The Public Use of Private Interest
to Revive the U.S. Residential Finance Market

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by
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Good morning ladies and gentlemen. I am delighted to be part of this discussion and I would like to thank Eric Nordman and the Center for Insurance Policy Research for this opportunity.

To place my remarks in context, I would like to draw attention to the central proposition of a book entitled “The Public Use of Private Interest.” This book was written many years ago by Charles L. Schultze, currently a senior fellow emeritus in the Economic Studies Program at the Brookings Institution. I think the relevance of the book will be clear if I quote from the description on the back cover which reads as follows:

> According to conventional wisdom, government may intervene when private markets fail to provide goods and services that society values. This view has led to the passage of much legislation and the creation of a host of agencies that have attempted, by exquisitely detailed regulations, to compel legislatively defined behavior in a broad range of activities affecting society as a whole. …Far from achieving the goals of the legislators and regulators, these efforts have been largely ineffective; worse, they have spawned endless litigation and countless administrative proceedings as the individuals and firms on whom the regulations fall seek to avoid, or at lest soften, their impact. The result has been long delays in determining whether government programs work at all, thwarting of agreed-upon societal aims, and deep skepticism about the power of government to make any difference.
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> Strangely enough in a nation that since its inception has valued both the means and the ends of the private market system, the United States has rarely tried to harness private interests to public goals. Whenever private markets fail to produce some desired good or service (or fail to deter undesirable activity), the remedies proposed have hardly ever involved creating a system of incentives similar to those of the market place so as to make private choice consonant with public virtue.
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> In this (book) Charles L. Schultze examines the sources of this paradox. He outlines a plan for government intervention that would turn away from the direct “command and control” regulating techniques of the past and rely instead on market-like incentives to encourage people indirectly to take publicly desired actions.

I feel sure that the continuing relevance of this book’s central thesis cannot escape the notice of anyone who has followed our prolonged national debate about financial regulation since the traumatic events of September 2008. It is quite amazing to realize that this book was written 36 years ago given that it so perfectly describes our current situation.

With this as background, let me say that I believe reviving the securitized residential mortgage market involves two fundamentally distinct challenges. I refer to these as a) the Computer System Challenge (within which I include data storage and communication issues as well as computer processing analytics) and b) the Social System Challenge. To date, discussions on how to revive the securitized residential mortgage market have focused heavily on the Computer System Challenge combined with an assumption of a command and control approach to forcing a pre-defined solution on the industry. Richard Field states the case very well with his analogy of the brown paper bag versus the clear plastic bag. His argument that daily, or even real-time, updates are essential and can be supported with today's technology is compelling. This approach may well be necessary to jump-start the wider availability of loan-level event-driven information for existing RMBS securities. In the long run, however, I think it will leave such information vulnerable to passive-aggressive resistance on the part of sell-side firms. The level of detail and timeliness will be the subject of continued wrangling, with providers seeking to contain cost by limiting the level of detail and reducing the frequency of the updates. Bureaucratic rules of engagement and the requirement for careful deliberation by regulators will slow the process of adding useful new information to such a database as products evolve in the future.

I believe the work of Michael Erlanger, and his firm Marketcore, offer a better approach in line with Charles Schultze's concept of the public use of private interest. In effect this approach involves using the police power of the state not, or at least not primarily, to impose detailed disclosure requirements. Rather it would use the power of regulation to force a reform in market structure that creates positive rewards for disclosure. It also would convert the resulting information into a valuable private asset with a strong constituency supporting its continuous expansion and improvement. Market forces would impose a powerful discipline to maintain the accuracy and timeliness of reporting by withdrawing the rewards for those whose disclosures fall short of expectations. By tracking any such shortcomings, the value of securities affected by them would quickly be discounted in line with increasing uncertainty about the performance of the underlying collateral.

The central concept in the Marketcore innovation is generation of a Transaction Credit in exchange for trade volume in the restructured market. This Credit could be used either for discounts on future trades or for discounted access to the detailed data such a system would generate. Furthermore, the very use pattern of the Transaction Credit would provide valuable insight to regulators and traders as to which securities are receiving increased market attention. In effect, the Transaction Credit becomes a means of driving transaction volume and associated liquidity to a new exchange by leveraging the most valuable thing the new exchange provides, namely the reliable, timely and detailed information it creates.

The problem is one of making the leap from an existing stable equilibrium to another, more socially desirable, stable equilibrium. Such a transition cannot be made easily or smoothly because it requires what has been referred to in developing a successful start-up business as "crossing the chasm." Virtually everyone agrees that the central problem underlying the collapse of the sub-prime mortgage market was lack of transparency. The problem is that this lack of transparency works to the advantage of those, mostly sell-side firms, who enjoy an asymmetric information advantage. This allows market makers to widen their spreads and pad their profits. Any threat to this advantage will be fought with all the influence the industry's deep pockets can muster.

Ultimately, crossing the chasm will require several powerful players to join forces.

- Buy-side firms will need to commit to utilizing a more transparent market place if it can be created.
- One or more technology firms will need to commit to building out Version 1.0 of the underlying technology.
- A second or third tier sell-side firm is needed who's management believes the higher profits from the higher trading volumes created by being in on the ground floor of a new market will outweigh any losses they may suffer from narrower bid/offer spreads on existing business.
- Finally, capital investors will be needed to underwrite the initial development cost in exchange for the powerful earning potential from fees for the valuable information that such a market will produce. Of course, these capital providers could overlap with the buy-side, sell-side and technology participants.

Of course, government has a crucial role in creating such a socially beneficial market. First and foremost it must avoid capture by existing vested interests who will seek to strangle such an innovation at birth. This means eliminating, or not creating, laws that obstruct its feasibility. Beyond that, government can actively encourage or even require that such a market be used by regulated industries who wish to invest in certain highly complex securities.

In summary, a major systemic risk haunts the US economy. Many financial institutions have significant "frozen" assets in securitized mortgage obligations that would be virtually impossible to liquidate in large volumes at anything close to current book values. If such institutions were faced with sudden cash outflows, this lack of liquidity could present a serious threat to their survival. In addition, relying almost exclusively on government guarantees to revive the residential funding market is highly questionable in light of the many other serious pressures on government finances.

Marketcore's patented methods offer the only structural innovation I have seen that promises to revive the securitized residential mortgage market and to do so WITHOUT the need for government guarantees. These methods create positive incentives for voluntary information disclosure. The transparency such disclosures create would close the often low- to mid-double digit bid/offer spreads that are paralyzing the market. Particularly in light of the well publicized strains on Federal Government finances, active steps toward implementing these innovative methods should be a national priority.