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Mortgage Securitization 426 Working Paper: Is it an Insurance Product?

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Securitization 426 Working Paper: Is it an Insurance Product?

Question: Does the process of Residential Mortgage asset backed securitization create an insurance product? Are commercial banks and investment banks who originate loans in Connecticut liable for insurance reporting and income tax payments to the State of Connecticut? Has it been a fraud on Connecticut consumers not to have been disclosed that they were participating in a conflicted insurance instrument that would arbitrarily lock them into paying high interest rates and record margins to retail banks? A discussion with a Connecticut Insurance Examiner initiated via its on-line complaint process is posted below.

Edited Version:

Abstract: This discussion highlights informed interaction between two knowledgeable parties about whether the residential mortgage asset backed securitization process involves the creation of an insurance product. Although an initial conclusion reached by an Insurance Examiner that it is not “insurance,” that same Examiner opened the door that it could be viewed as “insurance.” If it is determined that insurance is involved, the obligation to collect taxes falls onto the Connecticut State Department of Revenue Services, the requirement to collect balance sheets falls onto the Insurance Department, and the decision to prosecute originators for perpetuating a fraud on bank loan consumers falls to the Attorney General and to individual consumers. If a decision to enforce current law is made, an informed projection suggests that the potential revenue to the State of Connecticut is in the multiple billions of dollars. Consumers could also have their excess payments reimbursed to them by the banks. It is expected that both the commercial and investment banking industries will strongly object to the interpretation of facts as outlined in this interaction. As such, it is expected that it will be a political decision that will determine the course of action taken and that this political decision will balance the collected revenue potential against the cost to the banking industry and the cost to Connecticut residents and homeowners who are currently paying excess revenues to the banking industry. The insurance question only addresses a part of the consumer fraud perpetuated by commercial banks. Conclusions reached in Connecticut can be applied in all 50 States.

Highlighted as blue font, the text below largely quotes or paraphrases original informal comments made by a Senior Examiner from the Connecticut Insurance Department. The comments in black font provide answers/scenarios to the Insurance Department’s statements by a Complainer so that the reader can reach their own conclusion about the implication.

Insurance Department Preamble: “Since you raised theoretical issues regarding the treatment of asset backed securities as insurance, I've asked others in the Insurance Department to provide assistance including our legal division. Please be mindful that the legal division cannot provide you with legal advice since their duties only extend to providing legal advice to personnel within the Insurance Department on Insurance Department matters. With that in mind, we will attempt to provide you with some information although we are unable to provide answers to each question you raise below.
You will need to retain your own counsel for specific answers and the pursuit of available remedies whether that is for yourself or on behalf of all CT citizens.”

The Law: Under CT law (Day v. Walsh, 132 Conn. 5 (1945), there are five elements that distinguish a policy of insurance from other similar contracts:

"(a) The insured possesses an interest of some kind susceptible of pecuniary estimation, known as an insurable interest [for example, the value of a house or a car that is insured in the property insurance context].

(b) The insured is subject to a risk of loss through the destruction or impairment of that interest by the happening of designated perils.

(c) The insurer assumes that risk of loss.

(d) Such assumption is part of a general scheme to distribute actual losses among a large group of persons bearing similar risks.

(e) As consideration for the insurer's promise, the insured makes a ratable contribution to a general insurance fund, called a premium.

A contract possessing only the three elements first named is a risk-shifting device, but not a contract of insurance, which is a risk-distributing device; but, if it possesses the other two as well, it is a contract of insurance, whatever be its name or its form."

Comments by the Complainer

(a): “Who is the Insured?” In the case of a transaction that involves a residential mortgage backed security, the “insured” is the originating bank that interacts with the homeowner/consumer to provide them the “interest rate cost” and “principal advance” associated with the loan that is made to that consumer. The insured has much data that allowed him to accurately estimate the pecuniary cost of his insurable interest. The “insured” benefits from both a risk-shifting device and a risk-distribution device that is an absolute pre-condition for the whole residential mortgage backed securitization process to operate as intended.

(b): “Risk of Loss?” The insured is subject to a risk of loss when the designated peril of non-payment by a homeowner occurs. The insured – i.e. the originating bank - suffers a risk of loss from any homeowners’ non-payment. The insured suffers the loss because of the requirement that the insured repurchase any initiated loan before initiating debt collection and foreclosure proceedings against a homeowner/consumer. The insured is instructed to collect on the debt by its signature to the Pooling & Service Agreement. The originating bank is the only licensed party, via its bank charter, permitted to interact with the homeowner/consumer (The accredited institutional tranche investor has no such “permission” or “license”). The originating bank has this obligation despite having sold the underlying mortgage note and lien to a Special Purpose Vehicle in accordance with recognized accounting principles and tax regulation.
(c) “Who assumes the risk of loss?” The uncapitalized Special Purpose Vehicle assumes the risk of loss by both the non-payment of its fees and by not paying all monies as initially intended to the tranche investors if homeowners are not current on their mortgage payments. The tranche investors benefiting from the lowest payment priority act as reinsurers, initially agreeing not to accept the total sums due to them. During the claims adjustment process, however, the instructions from this “low priority reinsurer” instructs the originating bank to foreclose on the property associated with the defaulting mortgage. The “low priority reinsurer” than begins to rely on its own “reinsurance agreement” with the originating bank. For the benefit of the “Tranche Investors” as a group, the originating bank agrees to purchase the defaulting mortgage for its full principal value, effectively making it an ultimate reinsurer of all of its own defaulting transactions (without accepting the original “timing risk” which remains with the tranche investors). The originating bank assumes the risk of principal loss by promising, via its executed Pooling & Servicing Agreement, to diligently enforce collection on a mortgage note which it ultimately can only do as an owner of the mortgage note and lien which it must purchase back from the Special Purpose Vehicle to whom it was sold in the first place.

In summary, the insurer is the Special Purpose Vehicle. It accepts significant “cashflow receipt-timing-risk” the cost of which it transfers to various tranche investors via a cashflow investment agreement. The first “reinsurer” is the “low priority tranche investor.” The other tranche investors are “excess-of-loss reinsurers.” After the passage of time, the ultimate excess-of-loss reinsurer is the originating bank that is required to get involved to collect on the debt as a principal owner of the Promissory Note.

(d) “Distributing actual losses?” Financial losses often have to do with timing associated with the receipt of cash payments. It is all part of a scheme to distribute actual losses among a large group of persons bearing similar risks. The concept associated with residential mortgage backed securities is ultimately to distribute the timing risk otherwise accepted by each insurer and reinsurer. It additionally distributes the risk of loss among the millions of ultimate clients represented by the tranche investors, ultimately landing back on the higher costs/premiums paid by all the mortgage homeowner/borrowers. The tranche investors and the originating bank benefit from the receipt of: a) the increased certainty of cash flow (by the bank, and especially towards the case of Tranche “A” or “B” investors1), and; b) the higher yielding effective “interest” they perceive themselves to be receiving (for the Tranche “C” investors). The ultimate structure, of course, has the homeowner/consumers paying the premium in the form of excess interest costs paid to Servicing Agents. The Servicing Agents ultimately is paid the same way an insurance broker is paid via their receipt of a “servicing fee” disclosed in the Pooling & Servicing Agreement.”

(e) “Premium payments?” The insurer’s promise is that the homeowner/consumer is receiving the best available interest cost loan at the point in time that loan is originated based on a formula that involves an “agreed to margin” that is added to a “cost of funds.”

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The general insurance fund is the monthly cashflow collected via the Servicing Agent and paid to the Special Purpose Vehicle and distributed to tranche investors.

Only by its self-designated labeling authored by the originating bank’s counsel is this pool of money not deemed to be a “general insurance fund.”

**Number of Insurance Elements Involved:** It becomes a fine twist of the English language, something that we all understand that the banks will contest, but the ultimate reality that the banks would not participate in any business unless it were: a) part of a general scheme to distribute actual losses among a large group of persons bearing similar risks, and; b) they collected cashflow, as a ratable contribution, no matter what name they use to define whatever they collect. A close reading of Pooling & Servicing Agreements show how carefully the documents make declaratory statements about what the authors think they are doing and collecting versus what reality suggests that it is, insurance and premium.

**Insurance Department Initial Conclusion:** We do not believe that all five elements are found in securitization transactions and therefore, these investment products are not insurance. For example, there is no general scheme to distribute actual losses among a large group of persons bearing similar risks. In the event one group of investors take a loss through a default on the backed mortgages, there is no protection for their investment.

**Complainer’s Reaction:** The statements that is made above is only correct at the first superficial level at which these transactions are generally described (especially by the banks). The analysis that needs to take place is at the level of the “claim” and “loss mitigation” process, so that the “insurance” elements can be discovered. Items to note:

1) Mortgage backed securities are only risk shifting devices in the originating phase in that the risk of non-payment is actually shifted to Tranche “C” investors, which is fine as long as they take their losses and walk away. The surety insurance elements, however, immediately take over and control once the Servicing banks are asked to enforce claims against collateral. The homeowner/customers are unwittingly forced to pay excess premiums by: a) the enforcement of high interest rates on loans they are forced to pay because of arbitrary changes in underwriting standards imposed by originating banks, and; b) via the sale of primary residences to satisfy the taking encouraged by municipal town clerks that enforce the rules are financially conflicted via their retirement fund investments from applying actual current law and practice.

2) If the Insurance Department deems that only risk shifting is taking place than the Insurance Department is concluding that the originating bank would have no particular reason to enforce any defaulting mortgage or to initiate
foreclosure on anyone. The bank would not want to just be considered a “bad
guy.” The situation involves a risk-distribution device because the originating
bank is ultimately obligated to repurchase its originated loan minus the timing
risk. This conclusion would mean that the Insurance Department would be
saying that the originating bank’s representations to its auditors and to the
SEC are false in that the risk of exposure to the mortgage loan has not been
removed from the originating banks’ balance sheets. This would require all
banks involved in any form of residential mortgage backed securitization to
re-state their financial statements.

The process of residential mortgaged backed asset securitization is both a risk-
shifting and a risk-distributing device on multiple distinct parties or it cannot
be wholly removed from the bank originator’s balance sheet.

3) For perspective on the whole process, the financial interaction that result from
the exchanges between accredited tranche investors directing the activities of
bank Servicing Agents and homeowner/consumers is not supervised by any
regulatory agency. The OCC, the SEC, and no known Insurance Department
claims supervisory responsibility for the interaction between the homeowner/
consumer and the sophisticated Tranche investor. This ultimate reality about
residential mortgage asset backed securities constitutes the only product in the
US economic system that is not supervised or regulated by any guidance from
a regulatory agency. The involvement of “insurance” concepts associated
with residential mortgage back securities and the enforcement of claims
makes the Insurance Departments of all the States the most likely logical
regulator of these activities. The banks will do whatever they can to avoid
this designation.

**Insurance Department Comment:** In contrast, if an individual's house burns down, the
insurer is there to indemnify the insured and make them whole. In effect, the other
insured policyholders whose houses are not burned down bear similar risks and the
insurer is able to distribute that loss among the large group. There is no risk of loss
through destruction or impairment by the happening of designated perils and we are
unable to conclude that mortgage defaults, for example, are the types of designated perils
to which insurance would respond. (There is mortgage insurance to protect the lender in
the event of default but that is outside the topic of this discussion.) Investors in the pool
share in the revenue stream but are not protected in the event of a default by the
homeowner whose mortgage forms the securitization.

**Complainer’s Comment:** Again, the originating bank and the Tranche investor are
the beneficiaries of the insurance. It is the originating bank, the party that retains its role
as Servicing Agent (a role similar in function to that of an insurance broker), that both
creates the “insurance product,” collects the “premium,” and ultimately reinsures itself
minus certain timing risks. The originating bank ultimately has the only interaction with
the homeowner/consumer (No other entity has the license or authority to do so). It is the
originating bank, together with “their” investment banker, that bear the responsibility
associated with creating the Special Purpose Vehicle that is the non-reporting and non-premium tax paying insurance entity enabling the insurance product to exist. The originating bank is also a “reinsurer” to itself, after certain “timing risks” are insured out of the equation. The Tranche investor is also a beneficiary of the insurance. The Tranche investor can also be deemed to have contributed to the payment of the premium via the total amount of money, a total that is greater than the sum total amount of the homeowners’ total mortgages, to the Special Purpose Vehicle.

Leaving aside “mortgage insurance,” which is a separate product that is not a part of this equation, tranche investors are protected by events of default by the actions of enforcement against homeowners by the originating banks and those originating bank’s deployment of capital necessary to enforce those mortgage loan obligations. All the homeowner/consumers who participate in any securitized pool bear the similar risk of arbitrary treatment by the unregulated Servicing Agent who, in my opinion, arbitrarily makes up new underwriting rules and charges new premiums without regulatory supervision causing targeted harm to large classes of Connecticut consumers.

**Insurance Department Comment:** “We trust that you understand that the Insurance Department is attempting to be responsive to your various inquiries. However, we again reiterate that the above is intended to be informal advice and that you should seek your own independent counsel if you have further questions on this topic. We appreciate your raising these concerns about fairly complex security and insurance issues.”

**Complainer Comment:** “You have been most helpful and most responsive. I appreciate the informal advice.”

**A Final Note about The Moral Dilemma by the Complainer:** Banks operate with “bank charters” that involve the conveyance and receipt of a “public trust.” The backdoor involvement in the insurance product created by residential mortgage backed securitization and the manner in which banks’ corporate counsels define terms strives to avoid identifying these activities as insurance. The broader moral argument is shallow: the banks’ legalistic definitions do not trump the requirement and involvement of any regulatory agency in the specific review and control of the banks’ servicing roles in the management of the interaction between homeowner/consumers and sophisticated accredited investors who use the bank to front their enforcement actions. The banks’ attitude, especially those banks supervised by the Office of the Comptroller of the Currency, is not a service to the State economies that permit these banks to operate in their geographic territories. If it is deemed that the residential mortgage asset backed securitization process involves the creation of one or more insurance products, than at least Connecticut’s Insurance Department can influence the interaction between homeowners and the often misdirected attitude of commercial banks operating in Connecticut.
The original complaint:

NB: The highlighted sections are those questions to which the Complainer was seeking “yes” or “no” answers. It didn’t work.

My complaint is about the securitization process sponsored by Chase that creates an insurance product that circumvents: 1) insurance licensing and reporting requirements in Connecticut, and; 2) avoids the payment of premium taxes to Connecticut.

For my discussion, I’m going to assume the securitization of residential mortgages involves the bundling of 100 individually underwritten situations involving Promissory Notes and mortgage liens with assets located in Connecticut. This bundle is sold in exchange for cash to a Special Purpose Vehicle. The Special Purpose Vehicle, involving only assets from one State - but not necessarily headquartered in that State - engages itself to receive cash from that State’s homeowners via the actions of a bank regulated Servicer. The Special Purpose Vehicle divides the cash it receives into separate tranches, or priorities, based on an "investment agreement" (organized and controlled by a "Pooling & Servicing" agreement) with a sophisticated accredited investor.

This process of dividing cash flow received from many people into different priorities, in my opinion, is a form of insurance. (Do you agree?) The highest priority tranche investor benefits from the fact that the lower priority tranche investors agree to delay the receipt of their cash in the event of a non-payment by a household. The “insurable interest” is that investor's desire for the certainty of the cash flow. (Do you agree?) There is no transfer of ownership of the assets (the Promissory Notes and the mortgage liens) to the investor. The assets involve only assets that are originated in Connecticut and, in the event of non-payment by a household, causes interaction between a tranche investor (who has not received any insurance license) and a household. (This is just a fact but you could agree that no license has been issued?) In my opinion, the cash payments made to the Special Purpose Vehicle convert themselves from “interest & principal” payments into “premium” payments because of the manner in which the Special Purpose Vehicle pools the cash and prioritizes its outflow. (If you agree that insurance is involved and is this statement one with which you could agree? Or you could provide your own hypothesis?) The premium payment becomes a premium taxable event at that point when the cash payment is made by the household who, in theory, is benefiting from the better interest rate the lender makes available. (Again, this is the hypothesis we are using but you can develop your own). This procedure is organized/facilitated by the originating lender to avoid premium taxes, insurance reporting, and insurance registration requirements associated with the insurance process. It does this for its personal economic benefit.

Complainer’s attempt to bracket answers to his questions and to provide perspective:

Connecticut Homeowner’s Question: I seek a position statement from the Connecticut Insurance Department. Anything that answers the question is satisfactory. To make it simple for the department, the answer can range from "We do not believe that [the identified event] involves insurance, an insurance licensing requirement, a requirement to report as an insurance company, a requirement to pay insurance premium taxes...," or that it
does. I am also satisfied with any answer in-between. It is, of course, absolutely your choice.

Even beyond the simple Insurance question that I seek to have addressed, the fundamental issue at stake is that no regulatory agency has taken responsibility for the activity that results in harm to Connecticut residents. In all cases, the final scenario associated with the process of residential mortgaged backed asset securitization, is that a Connecticut resident who starts off with a "borrowing" relationship with a "regulated bank" ends up interacting with a 100% unregulated sophisticated accredited out-of-State investor whenever a dispute arises.

Another insurance examiner has stated that residential mortgage asset back securitization does not involve an "insurance" matter because no insurance organization is named in my complaint. I think this hard rule should not apply as I think that the securitization process specifically avoids designating itself as an insurance product strictly for the benefit of not reporting to State insurance departments and to avoid paying premium taxes. In my opinion, the local originator is actually reimbursed "premium" paid by a local homeowner as he pays his "interest payments." The local originator receives his "reimbursement of premium" in the form of the "servicing fee" they receive for acting as a conduit for the creation of the product that benefits from a product that looks, smells, and feels like an "insurance product." The benefits of that insurance product involves property located in Connecticut and citizens and businesses located in Connecticut. In my opinion, the delivery and the consumer interaction should therefore be regulated by something in Connecticut.

This is currently not happening.

My issue applies to any organization that originates or sells mortgage backed securitized transactions involving Connecticut beneficiaries.

**Technical Consideration:**

**When does “interest” become “premium”?** It won't be easy to identify when "interest" actually becomes "premium." I do not think that is the Insurance Department's concern. After each homeowner receives cash, the Insurance Department only needs to determine whether the cash sent to the Special Purpose Vehicle is "premium" because it is pooled and paid to investors based on different priorities. The Tranche "A" investors are buying cashflow certainty (an insurable interest) because the Special Purpose Vehicle pools the cash from all homeowners. It is the Special Purpose Vehicle that acts as an insurance company. It is the Special Purpose Vehicle that should be reporting, or should be licensed, because they are accepting "premium" from Connecticut homeowners.

The Insurance Department can claim all monies paid are premium. At worst, they can claim everything is "premium" above the banks cost of funds. (The OCC bank's cost of funds has been basically zero since November 2008).

The Connecticut homeowner who pays the premium is initially benefited from his
payment by being told that he was receiving a lower interest rate. The manner in which things turned out, however, Connecticut residents ended up paying much higher interest rates had this insurance not been part of the equation.

The process of asset securitization is a highly complex situation but it has an important impact on Connecticut consumers. There are multiple other issues that get raised but I believe that only this one that I highlight involves the question of insurance. I hope you will be able to give me answers to the question I again paste and highlight below.

Residential mortgage securitization stems from an industry that initially only involved surety bonds issued by AAA property/casualty companies in the 1980s on commercial situations. Investment bankers at that time took the commercial concepts and structured these residential securities to circumvent the hassle and cost of working with the regulated sureties around restrictions the insurance industry knew it still needed to address. Involvement in residential consumer situations were considered very different from those issues that needed to be addressed in sophisticated accredited commercial situations. The commercial banks, investment bankers, and their counsels were advised that whether or not they worked with the insurance industry, it did not change the nature that they were dealing with an insurance product.

I hope that you will eventually agree with me and that the State can be made to benefit from an interpretation that the residential mortgage backed asset securitization process involves the creation of at least one insurance regulated activity. Whatever you provide, whatever conclusion you reach, it will be helpful to the debate that must be resolved.

Caveat from Complainier: My interpretation is subject to adjustments via personal interpretation as to where an insurance activity actually starts and ends, especially as it relates to the consumer/client and the insurer.

I am not attempting to make anything purposefully difficult for the OCC banks. However, I understand the financial harm their actions have caused and continues to cause. I also know that Connecticut suffers. As such, I believe my remarks to the Connecticut Insurance Department’s informal remarks creates a platform where others may be able to decide whether they wish to collect the unpaid taxes, and enforce controls, so that all Connecticut citizens do not continue to suffer.

Based on this exchange, the Office of the Attorney General should be receiving two options depending on whether the Insurance Department deems "insurance" to exist. Under both conditions, based upon the interaction we have been able to have, I would think that it is the Insurance Department's role to communicate its conclusion, one way or the other, to our Connecticut Attorney General.

For perspective, I think the banks will be far more concerned if you determine finally that they are not involved in an insurance product. The consequences of not being treated as insurance suggests that for accounting purposes, the banks’ off-balance sheet treatment of originated loans does not meet the spirit of accounting standards that allow for their off-
balance sheet treatment. This would suggest that the statements reported to the banks’
auditors and to the SEC were false. The cost of the consequences of this on the banks’
capital allocation requirements and the stock market manipulation this would suggest will
seem much harsher to the banks than the financial consequences of insurance being
involved.

On the other hand, a decision that this process involves insurance will allow Connecticut’s
Department of Revenue services to collect back taxes and new revenues to fund those
social programs and our Connecticut Court System that is in current need of funds.