



Testimony Regarding Bond Insurance

Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services | United States House of Representatives
February 14, 2008

I would like to thank Chairman Kanjorski, Ranking Member Pryce and the other members of the Capital Markets Subcommittee of the House Financial Services Committee for allowing me to testify today.

My name is Eliot Spitzer and I am Governor of New York State.

In my testimony, I would like to discuss the bond insurance problem, why it is so severe, how we got here and why New York is so involved in trying to structure a resolution. New York State Insurance Superintendent Eric Dinallo will discuss in more detail how we have been dealing with the problem in the next panel.

We start with a fundamental question. How is it that problems, even serious problems, for a small group of relatively small companies conducting a relatively obscure business—insuring bonds—can have such a large impact on our entire economy?

And let's be clear, the problems of the bond insurers are spreading and threaten serious problems well beyond the financial markets. The problems in this market will affect many average Americans. It will affect the cost of college loans. It will affect museum budgets. It will affect state and local taxes.

Let me give you several examples of its far reaching impact:

It will affect the individual investors who own about two-thirds of the municipal bonds either directly or through mutual funds, a total of about \$1.6 trillion, most of which are insured. If all of the bond insurers lose their triple-A rating, the value of the insured muni bonds held by investors declines. This has already happened to some insured muni bonds. That means millions of average Americans who viewed them as a low-risk investment, have lost or potentially could lose money, even though the underlying bonds have not defaulted. Many of these investors have already stopped investing in municipal bonds, reducing demand. Since interest rates go up when demand goes down, borrowing costs have sky rocketed.

It will and has had an effect on governments that rely on the municipal bond industry to finance important capital projects. The result of a destabilized bond insurance market is that some governments, already facing reduced income due to the slowing economy, will have higher borrowing costs. That means shifting funds from schools and police to pay interest.

Faced with higher borrowing costs, many governments have put off issuing bonds. At a time when the economy is weak, we do not want to slow the pace of capital construction by the public sector.

Bond insurance is particularly important for small towns and rural communities. They need it to put their bonds on an equal footing with large state authorities and big cities.

If they cannot obtain bond insurance or have to pay a higher price for it, it will likely cost them more to borrow the funds they need for important capital projects. Again, that will mean delay or cancellation of important capital construction, or increases in taxes or fees that pay for these bonds, or less money for vital services.

Another impact has been on the market for auction rate securities which governments use to finance debt.

Auction rate securities are an example of the financial creativity that makes New York the financial capital of the world. They are a way to borrow long term while paying lower short term interest rates. The interest rate on the bond is set weekly or monthly through an auction. But recently many of those auctions have failed, meaning there were not enough buyers. On Tuesday alone I am told at least 100 auctions failed.

New York State has about \$4 billion of these securities outstanding. Auctions for our securities are among those that have failed. This has nothing to do with the creditworthiness of the State. The risk of default on a bond backed by any State is virtually non-existent and certainly has never occurred in New York.

The Port Authority of New York and New Jersey, an extremely solid institution, was paying four percent on its auction rate bonds. It is now paying 20 percent. Though it is only paying that rate for a very short time, that is a rate that would normally only be paid by a very risky borrower.

The higher costs have nothing to do with our ability to pay, which is unchanged and solid. It is in good part because of questions about the ratings of the bond insurers and the other effects of the subprime crisis.

And we are all well aware that this crisis has also had an enormous impact on our financial institutions. The write downs and losses that large financial institutions are taking on collateralized mortgage securities related to subprime mortgages are significant. To date, banks and investment banks have had to recognize more than \$100 billion in losses and give up substantial amounts of ownership equity to gain infusions of capital, often from foreign investors.

There is a general tightening of credit, which means less money available for companies to borrow so they can expand and consumers to borrow so they can buy homes, cars, appliances and other goods. This comes at a time when the economy is already weak.

In sum, if we do not take effective action, this could be a financial tsunami that causes substantial damage throughout our economy.

So how did we get here?

It is worth remembering that the issue we are discussing is a result of a series of decisions and actions or inactions that begin with the broader subprime mortgage crisis. It also highlights that at each stage of the subprime mortgage transaction structure, there were missed opportunities to identify and avoid this risk.

So let's look at each step of the process.

The first step and the cornerstone of this problem is the mortgage brokers, property appraisers and lenders who reduced their standards—and in some cases threw out any standards—and issued millions of mortgages to borrowers who could not afford them. Since most of these mortgages

had very low introductory teaser rates, it was possible for a time to avoid the fact that the borrowers could not afford them, though not for very long.

Now as teaser rates reset, many of those home buyers find they cannot afford the rising adjustable rate payments on homes that are not worth as much as they borrowed. Some are not making mortgage payments, leading to a spike in foreclosures. In addition, the lenders that hold the loans find diminished and sometimes inadequate collateral value as the real estate market continues to decline.

This is causing serious problems around my state and around the country. Hard working people are losing their homes. The growing numbers of vacant houses in communities further reduces home values and impacts the quality of life. This has led to a cascading effect, driving home values down nationwide.

We still do not know how many will ultimately be unable or unwilling to pay, but it is clear that the numbers are quite high. Some estimates are that for some pools of subprime mortgages, as many as one in four or more will default.

Clearly, we would not be here today if the mortgage brokers and lenders and appraisers had maintained reasonable standards. But we would also not be here today if the relevant regulators had stopped these bad lending practices.

The fact is, there were attempts to prevent the bad lending practices early on, before most of the damage was done. Several years ago, state attorneys general and others involved in consumer protection began to notice a marked increase in a wide-range of predatory lending practices by mortgage lenders, including misrepresenting the terms of loans, making loans without regard to the consumer's ability to repay, making loans with deceptive teaser rates that later ballooned astronomically, packing loans with undisclosed charges and fees, paying illegal kickbacks, and other similar practices. These practices were having a devastating effect on home buyers. In addition, we believed at the time that if left unchecked, the widespread nature of these practices threatened to have serious consequences on our financial markets. Little did we know quite how severe.

Individually, and together, state attorneys general of both parties brought litigation or entered into settlements with many subprime lenders who were engaged in predatory lending practices. State legislatures, including New York's, enacted laws aimed at curbing such practices.

But those efforts by States to protect consumers and capital markets were blocked by the Bush Administration. The Office of the Comptroller of the Currency, the federal agency responsible for regulating federally chartered banks, intervened to prevent any effective regulation at the local level. The OCC invoked a clause from the 1863 National Bank Act to issue formal opinions preempting state predatory lending laws, thereby rendering them inoperative to nationally chartered banks. The OCC also promulgated new rules that prevented states from enforcing any consumer protection laws against national banks. Clearly the OCC was unable or unwilling to take action at the federal level. Remarkably, the OCC acted to preempt State efforts to halt predatory practices but did little to address these serious problems.

The OCC was more than happy to allow the problem to grow and the bubble to inflate.

The best way to stop the subprime mess would have been at step one, at the point of loan origination, before the vast reservoir of bad debt was created. It didn't happen.

Now let's look at step two in the process, which is securitization. Those subprime mortgages were then homogenized, that is, packaged into increasingly complex structured securities, like the CDOs, that we are now reading about. Now there is nothing inherently wrong with securitization. Indeed it has had an enormous upside for the market place and has been done for years with no problems. On the other hand, securitizing bad loans does not make them good loans. Or, to use the relevant cliché: garbage in, garbage out.

The investment banks securitized and marketed enormous volumes of debt as rock solid credits. Federal regulators could have and should have but did not stop the poor underwriting practices of the investment banks.

Now step three. These securities were then given top credit ratings by the rating agencies, making them appear once again to be a safe and nearly risk free investments. The rating agencies simply failed to properly understand the risk of the debt that was coursing through the marketplace. I think we would now all accept that greater scrutiny and oversight of the rating agencies by the S.E.C. was called for.

Then, step four. The subprime structured securities were provided with insurance by the bond insurance companies, making them appear even safer. The bond insurers should have and could have done a more independent and better evaluation of risk and refused to provide insurance. The bond insurance companies began as companies which provided only insurance on bonds, hence the term monoline insurer. That portion of their business is still quite significant and virtually default free. But as monolines sought to expand their business opportunities, they began to provide AAA rated insurance to increasingly complex securitized debt instruments. As we have now seen, these insurance companies may not have sufficient capital to cover the potential defaults of some of these instruments and state insurance regulators, who are the primary regulators of these entities, should and could have set higher standards for these insurers, which could have reduced their inappropriate risk taking. Superintendent Dinallo will address this further in his testimony.

Fifth and finally, the securities were sold to investors or held by the banks themselves as an investment. And now here we are.

This whole sequence of transactions has now come unraveled. The bond insurance companies are the thinnest point of defense. Although the insurers believe they have enough capital to pay eventual claims, the securities they insured have been downgraded in expectation of defaults. That requires the companies to add additional capital reserves to maintain their ratings. If they cannot maintain those ratings, a downgrade in the bond insurance company rating would cause the ratings of all of the debt that it has insured to drop accordingly. This cascading effect has rippled through both the municipal side of the business and the more complex securitized side, leaving massive declines in value, market dislocation and write offs. Hence the desire to recapitalize the bond insurance companies presents the first step in the sequence to stop the further spread of the problem.

I want to make three points here.

To those who have raised the issue of federal regulation of insurance, I would note that just creating an agency with the power to act does not guarantee it will in fact act. Creating a national regulator will not make a difference if those appointed to run it choose not to use those powers effectively. Many failures have been caused by the lack of Federal regulatory entities to regulate--

or --worse to block prudent regulation by others. One of the benefits of having 50 state regulators is that it is more likely that someone will recognize a problem and act on it.

Second, securitization is clearly here to stay. Properly used, it can be a valuable tool for raising capital and spreading, and therefore, reducing risk. But we must understand the moral hazard risks that it entails so we can properly identify and control those risks without either reducing appropriate use of securitization, or having to go through massive market dislocations from inappropriate risk taking.

Clearly, there must be a way to ensure that the risks that are packaged are accurately reported through each stage of the process so that underwriters, credit rating agencies, bond insurers and investors all understand the actual risk and make decisions on that basis. This is certainly an area where we should apply that creativity we prize.

Third, every institution involved should be taking a hard look at what happened and instituting reforms. That includes the private sector firms that underestimated the risks they were taking, and the government regulators that took no action.

I know that the New York State Insurance Department, along with insurance departments of other states, is studying how best to improve regulation. Superintendent Dinallo will address that issue when he testifies as part of the next panel. But the fact that the states need to improve does not lead to the conclusion that federal regulation of insurance is the answer, especially given the performance of other federal regulators on this issue.

Now, let me explain why I'm here testifying on this issue and, in fact, why the New York State Insurance Department has been playing a leading role in dealing with the problems in the bond insurance industry. As I stated at the outset, the bond insurance industry's problems have an impact on the American public as investors, through its state and local governments and financial institutions.

Some people say the federal government should be leading the effort. But the facts are that insurance is regulated by the states and most of the bond insurance companies are domiciled in and primarily regulated by New York. Ambac, the major company that is not domiciled in New York, has its actual headquarters around the corner from our Department's office in Manhattan.

As the primary regulator, the New York Insurance Department has the powers and ability to deal with the issue. We license insurers, we review their market conduct, and, if a company should become insolvent, we can rehabilitate or liquidate it.

We are not alone in addressing this problem. We have the assistance of the Wisconsin and Maryland Insurance Departments, which regulate Ambac, ACA and Assured Guaranty. We have the advice and support of the New York Federal Reserve Bank and the U.S. Treasury, with whom we regularly discuss developments. And we have hired a top notch financial advisor, Perella Weinberg, to help us analyze the various proposals and conduct discussions with the parties.

New York has a history of leadership in this area. In the 1980s, New York led the tough fight to prevent property casualty insurance companies from offering bond insurance. We can now see the wisdom of that stand. If the property casualty insurers were suffering from the potential losses in bond insurance, their solvency could be at risk and they could be seeking to raise their premiums in all their other businesses, potentially causing large increases in homeowner, auto and business insurance costs.

And it is New York's statutes for bond insurance, Article 69 of the New York State Insurance Law, that are the standard for state insurance departments around the country.

The bottom line is that over the last few months, it is the New York State Insurance Department that has been working daily with all the stakeholders—the bond insurers, their major stockholders, the banks and investment banks, financial advisors, private equity investors, and the rating agencies—to find solutions to the current problems.

As insurance regulators, it is our responsibility to protect policyholders and ensure a healthy, competitive market for insurance products. In the case of bond insurance, there are two main groups of policyholders. There are the municipal governments who bought insurance for the bonds they issued and the investors who bought those bonds. Then there are the banks and investment banks who bought insurance for the structured securities, including mortgage-backed securities they sold and invested in.

We have been working to facilitate solutions that protect all policyholders. After all, many of the banks and investment banks are New York companies.

From the beginning, we have been working on a parallel track on a range of possible solutions. Our strong preference has been to find ways to strengthen the bond insurers so they could maintain their top triple-A credit rating. But we have been clear from the beginning that municipal investors cannot be allowed to suffer from problems caused by another sector of the market. As one of the alternatives, we have some time ago requested that all of the bond insurers who are in trouble develop plans that will protect the municipal side of the business. We believe these plans should protect the triple-A rating of the municipal bonds. Superintendent Dinallo will describe in more detail our efforts and the results to date.

I hope you will agree that our priority now must be to reduce the harm to investors, governments and our financial institutions that support the American people and our economy from the subprime problems. To achieve viable solutions, it is essential that we continue to work with other regulators, the banks and the rating agencies. As I have already noted, all of us have something to learn from the subprime mess and all of us need to improve our performance going forward. But we cannot afford to let this valuable discussion degenerate into the kind of blame and finger pointing that damages our ability to focus on the essential immediate task.

I welcome your questions.