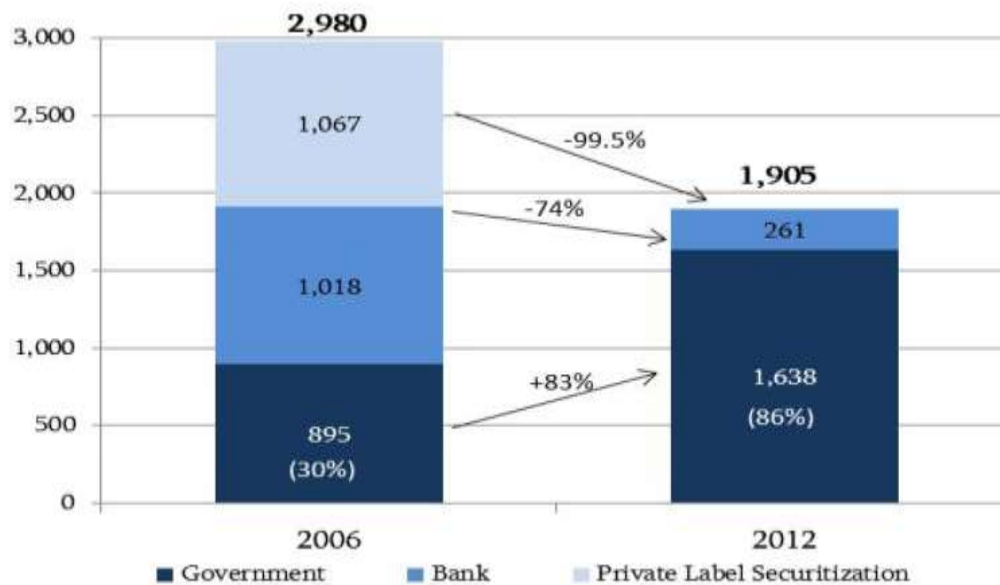
Source: Federal Reserve Board



Notes: Other includes life insurance companies, finance companies, real estate investment companies, private pension funds, state and local government retirement funds, households and nonprofit institutions, and non-financial corporate and non-corporate businesses.

Figure 12: Mortgage Originations by Credit Source 2006 Versus 2012 (\$ Billions)

Source: Inside Mortgage Finance



Note: Government includes GSEs, FHA, and VA.

Mortgage Investors' Interests Align with Responsible Borrowers

Mortgage investors are aligned with both homeowners and the government in our shared goals of keeping responsible Americans, including low- and middle-income families, in their homes and rebuilding and maintaining a vibrant real estate market. The benefits of securitization are widely known and accepted.²⁷

In fact, the maintenance of a healthy securitization market is a vital source of access to private capital for mortgages, as well as automobiles and credit cards. Additionally, an efficient securitization market provides additional capital and at a cheaper cost to mortgage loan originators allowing them to make more loans to more qualified borrowers. The use of private-label RMBS as a funding source has many benefits, including:

- Expanding the availability of housing finance opportunities for low- and middle-income families.
- Reducing the cost of credit.
- Equitably distributing risk in the mortgage finance industry.
- Preventing a build-up of specific geographic risk.

In summary, these features and many others are those of a market which makes access to capital cheaper and, thus, spurs more mortgage lending.

Mortgage investors seek effective, long-term, sustainable solutions for responsible homeowners seeking to stay in their homes. Mortgage investors, primarily the first lien holders, do not object to modifications as part of a solution and wish to strive for additional remedies to assist homeowners. Likewise, if borrowers are speculating in the housing market, engaging in a strategic default or paying only their second-lien mortgages, then they should not be eligible for receiving subsidized first lien interest rates. Potential structural changes should be examined including:

- Full recourse.
- Blockage of interest payments on second lien debt if the first lien is in default.
- Prohibitions on second lien debt above a specified loan-to-value (LTV).

With a restored, vital and healthy securities market, more private capital will be attracted into mortgage investments. In turn, such a market would provide more affordable mortgages for potential qualified home buyers.

²⁷ *Securitization and Federal Regulation of Mortgages for Safety and Soundness*, CRS REPORT FOR CONGRESS at 2 (RS-22722, Oct. 21, 2008). (“This securitization of mortgages increased the supply of funds available for mortgage lending.”)

Obstacles to the Return of Private Mortgage Capital

The current legal and regulatory landscape presents numerous obstacles for private capital returning to the mortgage market and RMBS in particular. In essence, mortgage investors simply seek the salient facts underlying a mortgage transaction in order to price the risk to their capital. The AMI has offered a number of policy solutions, which are described in its *Reforming the Asset-Backed Securities Market White Paper* (March 2010).²⁸ Just as with traditionally chartered bank-servicers, the vast majority of capital market investors have many options as to where to deploy their capital. They do not have to fund mortgages, and they will only do so if it makes sense on a risk-versus-return basis. In the case of mortgages, they look at known returns versus perceived risks.

Inability to Compete with the Government

Presently, the government subsidizes mortgage rates by keeping the cost of credit low by charging insufficient amounts through its “g-fee” at the time it creates a GSE securitization product. Although these fees are rising, they are still insufficiently low for the private label securitization product to compete in the market. It is natural money is attracted to a product where the government guarantees risk at subsidized rates versus a private market with no guarantee or one with private insurance. Raising g-fees to market levels will help attract private capital through crowding in. This is necessary—but not sufficient—to get private capital into the market in greater size than it is right now.

With respect to risks, because investors got badly burned on RMBS during the financial crisis and had their legal and economic rights trampled on in the aftermath to the crisis, in legal battles with various parties and some “help homeowners” initiatives, there is much the U.S. Congress can do going forward to lower perceived risks to investing in mortgages. Congress can encourage private-sector competition and create clear “rules of the road” so the mortgage market is restored. This is absolutely essential.

Competition, Crowding Out and Making the GSEs Truly Private

In terms of competition, private investors in RMBS right now are “crowded out” by the government to a large degree. Between quantitative easing and government pressure for lower lending rates to spur economic growth, private capital simply cannot compete at these credit spreads.

Even if the Federal Housing Finance Agency (FHFA), as conservator of the GSEs, were to raise g-fees to market levels by regulatory order, this would not solve the problem. Fannie Mae and

²⁸ <http://the-ami.org/2010/03/22/ami-white-paper-reforming-asset-backed-securities-market/>

Freddie Mac are in the same business as private mortgage investors and mortgage insurers, bearing credit risk in exchange for financial compensation, and they should not have the low-funding-cost and other advantages of government sponsorship. Congress should prepare a transition plan to end government sponsorship, and the credit-risk-bearing functions of these entities must be fully privatized, to ensure a level competitive playing field.

It is an indisputable fact of the financial markets today that banks, mortgage insurers and private capital market investors simply cannot—they do not have enough capital to—support the \$10 trillion U.S. mortgage market without the credit-risk-bearing functions of Fannie Mae and Freddie Mac. This point is graphically illustrated by Figure 11. Accordingly, it must be noted:

- Commercial banks do not provide more than 20% of the nation’s outstanding mortgage capital, and adding thrifts and credit unions does not get them above 30%.
- Mortgage insurers fit into the “other” category on the chart, and at only a few billion in mortgage capital are insignificant in terms of U.S. mortgage funding needs.
- Private-label RMBS at the height of the recent boom were never more than 20% of the market themselves, and it will take a lot of work (see below) to get back to this level going forward any time soon.

While simply wiping out Fannie Mae and Freddie Mac would be good for investors from a competitive standpoint, the effects this would have on mortgage availability would be disastrous, seriously wounding the now-recovering housing market and causing losses to mortgage lenders, insurers and investors on outstanding loans.

Besides, wiping out Fannie Mae and Freddie Mac would put even more mortgage market power into the hands of the nation’s largest banks, which is not and should not be a government goal.

The easiest and most direct way to have less government capital and more private capital in the mortgage market is for the government to sell its stakes in genuinely transformed GSEs into the capital markets and get taxpayers paid back. Fannie Mae and Freddie Mac’s debt-fueled purchases of low-quality RMBS and insufficient equity capital were what got them into trouble before conservatorship. Congress can put the GSEs’ portfolios into run-off, pay off the debt and ban them from buying RMBS going forward, without wiping out their core guarantee businesses on high-quality mortgages, which were never a problem. Subprime and other low-quality loans could be left to financial institutions and investors who are not systemically important.

After restructuring the GSEs to prevent problems of the recent past by limiting them by charter to high-quality guarantees ensuring sound regulation with appropriate equity capital, severing government sponsorship and entity-level backstops, the core mortgage guarantee businesses can be sold into the private markets with no government backstop. The funds realized can repay the government for its assistance. In bearing mortgage credit risk, the new privatized GSEs should compete on an equal footing with banks, mortgage insurers and private-label RMBS—with market-based costs of capital, g-fee rates and no special privileges.

Trust Indenture Act: Investor Bill of Rights and Bank Quality Control

Another useful source of inspiration for solving the issues at hand may be found in the federal Trust Indenture Act (TIA). As history teaches, the 1929 financial crisis resulted in a crash of the stock (equities) markets. Yet, the bond industry crash in the 1929 crisis it is less well-known. In response, in 1934, Congress tasked the Securities and Exchange Commission (SEC) to explore solutions for revitalizing the corporate bond market. The SEC prepared a report authored by the commissioners, including future U.S. Supreme Court justices William Douglas and Abe Fortas.²⁹

The 1936 SEC Commission Report's Finding

The 1936 SEC report on the problems surrounding the corporate bond market bears striking similarities to the issues facing the RMBS investment space at present. The report reads as if torn from recent financial news headlines:

The basic problem is to refashion the trust indenture [a corporate bond] for the purpose of according greater protection to investors. That entails prescribing minimum standard specifications for the conduct of trustee and issue thereunder. This means a more proper balance between the interests of investors and requirements of issuers ... where its failure to take swift and positive action leave the investors without effective protection of their interests. In this situation the inherent incompatibility of interest arises, common to all creditors and debtors.

Accordingly, the SEC report catalogs a number of the resulting problems from the lack of appropriate investment standards, systems and safeguards present up until Congress' enactment of the TIA. In particular, the TIA addressed the following defects of the bond industry of the early 20th century, and as well, any forthcoming new bill should also address these issues in the RMBS space:

- The eligibility and duties of a trustee.

²⁹ The full report may be found on the AMI website at: <http://the-ami.org/2012/04/27/the-sec-tia-report-to-the-senate-banking-committee/>.

- The Trustees' duties in connection with breaches of representations and warranties.
- Transparency and periodic reporting.
- Creditor rights.
- Registration before the federal regulators pursuant to the securities laws.

These parallel the issues mortgage investors have noted before Congress and in our other advocacy.

The 1936 SEC Commission Report's Results

The result of the 1936 SEC report was Congress' enactment of the TIA. This landmark legislation has enabled the corporate bond market with the standards and structures necessary for its efficient operation, so much so investors do not even realize it is in effect.

Today, investors believe the congressional enactment of a new, explicit parallel to the TIA for the RMBS industry would have dramatic, positive effects for the return of private capital to the U.S. mortgage market. Further, such TIA legislation would benefit many demographics of borrowers, including first-time, low- and middle-income borrowers. The drafting of such a TIA-RMBS bill can be accomplished in several ways. The AMI has developed a draft version of the TIA-RMBS bill. Further, the AMI appreciated and supported Chairman Scott Garrett's (R-NJ) 2010 legislation, the Private Market Enforcement Act, H.R. 3644, as well as similar legislation offered by Congressman Brad Miller (D-NC).

Investors believe the recommendations below, which are detailed in depth in the AMI white paper, are entirely consistent with the government's traditional roles of standard-setting in capital markets: 1) support healthy and efficient securitization and mortgage finance markets, with additional information made more widely available to participants, regulators and observers; 2) incentivize positive economic behavior among market participants; and 3) reduce information asymmetries distorting markets.

This process resulted in a report to Congress on how underwriters sold bad corporate bonds into the market, the legal documents were weak, trustees did not protect bondholders, and investors had few rights and no real remedies to enforce the rights they did have.

- In response, Congress passed the TIA of 1939, which mandates bonds sold into the financial markets must have legal structures and documents that work for investors. This statute has worked for almost 75 years without an overhaul, and now we do not worry about the bond market blowing up because of bad legal structures the way the mortgage markets did.

- The problems seen in the MBS market today are almost exactly the same as those in the bond market after the 1929 crash. This argues for the same solution, mandatory standards and legal structures—a solution from Congress the corporate bond market has successfully lived with for the past 70 years. Of the thousands of financial professionals trading corporate bonds in the U.S. market today, few know what the TIA is, but all see it works.

In response to critics who oppose letting the private market figure this out if it is so important, private investors are here to tell Congress there is no negotiation of the fundamental noneconomic terms of RMBS. Hence, certain important national goals are not achieved. Underwriters do not negotiate with smart investors or even average investors. They write legal documents and make selective disclosures to sell deals to the marginal investor, the one who does not read the papers and does not know or understand what he or she is buying. These are the RMBS sold into the capital markets and more sophisticated investors have to research and trade.

This dynamic leads to the classic “race to the bottom”—minimal disclosures as to the mortgages securitized, no effective enforcement of representations and warranties (R&W) investors rely on, and weak legal structures which do not protect investors in practice. This is what led to the illiquidity in the markets and investor losses in the financial crisis, and private capital will not come back in size to fund mortgages if investors think this could happen again.

We need to mandate systems, standards and structures to get data on the underlying mortgages out into the market so credit risk can be appropriately priced and compensated. We need to have third parties—investor representatives—enforcing R&W, instead of servicers protecting their affiliates that would be liable, so underwriters give accurate data to investors and stand behind their financial products. If investors understand and can control the credit risks they are assuming, they will be fairly compensated for the occasional losses they agreed to bear.

A TIA for RMBS (TIA-RMBS) would include, among other things:

- Real-time public loan-level information available to all investors, not just ratings agencies, both at the time of underwriting and as loan performance emerges.
- “Cooling off” periods when RMBS are offered so investors have a real opportunity to analyze what they are being offered.
- Public deal documents for all RMBS for investors, other market participants and regulators.

- Standard pooling and servicing agreements for all RMBS, with enforceable, understandable, and non-waivable, standard representations and warranties going all the way back to loan originators, for which R&W would be effectively enforced by third parties with the minimum cost and litigation.
- Clear and standard definitions, including for fundamental mortgage concepts like “delinquency” and “default.”
- Addressing conflicts of interest involving servicers (including second liens and third-party services like force-placed insurance) to make sure they manage the mortgage pools in the best interests of investors.
- Protection for investors against servicers settling their legal liabilities to third parties with trust property (i.e., robo-signing settlements allowing servicers to make modifications on investor-owned loans as consideration) and against local governments seizing their mortgage loans under eminent domain.
- Simplified MBS pool structures and governance structures, for greater secondary market liquidity and effective investor supervision of trustees and servicers.
- Better credit ratings for RMBS investors, based on the same detailed data investors should get and updated continuously over time.

The quality-control functions essential to the proper functioning of RMBS trusts must be mandated by the government and paid for by the economics of mortgage securitization transactions. As has been seen over the last several years, these functions will simply not be performed otherwise. Transactions that depend on dumping bad loans on investors for their economics to work should not be brought to market.

Congress should put a single regulator with appropriate experience in charge of all mortgage-backed securities, who can work with the Consumer Fraud Protection Bureau (CFPB) to ensure mortgage servicing standards address the needs of investors, as well as homeowners. We should make sure servicer compensation is properly structured to accommodate different housing market conditions. We need uniform accounting and reporting policies for RMBS pools, as well as uniform procedures for loan servicing and restructuring known to all parties upfront and not changed ad hoc in response to political demands.

To deal with the conflicts of interest between first-lien loans and second-lien loans, there needs to be a new inter-creditor regime for securitized mortgages. Owners of first-lien loans should: 1) have consent rights over second-lien loans that lead to unsustainable LTV levels; 2) get paid before the owners of second-lien loans are paid by the same borrowers; and 3) control any modification or restructuring process. Property-level losses should be allocated properly among creditors based on legal priority, and junior creditors should be impaired before more senior creditors.

If investors are to get a fair deal going forward, Congress must end the “put-back wars” which have paralyzed loan origination.³⁰ This will allow banks to limit their legal exposure the next time the market turns down, cutting off the “tail risk” they will have to buy back defaulted loans—so long as they meet new required market standards for data completeness, timeliness, integrity and appropriate protection of investors.

Mortgage Market Infrastructure

Beyond securitization, the mortgage market infrastructure needs to be reformed and modernized. To this end, Congress should consider:

- Facilitating a single national internet database of mortgages—perhaps for real estate ownership as well—that tracks, validates and clarifies mortgage loan ownership, putting to rest troublesome issues that have dogged the legal system since the foreclosure crisis began.
- Mortgage servicing standards addressing the needs of investors, as well as those of borrowers.
- A single national uniform foreclosure law, non-judicial but still ensuring important homeowner protections, to govern enforcement of security interests in real property exactly the way Article 9 of the Uniform Commercial Code handles security interests in personal property.
- The difficulty for investors to charge the lower interest rates normally associated with secured lending, when the difficulties of foreclosing in property in many jurisdictions makes the capital we have invested effectively unsecured.

Recent experience has shown the mortgage market is national in scope. Congress should help model uniform state laws to bring about consistency among states in dealing with these important mortgage-related issues affecting investors not only nationwide, but around the world.

Political Risk of Eminent Domain

Another serious impediment to private capital arises from the government’s intervention in the housing market, which results in uncertainty and the possibility of severe loss. Investors characterize this as the new “political risk premium” surrounding our activity. Recently, we

³⁰ Investors’ demands for lenders to put the mortgage back “i.e. mortgage put-back” through litigation asking lenders to repurchase loans whose representations and warranties were allegedly false gave rise to the term “put-back wars.”

witnessed such harmful activity in the mortgage space with both the National Mortgage Settlement³¹ and the proposed use of eminent domain as a foreclosure mitigation tool.

We fully concur with the mainstream concerns of many, including the FHFA and many think tanks³² regarding the use of eminent domain, the potential to limit consumer credit and harm communities economically, the impact on securities and other institutional holdings, and the ultimate losses imposed upon taxpayers due to alterations to the GSEs' (Freddie Mac and Fannie Mae) securities holdings. We further wish to emphasize that among the consequences of this use of eminent domain is the likely further curtailment of access to the 30-year fixed mortgage, an integral part of the American Dream, and additional harm to taxpayers who are holders of the GSE and private-label securities through their public or private pensions, 401(k) plans and/or mutual funds.

The use of eminent domain to restructure residential loans is a controversial, untried and likely unconstitutional use of government power.³³ The use of such government power is a blunt instrument. The burden on its proprietary and the justification for its use must reside with its advocates. While some would claim it is a last resort, there are no indications this is true or that, in the case of performing mortgages, said borrowers should be entitled to relief. Either way, it appears the negative consequences will always outweigh the purported benefits. Even though the AMI is extremely sympathetic to the problems surrounding the housing sector and borrowers for the past six years, the case has not been satisfactorily made for the use of eminent domain, particularly given all of the programs available to troubled borrowers, some of which are too new to have fully registered their potential. Further, government data suggest many indices after a six-year housing crisis, including home prices and relief for borrowers, are showing consistent improvement.

In summary, the risk of the use of eminent domain in this manner poses more risks to the housing markets, communities and the availability of credit than any advantages portrayed by those who seek its financial gain. Investors were pleased when the concept was reviewed in its entirety and the facts come to bear, communities rejected eminent domain in this context. For

³¹ <http://www.nationalmortgagesettlement.com/>.

³² Think tanks and nongovernmental organizations (NGOs) across the political spectrum question the use of eminent domain in this context. See, e.g., the Progressive Policy Institute's (PPI) report: www.progressivepolicy.org/wp-content/uploads/2012/07/07.2012-Gold_Can-Eminent-Domain-Help-Underwater-Homeowners.pdf.

³³ Cornell Law Professor Robert C. Hockett, a key architect, spokesman for the eminent domain proposal and past MRP consultant has conceded that this plan is untried and legally unverified. "In an interview Wednesday, Hockett conceded that the eminent domain seizure of a mortgage loan has apparently not been tested explicitly in court." http://newsandinsight.thomsonreuters.com/Legal/News/2012/07 - July/Eminent_domain,_MBS_and_the_U_S_Constitution_a_one-sided_fight_/.

these reasons, AMI supported those efforts to protect investments from government takings, as with the last session's introduced bill, The Defending American Taxpayers from Abusive Government Takings Act, H.R. 6397.

Private Mortgage Capital in the U.S. Market Conclusion

Today, nearly one decade after the financial crisis, mortgage funding through the capital markets remains in a weakened state on government life support. The recent landmark financial services legislative reforms did not fully address the many serious issues at stake. Further, mortgage investors have asked Congress to step in to help restore and strengthen the private market, through establishing standards, systems and rights. There are tremendous gains the government can make in improving competition and decreasing risk—and, therefore, increasing the participation of private capital.

Mortgage investors believe the vibrancy and effectiveness of the U.S. capital markets can be restored, in part, by enhancing the transparency around fundamental regulatory structures, standards and systems. Toward this goal, the government has a role—not through big government, but rather, the light touch of a prudent standard-setter and facilitator. With appropriate standards and rights for the holders of asset-backed securities, securitization would achieve the goals sought by many—the more efficient funding of capital markets, lessening volatility and the resulting better economic activity.

In the absence of transparency, the future of the U.S. housing finance system will remain dark, hurting America's global competitiveness and our domestic economic health. The results will include less home lending, more expensive credit, and fewer housing options and less opportunity for working class Americans. These are the reasons we need solutions promoting more transparent systems to restart our private mortgage markets. Hopefully, we can all look forward to a larger mortgage funding market, more private and more systemically sound than the one we have experienced in the past decade. Americans of all walks of life deserve the ability to realize the full American Dream of home ownership.

Efforts to Revive the Private-Label RMBS Market

By Dimitris Karapiperis, Research Analyst, NAIC Center for Insurance Policy and Research

Introduction

It has already been shown in the previous sections of the study that the issuance in the private-label market has shrunk substantially since the global financial crisis. For the past eight years, non-agency mortgage securitization has been a shadow of its former pre-crisis self with issuance trickling in at levels not seen since the mid-1990s. According to the Securities Industry and Financial Markets Association (SIFMA), private-label securitization of new mortgages (excluding home equity loans) totaled just \$19 billion in 2015, a mere 2.6% of the 2005 peak of \$726 billion.³⁴

Structured Finance Industry Group's RMBS 3.0 Initiative

As a result of the crisis, investors started demanding greater disclosure from issuers as a prerequisite for bringing back the much needed trust between the buy and sell side. To respond to the need for buyer-seller consensus regarding transparency and standardization in securitization deal disclosures, the Structured Finance Industry Group (SFIG) launched the RMBS 3.0 initiative. The primary goal of the initiative, as stated by the SFIG, is to reinvigorate private-label securitization by bringing together a broad cross-section of market participants to identify and agree upon a set of best practices. The critical task assumed by RMBS 3.0 is to attempt to create new industry standards, as well as address other essential parts of the RMBS issuance process. The work of the RMBS 3.0 initiative is captured in a series of green papers published by the SFIG.³⁵

Addressing the structural flaws found in legacy private-label securitizations, including misaligned incentives, ineffective enforcement mechanisms, weak or no oversight of transaction parties, and lack of transparency is vital to bring back the private-label market. During his remarks in the SFIG's 1st annual private-label symposium, Michael Stegman (counselor to the Secretary of the Treasury for housing finance policy) cautioned if these flaws are not remedied, the private-label market will not return at scale since investor demand will not be sufficient for the senior bonds to sustain it.³⁶

Recognizing the often divergent interests and analytical capabilities of different parties in the private-label securitization market, such as issuers and sponsors, categories of investors by risk

³⁴ See www.sifma.org/research/statistics.aspx.

³⁵ See www.sfindustry.org/images/uploads/pdfs/RMBS_3.0_Third_Edition_Green_Papers.pdf.

³⁶ U.S. Department of the Treasury 2014. "Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman Before the Structured Finance Industry Group 1st Annual Private Label Symposium." See www.treasury.gov/press-center/press-releases/Pages/jl2694.aspx.

appetite, as well as rating agencies and regulators, agreeing on a universally applicable and appropriate fixed set of standards may be impossible. However, even though a “one-size-fits-all” approach may not be ideal, an agreed upon framework of standards, practices and procedures which can adequately account for and accommodate the different interests of all parties involved, especially those of issuers and investors, is a necessary requirement for the revival of the private-label market.

The RMBS 3.0 initiative’s declared goal is to develop solutions reflecting the divergent views and interests of the private-label market’s participants. Although RMBS 3.0 is not in a position to develop and impose legally enforceable standards, it wants to achieve consensus among all participants to the greatest extent possible. Essentially, RMBS 3.0 aims to:

- Create standardization where possible reflecting widely agreed upon best practices and procedures;
- Clarify differences in alternative standards to improve transparency across all RMBS transactions;
- Develop new solutions to problems impeding the emergence of a sustainable and scalable RMBS market; and
- Draft or endorse model contractual provisions or alternative “benchmark” structural approaches, where appropriate, to reflect the foregoing.³⁷

The focus of RMBS 3.0 is on the following three areas related to private-label RMBS transactions:

- Representations and warranties, repurchase obligations and other enforcement mechanisms;
- Due diligence, disclosure and data issues; and
- Roles and responsibilities of transaction parties and their communications with investors.

Investors in the private-label RMBS market generally demand stronger representations, warranties and enforcement mechanisms than agency RMBS investors. An important reason is available government guarantees basically insulate agency RMBS investors from credit risk.

Standardization of information is a central theme of RMBS 3.0 discussions as it can provide investors with the ability to evaluate securities to protect them against fraud and misrepresentation. While investors require full transparency regarding loan level collateral data, they should be able to rely on representations and warranties of the lenders and the

³⁷ See www.sfindustry.org/images/uploads/pdfs/RMBS_3.0_Third_Edition_Green_Papers.pdf.

security issuers that the mortgage loans have been underwritten to a prescribed set of high standards and the properties have been properly appraised.

RMBS 3.0 developed a set of representations and warranties, presented in the green paper, capturing nearly 50 distinct points of information about a private-label RMBS deal regarding underwriting requirements, such as borrower characteristics and qualifications, taxes, fees and assessments paid, no liens, no defenses, down payment, property valuation, fraud, and insurance among others. In the green paper, RMBS 3.0 presents an overview and history of each issue before and since the global financial crisis, as well as the industry positions and versions of the representation and warranty language already used by market participants. Then, RMBS 3.0 presents issuers with alternative iterations of the representation and warranty language that would best promote full disclosure and transparency and enhance trust in the marketplace between issuers and investors. Furthermore, in the same section, RMBS 3.0 considers the development of effective and efficient means of breach identification, communication, evaluation, pursuit and enforcement, which is critical in protecting the integrity and proper functioning of a new RMBS market.

In the second section of the green paper, RMBS 3.0 presents recommendations for due diligence, disclosure and data standards. The pre-crisis standard narrative disclosure about underwriting guidelines generally failed to convey sufficient granular information in a succinct manner. RMBS 3.0 proposes a more effective way of disclosing underwriting guidelines used to originate mortgage loans to improve disclosure and aid investor understanding. A sample underwriting guidelines matrix was developed by RMBS 3.0 as a visual aid to convey the type and range of underwriting information needing to be disclosed by issuers to investors.

In the third section of the green paper, RMBS 3.0 presents the SFIG's current assessment of the roles and responsibilities the parties to a private-label RMBS transaction should have in the new 3.0 mortgage securitizations. This includes mapping out the specific roles and functions of trustees, master servicers, securities administrators, custodians and other potential parties.

Federal Government Efforts

The U.S. Department of the Treasury (the Treasury) is closely following the reform efforts of RMBS 3.0 participants to arrive at a consensus regarding a new set of industry standards with great interest. Responding to the problems of the private-label securitization market, the Treasury has proposed its own solution in the form of a benchmark transaction whose terms are accepted by both issuers and investors.³⁸ A sufficiently large benchmark transaction, a

³⁸ U.S. Department of the Treasury 2014. "Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman Before the Structured Finance Industry Group 1st Annual Private Label Symposium." See <https://www.treasury.gov/press-center/press-releases/Pages/jl2694.aspx>.

product of a collaboration of all parties involved—issuers, investors, servicers, trustees, rating agencies and others—could become the de facto industry standard by reflecting all those structural reforms needed to reestablish trust and revive the market. A simple and transparent benchmark transaction could, according to the Treasury, provide the basis for all future transactions while also allowing for future innovations and custom structures as issuance is re-energized and liquidity returns to the market.³⁹

However, the lack of favorable market conditions forced the Treasury to shift its focus from the establishment of the benchmark transaction toward supporting a number of more immediate structural reforms developed in collaboration with market participants.⁴⁰ These reform proposals intersect with the work of RMBS 3.0 and deal primarily with the three areas of significant structural weaknesses in private-label securitizations:

- The concept of deal agent;
- Servicing activities and oversight; and
- Origination representation and warranties.⁴¹

The inclusion of a deal agent who would act in a fiduciary-like capacity in the best interest of the trust without any conflict of interest with other transaction parties would improve the current structure of special purpose vehicles. It would enhance transparency and oversight and, therefore, increase investors' confidence in the private-label securitization market.⁴²

Investors support the strengthening of minimum servicing requirements by requiring servicers to maximize the value of the collateral to the trust and improving the alignment of interests between servicers and the trust and thereby investors. Also, improving the disclosure and repurchase enforcement mechanism is central to rebuilding trust in the market. Establishing a set of clearly defined representations and warranties is critical in bringing investors back in the private-label securitization market.

Efforts to Revive Private-Label RMBS Conclusion

It is abundantly clear it is imperative for all parties in the private-label securitization market to arrive at a consensus on at least a set of minimum accepted standards for a next-generation private-label RMBS. The experience of both the RMBS 3.0 initiative and the Treasury's efforts shows that only through open and honest collaboration and close coordination, issuers,

³⁹ Ibid.

⁴⁰ U.S. Department of the Treasury 2016. "Remarks by Deputy Assistant Secretary Monique Rollins on Reforming the Private Label Securitization Market at the Asset Backed Securities (ABS) Vegas Conference." See <https://www.treasury.gov/press-center/press-releases/Pages/jl0371.aspx>.

⁴¹ Ibid.

⁴² Ibid.

Efforts to Revive the Private-Label RMBS Market

investors, policymakers and other stakeholders could have a chance to successfully reinvigorate the private-label market.

Strengthening Private-Label RMBS Investor Protections

By Mark Adelson, Independent Consultant and Editor of *The Journal of Structured Finance*

Introduction

Revival of the market for private-label residential mortgage-backed securities (RMBS) depends partly on investors regaining confidence they have meaningful and enforceable protections. They need to know they will have a remedy if they are wronged.

The law provided incomplete protection to investors who purchased private-label RMBS from 2005 through 2007 (i.e., the period preceding the global financial crisis). Those investors suffered significant losses on those investments. Collectively, those investors assumed huge losses caused partly by misrepresentation or fraud on the part of private-label RMBS issuers and underwriters. In the aggregate, private-label RMBS investors lost hundreds of billions of dollars on their RMBS investments from the 2005 through 2007 vintages. Many members of the insurance industry, particularly life insurance companies, were among the victims.

A good number of the victims attempted to recover their losses by bringing lawsuits against private-label RMBS issuers and underwriters. Some achieved a measure of success. Table 1 lists settlements and verdicts in a selection of the cases. Some cases involved claims under the federal securities laws. A greater number, however, were based on contractual claims or claims under state securities laws (i.e., so-called “blue sky” laws).

Table 9: Selected Settlements Involving Claims Relating to the Issuance and Sale of Private-Label RMBS or Breaches of Representations and Warranties

Date	Amount (\$ Millions)	Defendant	Plaintiff
12/31/2010	1,520	Bank of America	Fannie Mae
12/31/2010	1,350	Bank of America	Freddie Mac
4/15/2011	1,100	Bank of America	Assured Guaranty
4/24/2012	280	Barclays	FHFA
4/27/2012	28	Option One	SEC
6/21/2012	40	Lehman Brothers	Local 302
3/21/2013	885	Credit Suisse	FHFA
4/2/2013	165	Bank of America	NCUA
5/28/2013	200	Citigroup	Allstate Ins.
5/28/2013	250	Citigroup	FHFA
6/21/2013	105	Flagstar Bancorp	Assured Guaranty ¹
7/25/2013	885	UBS	FHFA

Strengthening Private-Label RMBS Investor Protections

Date	Amount (\$ Millions)	Defendant	Plaintiff
10/17/2013	12	Deutsche Bank	NV Atty Gen'l
10/25/2013	5,100	JP Morgan Chase	FHFA
11/6/2013	335	Wells Fargo	FHFA
11/7/2013	154	RBS	SEC
11/15/2013	4,500	JP Morgan Chase	private MBS investors
11/19/2013	9,000	JP Morgan Chase	DOJ & various states ²
12/2/2013	404	Bank of America	Freddie Mac
12/20/2013	1,925	Deutsche Bank	FHFA
12/31/2013	475	Ally Financial	FHFA
1/7/2014	10,000	Bank of America	Fannie Mae
1/6/2014	undisclosed	Goldman Sachs	Prudential Insurance
1/31/2014	8,500	Bank of America	various MBS investors
2/7/2014	1,250	Morgan Stanley	FHFA
2/24/2014	275	RBS	NJ Carpenters Health Fund
2/24/2014	undisclosed	JP Morgan Chase	Syncora Guarantee
2/27/2014	122	Société Générale	FHFA
3/21/2014	885	Credit Suisse	FHFA
3/26/2014	9,300	Bank of America	FHFA
4/21/2014	undisclosed	UBS	Union Central Life Ins.
4/24/2014	280	Barclays	FHFA
4/29/2014	110	First Horizon	FHFA
6/19/2014	100	RBS	FHFA
7/14/2014	7,000	Citigroup	DOJ & various states
7/24/2014	275	Morgan Stanley	SEC
7/31/2014	285	Citigroup	SEC
8/14/2014	undisclosed	RBS	Assured Guaranty
8/21/2014	16,650	Bank of America	DOJ & various states
8/22/2014	3,150	Goldman Sachs	FHFA
8/28/2014	undisclosed	Bank of America	National Integrity Life Ins.
9/8/2014	95	Morgan Stanley	pension funds
9/12/2014	550	HSBC	FHFA
11/17/2014	undisclosed	Bank of America	FDIC
11/12/2014	undisclosed	Citi	Schwab
12/18/2014	95	Morgan Stanley	class action
1/15/2015	459	various banks	FHLB San Francisco

Date	Amount (\$ Millions)	Defendant	Plaintiff
2/1/2015	500	JP Morgan Chase	retirement funds
2/6/2015	undisclosed	Goldman Sachs	life insurers
2/13/2015	235	Citigroup, Goldman Sachs, UBS	NJ Carpenters Health Fund
2/25/2015	2,600	Morgan Stanley	DOJ
3/26/2015	undisclosed	UBS	Capital Ventures Int'l
4/2/2015	undisclosed	Bank of America	BNP Paribas
4/27/2015	undisclosed	Bank of America	Prudential Securities
5/16/2015	806	Nomura	FHFA
6/26/2015	undisclosed	JPMorgan	Schwab
7/17/2015	388	JPMorgan	class action
8/13/2015	undisclosed	HSBC	Schwab
8/13/2015	272	Goldman Sachs	union pension funds
8/14/2015	undisclosed	Deutsche Bank	Mass Mutual
9/22/2015	undisclosed	Deutsche Bank	FHLB Des Moines
9/30/2015	undisclosed	Credit Suisse	Schwab
10/27/2015	325	Barclays	NCUA
10/27/2015	53	Wachovia Cap. Mkts.	NCUA
11/2/2015	undisclosed	First Tennessee Bank	Schwab
12/15/2015	undisclosed	Bank of America	Schwab
12/18/2015	225	Morgan Stanley	NCUA
1/14/2016	5,060	Goldman Sachs	DOJ
1/22/2016	63	various banks	Virginia
1/25/2016	995	JP Morgan Chase	Ambac
1/29/2016	63	Morgan Stanley	FDIC
2/11/2016	3,200	Morgan Stanley	DOJ and states ³

¹ Settled at the appeal stage after a decision at trial.² Reported as \$13 billion but included \$4 billion of previously announced settlement with the Federal Housing Finance Agency (FHFA).³ Reported as \$3.2 billion but includes \$2.6 billion of previously announced settlement with the U.S. Department of Justice (DOJ).

Federal Securities Claims

The federal securities laws generally provided less protection for investors who bought RMBS in the years before the financial crisis. The crux of the problem was the short timeframe for bringing lawsuits under those laws. By the time many investors figured out they had been misled and suffered losses, it was too late to pursue federal securities claims.

In theory, the most powerful provision for an injured investor to use for recovering losses would be Section 12 under the federal Securities Act of 1933. This provision allows an injured investor to rescind the purchase of the securities. But the longest deadline for suing under Section 12 is three years after the purchase. For investors who bought highly-rated, senior tranches of private-label offerings, it often took longer than three years for the performance of the underlying loans to deteriorate to the point where those securities became realistically vulnerable to losses. In most instances, the investors could not tell they should have started a Section 12 lawsuit until the deadline had already expired.

Today, years after the fact, some might assert investors should have commenced legal actions as soon as the performance of the loans backing their securities started to slide. But this view ignores the fact the highly-rated, senior tranches of private-label RMBS transactions were designed to withstand substantial deterioration in the performance of their underlying loans and still not suffer losses. Even though the performance deterioration on some subprime loans started to emerge in 2007,⁴³ the impact on senior tranches did not become apparent until years later.

Apart from Section 12, the federal securities laws include other provisions theoretically offering remedies. However, those provisions are usually less useful to RMBS investors. Most importantly, they generally provide for limited damages rather than rescission of the sale. In addition, some of the other provisions require difficult elements of proof, such as intent to defraud (“scienter” in legal terminology).

Ultimately, most investors who sued used either state “blue sky” laws or common law principles such as fraud or breach of contract. They did not use the federal securities laws. An important exception, however, was the Federal Housing Finance Agency (FHFA). The FHFA successfully pursued claims under the federal securities laws against many defendants. (See Exhibit 1.) Unlike other investors, the FHFA has the benefit of a special law (12 U.S.C. § 4617(b)(12)) giving it more time to start legal proceedings.

To make the federal securities laws effective in protecting RMBS investors, the U.S. Congress could extend the deadline for bringing claims. For example, Congress could amend Section 13 of the federal Securities Act of 1933 to provide a 10-year deadline. An amendment to Section 13 might read as follows:

SEC. 13. (a) For any security other than an asset-backed security (as that term is defined in section 3(a)(79) of the Securities Exchange Act of 1934) or a mortgage related security (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934), no action shall be maintained to enforce any liability created under section 11 or section

⁴³ Performance deterioration followed later on prime-quality loans and on so-called alt-A loans.

Strengthening Private-Label RMBS Investor Protections

12(a)(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence, or, if the action is to enforce a liability created under section 12(a)(1), unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section 11 or section 12(a)(1) more than three years after the security was bona fide offered to the public, or under section 12(a)(2) more than three years after the sale.

(b) For an asset-backed security (as that term is defined in section 3(a)(79) of the Securities Exchange Act of 1934) or a mortgage related security (as that term is defined in section 3(a)(41) of the Securities Exchange Act of 1934), no action shall be maintained to enforce any liability created under section 12(a)(1), unless brought within one year after the violation upon which it is based. In no event shall any action be brought to enforce a liability created under section 11 or section 12(a)(1) more than ten years after the security was bona fide offered to the public, or under section 12(a)(2) more than ten years after the sale.

Congress could potentially address the losses already suffered by private-label RMBS investors by making such an amendment retroactive with respect to all RMBS issued after Jan. 1, 2005. Unless Congress extends the deadline for bringing lawsuits under the federal securities laws, those laws are likely to remain largely ineffective in protecting investors.

Contractual Representations and Warranties

In contrast to claims under the federal securities laws, claims based on contractual representations and warranties provided a more fruitful avenue through which injured RMBS investors could recover some of their losses. A typical RMBS deal includes contractual representations and warranties by the issuer about the characteristics of underlying loans. If a loan does not comply with the representations and warranties, then the issuer must either repurchase it or replace it with a substitute loan that does comply. When issuers refused to repurchase or replace defective loans, investors sued. As noted in an earlier section, the lawsuits came to be known as “put-back” cases because the investors were “putting the loans back” to the issuer.

Although put-back cases worked for many investors, their effectiveness in the future may be diminished. Before the financial crisis (and until quite recently), most market participants viewed the representations and warranties in a private-label RMBS transaction as lasting for its entire life. Namely, the issuer would be obligated to repurchase or replace a defective loan regardless of when the defect was discovered, even decades after the transaction’s inception. However, a recent decision by New York’s highest court nullified that view. In *ACE Securities Corp. v. DB Structured Products*, 25 N.Y.3d 581 (2015), the New York Court of Appeals ruled the deadline for bringing a lawsuit on a transaction’s representations and warranties is six years after its closing date (i.e., the date the contracts are signed). That deadline applies even if an

investor does not discover a breach of representations and warranties until after the six years have passed.

The *ACE Securities* decision is important for investors across the whole country because the documents for private-label RMBS generally specify New York law as the governing law. Since the *ACE Securities* decision, a number of investor cases have been dismissed for having missed the six-year deadline.

As it now stands, the *ACE Securities* decision may impede a revival of new private-label RMBS issuance. A key role of a transaction's representations and warranties is to reduce or eliminate the need for in-depth, pre-closing reviews of each underlying mortgage loan. This makes the process of executing the transaction more efficient. Investors have been willing to accept the risk of unidentified defective loans (i.e., those breaching representations and warranties) partly because life-of-deal representations and warranties have given them the chance to put defective loans back at a later date.

Economic cycles and real estate bubbles are a key driver of mortgage loan defaults. Defects in loans may remain concealed during good times but reveal themselves—via defaults—during hard times. If a private-label RMBS had life-of-deal representations and warranties, the issuer would be required to repurchase or replace defaulting loans which are defective, while non-defective loans would remain in the deal and their associated losses would be borne by the investors. Only defaulted loans would need to be checked for compliance with the representations and warranties. There would be no need to check whether performing loans comply. This would keep the cost of loan reviews—and the cost of doing deals—low enough to be economical.

By contrast, without representations and warranties lasting for a transaction's whole lifetime, investors may demand full reviews of all of an RMBS's underlying loans before closing. The expense could make such transactions uneconomical for issuers.

New York's legislature could reverse the *Ace Securities* decision. It might do so by adding a new subsection (e) to section 206 of the state's Civil Practice Law & Rules (CPLR):

(e) Based on breach of contractual representations and warranties in connection with sale of securities. In an action based upon a breach of contractual representations and warranties in connection with the sale of securities, the time within which the action must be commenced shall be computed from the time the person injured shall have discovered the facts constituting the breach.

Such an amendment to CPLR § 206 would change the calculation of the deadline from a "time of breach" approach to a "time of discovery" approach. The debate between "time of breach"

and “time of discovery” rules for New York’s statutes of limitations has been going on for a long time. Over the years, the legislature has adopted special “time of discovery” rules for certain types of lawsuits, such as actions by victims of toxic torts (CPLR § 214-c) or by Vietnam War veterans exposed to Agent Orange (CPLR § 214-b).⁴⁴ It may be time to extend similar protection to investors.

Strengthening Investor Protections Conclusion

Private-label RMBS have an important role alongside mortgage-backed securities issued by Ginnie Mae, Fannie Mae and Freddie Mac in funding residential mortgage loans. Securitization provides funding for two-thirds of the nation’s residential mortgage loans. The private-label securitization market functioned well and without apparent abuses from their inception in 1984 until the pre-crisis housing bubble (roughly 2003–2007, with the benefit of hindsight). The willingness or ability of banks to fund non-conforming mortgage loans⁴⁵ on their balance sheets is unlikely to last forever. Therefore, the revival of the private-label securitization sector is a matter of national interest.

⁴⁴ Mandery, M. *New York County Supreme Court Refuses to Apply Discovery Rule to Case Brought by Victim of Childhood Sexual Abuse After Expiration of Statute of Limitations*, 66 St. John's L. Rev 235 (2012) (<http://scholarship.law.stjohns.edu/lawreview/vol66/iss1/10>); see also White, S.L., *Toward a Time of Discovery Rule for the Statute of Limitations in Latent Injury Cases in New York*, 13 Fordham J. of Urban L. 113 (1984) (<http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1251&context=ulj>); Cioffi J. and Serritella, J.R., *When Is It Too Late for Investors to Bring RMBS-Related Claims?*, Banking L. J. (www.dqlaw.com/images_user/newsalerts/Cioffi_RMBS_Related_Claims.pdf).

⁴⁵ A non-conforming mortgage loan is one that does not meet the eligibility criteria of Ginnie Mae, Fannie Mae or Freddie Mac.

Transparency and Private-Label RMBS

By Richard Field, Director, Institute for Financial Transparency

Introduction

Despite investors' incentive to chase yield encouraged by the Federal Reserve's zero interest rate policies pursued since 2008, the market for private label mortgage-backed securities has not really thawed. The main reason is the lack of transparency in the market. The financial crisis showed investors buying opaque structured finance securities based on public credit ratings and/or originator representations could result in significant losses. As a result, investors effectively went on a buyers' strike in 2008 which should not end until there is true transparency in the RMBS market. While there has been a significant amount of activity surrounding disclosure for structured finance securities, these securities still remain as opaque as they were in the run-up to the financial crisis.

The Nature of Transparency

Transparency has two components: 1) "what" is disclosed; and 2) "when" is it disclosed. It was shown by this author in the 2012 CIPR housing finance study,⁴⁶ using a simple model of a brown paper bag and a clear plastic bag, it was in fact the "when" the disclosure was made that was necessary to restart the private-label RMBS market. Ending the opacity of these securities requires the reporting of observable events involving the underlying assets when they actually occur. Regrettably, this type of asset level reporting is still not made available to investors keeping the market effectively frozen.

Frozen in Time

Why has there not been legislation to bring transparency to structured finance securities? The federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) represents the best efforts of the U.S. Congress at restarting the private-label RMBS market. Recognizing the absence of trust in these opaque securities, the U.S. Congress adopted the concept of "skin in the game." The assumption behind this concept is issuers will be less likely to offer potentially toxic securities if they are in line to suffer losses too. Unfortunately, this assumption neglects the simple fact issuers could generate sufficient profits originating the underlying assets and selling the structured securities even with a 100% loss on their retained interest in the deals.

⁴⁶ Dimitris Karapiperis, 2012. "Financing Home Ownership: Origins and Evolution of Mortgage Securitization, Public Policy, Financial Innovations and Crises" National Association of Insurance Commissioners (NAIC) Center for Insurance Policy and Research (CIPR), August 2012, www.naic.org/documents/cipr_120812_white_paper_financing_home_ownership.pdf.

Why has there not been new regulation to bring transparency to structured finance securities? Clearly Regulation AB, the regulation covering disclosure requirements for structured finance securities, failed as it allowed opaque subprime mortgage-backed securities to be sold in the run-up to the financial crisis. Since 2012, the U.S. Securities and Exchange Commission (SEC) has rolled out a revised Regulation AB. Under this revised regulation, the opaque, toxic subprime mortgage-backed securities of 2007 and 2008 could still have been issued. The only change in these securities would be the use of a standardized disclosure format. Enough time has passed to show the revised regulation has also failed to restart the market. Predictably, it failed because it does not address the “when” of transparency and require disclosure on an observable event basis.

Why has then collecting, standardizing and disseminating the underlying asset performance data in a data warehouse not restarted the market? Unless the data is available on an observable event basis, RMBS transactions are still opaque. In the European Union (EU), a data warehouse was created under the auspices of the European Central Bank (ECB).⁴⁷ This has not restarted the market. In the U.S., Fannie Mae and Freddie Mac are jointly developing a data warehouse, the Common Securitization Platform (CSP).⁴⁸ Although it will not be launched until 2018, its future success is not guaranteed given the experience of the European data warehouse. The CSP does not provide investors with the observable event-based reporting they need so they have the transparency necessary to know what they actually holding in their portfolios.

Why have portfolio managers on the buy-side not demanded observable event-based reporting for structured finance securities? The obvious answer is they have an inherent conflict of interest preventing them from demanding transparency. Their conflict of interest reflects the simple fact their function is dependent on their claiming to have access to all the information necessary to effectively manage a portfolio of these opaque securities. Admitting they do not have the necessary data to know what they own is the equivalent of confessing to blindly betting with either their employers’ money or the investors’ money and putting their jobs and careers in jeopardy.

Upton Sinclair observed, “It is hard to make a man see something when his very job depends on his not seeing it.” In asset management, this observation must be modified. When applied to portfolio managers, no single person has better X-ray vision than a person whose job depends on being able to see and value the contents hidden inside a brown paper bag.

⁴⁷ https://eurodw.eu/wp-content/uploads/Kanoni_Schaber_EuropeanDataWarehouse.pdf

⁴⁸ <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Details-Plans-and-Timelines-for-the-SS-and-CSP.aspx>

Transparency Label

So has anything positive occurred since the Center for Insurance Policy and Research (CIPR) RMBS study was published in 2012 to bring transparency to structured finance? The answer is yes.

Under the leadership of the Institute for Financial Transparency (IFT), the Transparency Label Initiative (TLI) has begun operations. This buy-side funded TLI will award labels to securities which provide sufficient disclosure so investors can know what they own or are thinking of buying. Securities without the label are by definition opaque, and buying or selling these securities is nothing more than blindly wagering on the contents of a brown paper bag.

Of course having a transparency label should not automatically mean investing in a security is a good idea and should not function as an investment advice or recommendation. The transparency label simply indicates the security provides sufficient disclosure so an investor could find out if making an investment is advisable or not.

Also, having a transparency label does not mean a security is a low-risk investment. A security with a label could easily be a very risky investment. The existence of the transparency label simply indicates the disclosures associated with the security are sufficient so investors could know what they own or are thinking of buying. A key part of knowing what you own or are thinking of buying is the ability to assess the risk of the security. When a security has a transparency label, an investor and/or experts hired by the investor have access to the necessary information to do their due diligence and assess the risk of the security.

The existence of a transparency label should directly affect security purchases. From the investors' perspective, the existence of the label changes how they allocate their investment portfolios. Investors can be expected to invest primarily where there is a security with a label so they can know what they own or to allocate towards managers who are restricted to only investing where there is a label. Why will this allocation occur? There is no good reason to allocate a sizable percentage of the investors' assets to blind bets. If the investor is a pension fund, endowment or foundation, there is no good reason to allocate any of their assets to blind bets. If the investors are regulated financial institutions, they also may allocate most of their investments to securities with a label as regulations could place restrictions on how much or what proportion of their investment portfolio is exposed to securities without a transparency label. It will also change the disclosures and behaviors of investors' portfolio managers. Going forward, these managers will disclose whether they are restricted to investing only where there is a label or if they can blindly speculate with the investors' money.

Why will issuers provide sufficient disclosure so their securities receive a label? The absence of a label greatly reduces the number of buyers for and increases the cost of an issuer's securities. For issuers with securities which do not receive a label, the only buyers will become investors who are willing to take unnecessary risks. This reduces the number of potential buyers, as there simply are not as many speculators as investors. In addition, when it is only speculators buying an issuer's securities, there is a substantial increase in the issuer's cost as the issuer has to offer much more attractive terms to attract speculators to essentially bet on the issuer's securities. Avoiding cost increases offers issuers ample incentive to provide the high level of transparency necessary to be awarded a label.

Study Conclusion

By Dimitris Karapiperis, Research Analyst, NAIC Center for Insurance Policy and Research and Eric Kolchinsky, Director, NAIC Structured Securities Group

In this study, the authors picked up from where the 2012 Center for Insurance Policy and Research (CIPR) study left off with the private-label residential mortgage-backed securities (RMBS) market still in the doldrums four years later. As securitization has since bounced back in most other asset classes, the key question the study attempted to answer is why the experience of the residential mortgage securitization market has been so dramatically different. Even more importantly, the study detailed how state insurance regulators, along with the National Association of Insurance Commissioners (NAIC), have effectively responded to regulatory challenges presented by the RMBS market. Early on after the crisis hit, the NAIC Structured Securities Group (SSG) underlined the critical importance of data accuracy, appropriate collateral recording and compliance, and adequate transaction and legal arrangement in the credit evaluation of private-label RMBS held by the insurance industry.

The mass downgrades during the global financial crisis and the loss of market confidence on RMBS credit ratings highlighted the need for an alternative approach allowing a more effective valuation of the private-label RMBS in insurers' portfolios. The methodology NAIC SSG developed has allowed for a more robust and regulatory-centered assessment of private-label RMBS credit quality producing NAIC designations used to calculate insurers' capital requirements that more accurately reflect assumed risks.

The sections authored by NAIC SSG members described the philosophical and operational process the NAIC SSG follows to analyze private-label RMBS and how this process has changed over the last six years.

The virtual tour through the four analytical steps of the financial modeling process, the macroeconomic model, the credit model, the waterfall and the valuation provided an inside look at how the NAIC SSG analysis examines each private-label RMBS transaction's structure, focusing on its past as well as expected performance. The analysis is distilled to a valuation which produces an NAIC designation based on insurers' individual positions.

A breakdown of the current residential mortgage market was presented highlighting the continuing dominance of the federal and related agencies, which accounted for a whopping 62% of the total outstanding mortgage debt at the end of 2015. The need to transfer at least a part of the massive risk ultimately borne by the taxpayers motivated the government-sponsored enterprises (GSEs) to develop and use several credit risk transfer products. The

Study Conclusion

structure of these transactions was explored, as well as how they are treated by the NAIC for accounting purposes when they are held by insurance companies.

Resecuritization of legacy RMBS was also discussed as a way to enhance the appeal of private-label securitization for investors and a significant source of post-crisis volume in the private-label RMBS market. Another RMBS asset type which has contributed to the post-crisis volume growth is a class of seasoned nonperforming or reperforming mortgage loans as a result of modifications or self-curing from serious delinquency.

Although insurers' holdings of private-label RMBS have gradually declined over the past six years, the insurance industry still remains an important institutional investor in the RMBS market with \$124.6 billion (par value) as of the end of 2015. In a section dedicated to an overview of insurers' private-label RMBS investments, it was shown how the mass downgrades of RMBS at the height of the 2008 global financial crisis affected insurers' portfolios and how the decision to transition to the new financial modeling process improved NAIC designations and produced more accurate reserves as a result.

The insights offered by the authors of the study add an important contribution to the ongoing discussion among all market participants about what steps and measures need to be taken in order to avoid past mistakes and help revive the private-label RMBS market.

The need to bring investors back to the private-label market is crucial for improving housing availability, as well as affordability. However, investors will return only if criteria such as certainty, transparency, uniformity, enforcement and recourse which can improve the functioning of capital markets for RMBS are agreed upon by issuers and investors and they are actually enforced. The Association of Mortgage Investors (AMI) believes investors would return to the RMBS market if:

- Congress helps establish the necessary systems, structures and standards for private capital to return;
- Congress should put a single regulator with appropriate experience in charge of all mortgage-backed securities, who can work with the Consumer Fraud Protection Bureau (CFPB) to ensure mortgage servicing standards address the needs of investors, as well as homeowners;
- Congress enables a single national database of mortgages to track, validate and clarify mortgage loan ownership;
- Congress establishes a single national uniform foreclosure law to govern enforcement of security interests in real property;
- Congress encourages private-sector competition and creates clear "rules of the road" so the mortgage market is restored;

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- The government sells its stake in genuinely transformed GSEs into the capital markets and gets taxpayers paid back;
- The market is transparent, has non-conflicted stakeholders and enjoys the full protection of contract law;
- RMBS have simplified pool and governance structures and effective supervision of trustees and servicers; and
- Better credit ratings based on the same detailed data investors should receive and updated continuously over time are available to all investors.

Furthermore, the AMI believes the government's role in the capital markets should be to:

- Support healthy and efficient securitization and mortgage finance markets, with additional information made more widely available to participants, regulators and observers;
- Incentivize positive economic behavior among market participants; and
- Reduce information asymmetries distorting markets.

Given the often divergent interests of private-label RMBS market participants, a number of key players involved in the Structure Finance Industry Group's (SFIG) RMBS 3.0 initiative strive to:

- Create standardization where possible reflecting widely agreed upon best practices and procedures;
- Clarify differences in alternative standards to improve transparency across all RMBS transactions;
- Develop new solutions to problems impeding the emergence of a sustainable and scalable RMBS market; and
- Draft or endorse model contractual provisions or alternative "benchmark" structural approaches, where appropriate, to reflect the foregoing.

It has become clear, the revival of the market for private-label RMBS depends on investors regaining confidence and trust they have meaningful and enforceable protections. Investors who had bought private-label RMBS before the crisis realized later when they sought to bring lawsuits against issuers in order to recover their losses they needed more strengthened legal protections. While some achieved a measure of success, the lawsuits demonstrated more adequate legal protections need to be provided under the federal securities laws, as well as the contractual representations and warranties of all private-label transactions for investors to return.

The study also showed the need for transparency is at the center of all the efforts to reinvigorate the private-label RMBS market as the financial crisis taught investors that buying

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opaque structured finance securities based on ratings and/or originator representations could result in heavy losses. Among the solutions considered to provide the market with the much needed transparency is the establishment of a label awarded exclusively to securities providing sufficient disclosure to investors to inform their investment decisions.

The experience of both the SFIG RMBS 3.0 initiative and the U.S. Department of the Treasury's reform efforts as well as the list of demands made by investors makes abundantly clear the fact all parties in the private-label securitization market must arrive at a consensus on at least a set of minimum accepted standards if a next-generation private-label RMBS and a healthy and a strong market is to emerge.

The CIPR thanks the contributing authors to this important study, as well as the readers. We express the sincere hope this study met the readers' needs and stimulated their thinking as to what steps need to be taken by issuers, investors, policymakers and other stakeholders in order to successfully reinvigorate the private-label market.

As documented in the study, there are several ideas about how to best accomplish the task at hand. The financial modeling efforts of the NAIC SSG are clearly an improvement of the prior reliance on credit rating agency ratings. There is general agreement continued lack of transparency and enforceable contract standards contribute to the problem.⁴⁹ Some believe a Congressional solution is warranted. Other would rely on the innovation in the private markets to drive change.⁵⁰

⁴⁹ Association of Mortgage Investors <http://the-ami.org/> and Mark Adelson <http://www.markadelson.com/>

⁵⁰ Institute for Financial Transparency <http://instituteforfinancialtransparency.com/> and Marketcore <http://www.marketcore.com/>



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