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The US Subprime MBS Crisis: New Legislative Agenda and Potential Ramifications for Foreign Jurisdictions

Yuliya Guseva

Columbia Law School, yg2161@columbia.edu

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Yuliya Guseva

Bibliographic Information

Yuliya Guseva is an S.J.D. candidate at the Department of Legal Studies of Central European University, Budapest, Hungary. She received an LL.M. degree from Columbia Law School in New York, 2008, and was awarded Harlan Fiske Stone Scholar.

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Article Abstract

The recent US liquidity crisis, triggered by the failure of mortgage-related securities, produced long-lasting ramifications inside and outside of the US. International financial indicators and the housing markets demonstrate that the mortgage-related liquidity problems keep reverberating throughout the US and the global economy. In the US, even such giants as Freddie Mac and Fannie Mae, which were expected to inject market liquidity, have declared considerable losses from subprime MBS. The ongoing crisis provided a fertile ground for a number of publications and research. However, a range of fundamental issues regarding legislative responses to the US MBS crisis and its international corollaries remain ambiguous. This research aspires to shed light on the momentous lessons of the crisis in a way assisting foreign lawmakers who seek to commence securitization in their jurisdictions.

First, the paper is premised on the argument that securitization is a profitable evolving phenomenon despite the present crisis and criticism in the scholarship of recent years. Secondly, the author discusses the consequences and possible methods of increasing the incentives of the parties, such as, inter alia, lenders and rating agencies, to ensure more responsible pricing of the underlying mortgages and collateralized securities. It is furthermore important to scrutinize the agenda of the US regulators and financial industries as their approaches are oftentimes transplanted abroad in some way. The third point in question is the impact of the US, as a model securitization jurisdiction, on other countries. The specific focus of this analysis is the example of transplanting the US model to the Russian Federation.

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Table of Abbreviations

ABS	Asset-Backed Securities
AHML	Agency for Housing Mortgage Lending (also “the Agency”)
Art.	Article of a statute or a Code
CMBS	Commercial Mortgage-Backed Securities
CMM	Capital Markets Mortgage
DOS	Due-on-Sale Clause
FHA	Federal Housing Administration
FSA	Financial Services Authority
GSE	Government Sponsored Enterprise
LTV	Loan-to-Value Ratio
MBS	Mortgage-Backed Securities
NBA	National Bank Act
OCC	Office of the Comptroller of the Currency
OTS	Office of Thrift Supervision
PMBS	Private Mortgage-Backed Securities
PTI	Payment-to-Income Ratio
REIT	Real Estate Investment Trust
RESPA	Real Estate Settlement Procedures Act
RMBS	Residential Mortgage-Backed Securities
SEA	Securities Exchange Act of 1934
SEC	Securities and Exchange Commission (also “the Commission”)
SIV	Structured Investment Vehicle
SOA	Sarbanes-Oxley Act
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle
TILA	Truth in Lending Act

Introduction

National financial markets nowadays evolve into a global phenomenon. Not surprisingly, the present US liquidity crisis triggered by the meltdown of mortgage-related securities markets produced long-lasting international ramifications.¹ In the US, the mortgage markets remain unstable with home sales and prices hitting record low² and an incessant growth of foreclosures.³ Most US banks, investment banks and other financial institutions sustained considerable losses, some failed,⁴ and almost all of them have written down substantial portions of their mortgage-related security portfolios. Even gigantic Fannie Mae and Freddie Mac suffered considerable losses from subprime MBS.⁵

The ongoing crisis provided fertile ground for a number of policy statements, legislative proposals, and theoretical publications. Similarly to the post-Enron public mood, the term “securitization” has become associated with financial instruments of dubious quality.⁶ However, originally, mortgage-backed securitization was perceived as the engine behind the American

¹ Laurence Norman, *Money-Market Rates Show Tumult Hasn't Subsided Yet*, WSJ (October 4, 2007), at C3.; Nina Koeppen, *ECB Says It Stands Ready To Inject Additional Liquidity*, WSJ (March 27, 2008); Alistair MacDonald *Northern Rock U.K. Regulator Admits Errors In Supervision of Northern Rock*, WSJ (March 27, 2008), Page C2; Margot Patrick, *Northern Rock Shares Secured; Assessment for Holders Pending*, WSJ (February 23, 2008), A2.

² See, e.g., Jeff Bater, *Gloom Persists as Demand Drops for Durable Goods, New-Home Sales Fall*, WSJ (March 27, 2008), A2.

³ See, e.g., *The Hammer Drops: America's Houses are Being Repossessed at a Record Rate. What comes next?* THE ECONOMIST (October 4th 2007); Mike Barris, *Property Report: January Foreclosure Filings Rose 57% From 2007*, WSJ (February 26, 2008).

⁴ “Bear [...] was brought to its knees by poor mortgage-bond trades in its own hedge funds and by the growing credit crunch, which began with the mortgage turmoil.” Gregory Zuckerman, *Hedge Funds, Once a Windfall, Contribute to Bear's Downfall*, WSJ (March 17, 2008), C1.

⁵ “Fannie puts its overall exposure to subprime mortgages at \$54.1 billion and its exposure to Alt-A loans [...] at \$350.6 billion. [...] Fannie already has had to write down the value of those securities, and some analysts say bigger write-downs may be needed.” James R. Hagerty, *Fannie, Freddie Shares Suffer Hit As Mortgage-Default Fears Mount*, WSJ (March 11, 2008), A3.

⁶ SPVs, off-balance sheet financing and the general lack of transparency in securitized transactions have been partially blamed for the Enron and other corporate scandals. See, e.g., Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539 (2004)

dream of home ownership in the era of high mortgage-interest rates in the 1960-1970s⁷ and today still remains a viable mechanism of mortgage financing.

This research targets several interconnected dilemmas. *First*, I emphasize that there are no theories fully explaining structured finance, pricing of securitization products and risk-allocation among various parties. Hence, the present crisis is not explained and could not be anticipated in advance at the theoretical level, nor were there any historical data on the behavior of ever-evolving structured instruments. *Secondly*, the paper scrutinizes the current mortgage crisis from the two perspectives. On the one hand, I consider the social consequences of the problem and the predatory lending, as a by-product of the subprime market. On the other hand, the analysis proceeds to the financial markets and the regulatory responses to the crisis. The issues raised in the paper cover the “moral hazards” associated with MBS and mispricing of financial products. An important element of the discussion is the methods as to how to increase the incentives of the parties, such as, *inter alia*, lenders and rating agencies, to ensure responsible pricing of underlying mortgages and collateralized securities.

The *third* issue is the impact of the US, as a model securitization jurisdiction, on other countries. The author analyzes the main periods in the history of securitization and compares them with some aspects of the Russian market. Particularly, the discussion is centered on the Russian housing agency as compared with the US GSEs. *Finally*, this paper argues that it would be too early to discard MBS as a profitable and socially useful financial instrument in the US and elsewhere. Instead of rejecting the US models, transplanting jurisdictions should merely make appropriate corrections in national law and regulatory practices preventing a similar credit

⁷ See, e.g., SECONDARY MORTGAGE MARKET AND MORTGAGE CREDIT HEARINGS (S. 2958, S. 3503, S. 3508, and S.3442) United States. Congress. Senate. Committee on Banking and Currency. Subcommittee on Housing and Urban Affairs, 91st Cong. Washington, U.S. Govt. Print. Off. (1970), at 1 and 36, on the expansion of purchasing powers of FNMA and the creation of FHLMC.

crunch from happening. In this sense, the US regulatory and market solutions remain an invaluable information source for other jurisdictions.

1. Theories of Securitization

The present crisis emphasized such fundamental issues as whether structured finance remains a vital mode of mortgage financing. No fundamental theory on the issue has been developed to date. Let us consider the pros and cons of securitization in a double paradigm of the costs and benefits for the originator and for the general public. Some argue that securitization benefits all parties through lower costs of financing.⁸ The three pillars of the “cost” theory are the “monitoring costs,” the bankruptcy costs of securitization⁹ and the greater liquidity achieved through conversion of illiquid mortgages or other assets to securities traded on the securities markets.¹⁰ The fourth element is transferring illiquid mortgages from balance sheets of banks and thrifts, thus, assuring a better match of the maturity of their assets and liabilities and providing for more capital available for future lending. In the 1980s-1990s, much ink was spilled acclaiming the benefits of lower costs and greater liquidity associated with MBS and discussing the potential for cutting off the GSE’s links with the government in favor of greater reliance on the then vibrant private MBS market.¹¹

In theory, securitization reduces the costs of monitoring the following elements: the quality of collateral - assayed by the rating agencies¹² - and, in case of commercial mortgage-

⁸ See, e.g., one of Prof. Schwarcz’s early articles on ABS “The Alchemy of Asset Securitization” (Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994)).

⁹ See also the discussions on the asset partitioning and its effect on organizational and property law, e.g., Hansmann, Henry, and Reinier Kraakman. *The Essential Role of Organizational Law*, 110 YALE L.J. 387 390, 420-421 (2002).

¹⁰ See, e.g., Joseph C. Shenker and Anthony J. Coletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1372 (1991); Faten Sabry and Thomas Schopflocher, *The Subprime Meltdown: Who, What, Where and Why...Investigations & Litigation*, 1633 PLI/CORP 89 (2007).

¹¹ Panos Konstas, *Privatizing Fannie Mae and Freddie Mac: An Operating Restriction May be Enough to Increase Competition and Efficiency*, 114 BANKING L.J. 943 (1997).

¹² On the role of “gatekeepers” in securitization, see the discussion *infra* at 18.

backed and asset-backed securities, lesser costs of monitoring of debtor's affairs in bankruptcy due to the use of SPVs. In sum, securitization is perceived as a more evolved form of secured financing. Some authors call into question whether bankruptcy and bankruptcy-remoteness matter.¹³ Both are only hypothetical risks loaded with risk-assessment uncertainties and arbitrariness. Other scholars continuously argue that the equitable concepts of "true sale" and "substantive consolidation" are important in the contexts of properly structured securitization transactions¹⁴ and potential bankruptcy reforms.¹⁵ In asset-backed securitization, bankruptcy remoteness is statistically significant; and after the *LTV* case¹⁶ the comparative spreads for debtors eligible to file under Chapter 11 increased as opposed to those who are not eligible under Chapter 11,¹⁷ including banks.

For individual mortgagors and mortgage lenders, bankruptcy reforms may be of lesser importance compared to the contract law, including, *e.g.*, DOS clauses and disclosure rules, and the mechanisms of home foreclosures, which are within the purview of either federal or state law. Here, the issue of federal preemption of state law and regulations as applied to national banks and S&Ls becomes the most important. For the purposes of securitization, standardization of mortgage instruments and unification of regulatory requirements have long been the top

¹³ Carlson, for instance, argues that "[o]ne is skeptical that mere hypothetical risks should be worth so much in the market. Nevertheless, securitization theorists have assumed that the cost of funds depends on the purely hypothetical question of bankruptcy jurisdiction." David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055 (1998), at 1057.

¹⁴ "[W]hile there should be no issue with challenging poorly-structured or fraudulent transactions, securitization transactions in general should not be viewed as "guilty" until proven "innocent"; rather, the contrary should be the case -- properly structured transactions that are within the acceptable practice of structured finance should enjoy legitimacy -- as securitization is a highly successful capital markets mechanism with a proven track record in the residential mortgage financing area." Shmuel Vasser, *The "Evil" Securitization and the American Dream*, 13 J. BANKR. L. & PRAC. 1 ART. 2 (2004).

¹⁵ Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?* 11 J. BANKR. L. & PRAC. 101 (2002).

¹⁶ *LTV Steel Company, Inc., In re*, 274 B.R. 278 (Bankr. N.D. Ohio, 2001).

¹⁷ Kenneth M. Ayotte and Stav Gaon, *Asset-Backed Securities: Costs and Benefits of: "Bankruptcy Remoteness"* (Apr. 2, 2006) (unpublished manuscript, on file with the Fordham Law Review).

priority issues, while concerns about the quality of the mortgages and consumer protection were among secondary issues.

Several years ago, mortgages were considered as the assets of the highest quality for the purposes of assessing the risk-weighted bank assets in the US and under Basel I.¹⁸ Times, evidently, changed due to the omnipresent use of irresponsible mortgage underwriting standards and the resulting mass foreclosures. The costs of foreclosures are soaring. In some regions, whole neighborhoods are affected by the crisis, what further drives down the real estate prices in general and the price recovered through foreclosure sales in particular.¹⁹ In fact, the low-quality loans and securities hit lenders with not lesser severity than borrowers, as the recent demise of Bear Stearns illustrates. No abstract theory has yet parsed and comprehensively analyzed the correlations between the quality of individual mortgage loans and the ultimate profits and losses of the investors.

The theories on securitization in corporate settings presume that it exists due to informational asymmetries and the hidden action problem between insiders and outsiders about pricing of assets of a company. By analogy, in the mortgage markets, “insiders” were mortgage originators, including mortgage brokers and banks, which promptly relocated the risks to investors. Iacobucci and Winter also point out at a number of what they deem as common fallacies²⁰ axiomatically presumed about ABS. One is that a low-quality firm can offer high-quality securities. Today, it appears that that was not a fallacy in case of the subprime markets,

¹⁸ See, e.g., Damian Paletta and Alistair MacDonald, *Mortgage Fallout exposes Holes in New Bank-Risk Rules: Looser Guidelines Fact a Backlash As Losses Pile Up*, WSJ (March 4, 2008), at 2. See also, e.g., JONATHAN R. MACEY, GEOFFREY P. MILLER AND RICHARD SCOTT CARNELL, *BANKING LAW AND REGULATION*, 3rd edition, Aspen Publishers (2001), at 283.

¹⁹ See, e.g., Jeff D. Ordyke, *Gauging Value In Real Estate As Prices Slide*, WSJ March 13, 2008; Page D1.

²⁰ Edward Iacobucci, Ralph A. Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUD. 161 (2005).

where borrowers, whose mortgages backed triple-A MBS, had low credit scores and the properties were not adequately assessed.

The same scholars,²¹ similar to other researchers,²² discern a number of common advantages of securitization, including, *e.g.*, reduced agency costs, superior signaling to the market that the assets are of appropriate quality and supplying better information to investors. In such a case, originators should have had the objective incentives to match the value of securities sold through an SPE to the value of collateral. Thereby, securitized products supposedly represent a better valuation of underlying assets. Again, as the present day market evinces, this hypothesis has not withstood practical tests in the long run.

The rating agencies failed to raise a red flag with regard to loans with high PTI and other questionable ratios signaling that the loans were originated to borrowers, who were unable to repay the loans, and were premised on the price of real estate collateral. At the same time, mortgage brokers and subprime lenders in general seemed to be unwilling to verify collateral assessments or creditworthiness of mortgagors²³ or to share the information with the market. One of the potential causes of the information asymmetry was misaligned incentives of market agents.

It appears almost indisputable that, *ab origine*, liquidity, monitoring and better pricing were the major traits of securitization. The question is why they did not work in the subprime markets. The answer lies in resolving the incongruity between the incentives of market participants and the provision of adequate pricing by virtue of upgrading obsolete disclosure

²¹ *Id.*

²² *See, e.g.*, Joseph C. Shenker and Anthony J. Colletta, *supra* note 10, at 1370-1381.

²³ *See, e.g.*, Deborah Goldstein, *Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions*, JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV.(1999), at 8. Available at <http://www.jchs.harvard.edu/publications/finance/goldstein_w99-11.pdf>.

mechanisms. The policy and statutory response to these problems is important not only for the US market and the impending overhaul of the regulatory regime, but for many other countries whether developed or developing. The problems of the US markets are affecting many economies around the globe. The recent nationalization of the Northern Rock Bank in the UK²⁴ is one of the examples of the global shock wave, even though several months ago Europe seemed to exhibit “a lot of resilience to the crisis.”²⁵

A theoretical analysis of the causes of the crisis is of consequence for not only the US or other developed market economies, but even more so for those countries, which attempt to transplant the American model of MBS. Developing economies face many phenomena that the US and Western Europe had to go through decades ago. Russia is an example. The absence of formerly state-provided public housing, high mortgage rates, inflation and growing real estate prices are all characteristic to Russia today²⁶ and to the US in the late 1960s-early 1970s.²⁷ Even though the fundamental underlying sources of this resemblance may be disparate,²⁸ similar policy and legislative approaches may, possibly, be applicable to both situations taking into account the general trends of convergence in global finances.

The absence of a comprehensive theory on MBS and structured finance complicates the resolution of the crisis in the US and clouds the policy alternatives for transplanting jurisdictions.

²⁴ *Supra* note 1.

²⁵ "Europe, Middle East and Africa are showing a lot of resilience to the crisis and the region is a central part of our strategy," UBS's Mr. Prella said. "Russia continues to grow, while there is a growing pool of liquidity in the Middle East. We expect a restructuring of the financial-services sector and that will provide growth," he added. U.S. *Investment Banks Cast Their Eyes Abroad Fees in Europe Surge As Performance Lags*, WSJ (October 4, 2007). See also Joellen Perry, *EU Expects Slowdown to Be Mild*, WSJ (March 27, 2008) Page A2.

²⁶ Greg Walters and Alex Nicholson, *Medvedev Says Inflation Is Price of Being World Power*, Bloomberg (March 25, 2008). Available at <<http://www.bloomberg.com/apps/news?pid=20601087&sid=aWcDP5OySNOE&refer=home>>.

See also *Analytical Review: Mortgage Financing and Securitization* [“*Ipotechnoe kreditovanie I Sekiyuritizatsia*”], RUSIPOTEKA (January, 2008). Available at <<http://www.rusipoteka.ru/review/0108-review.pdf>>.

²⁷ See the discussion *infra* at 34-44.

²⁸ For instance, Russia profits on the oil exports while the US suffered from the Oil Crisis; Russia does not have such a well-developed bank system as the US had had for decades; *etc.*

It will take time before economists come up with plausible general theories. The following sections do not attempt to provide economic theories or solutions. Instead, the author tackles various social and legal problems associated with the mortgage meltdown, the subprime and predatory lending and analyzes the existing legislative proposals in light of the historical goals of MBS, *i.e.*, better liquidity and cheaper mortgage capital.

2. Social Ramifications of the MBS Crisis

Subprime and Predatory Lending: The State, The Federal and The Market

It is already common knowledge that the risks of subprime mortgage collateralized securities were significantly underpriced. Among the reasons are predatory and negligent subprime lending, leading to misevaluation of real estate collateral. Unfortunately, no long-term performance records related to subprime MBS were available as the products were substantially new. Mortgage subprime and predatory lending are themselves relatively new phenomena. Some believe that predatory and totally legal subprime lending practices were based on the “increases in capital made possible by securitization, increase in risk-based pricing facilitated by technological advances, and the deregulation of the banking industry.”²⁹

Prior to the upsurge in derivatives and other complex financial innovations, the old disclosure measures, such as the Truth in Lending Act³⁰ (hereinafter “TILA”), worked well. Notably, when TILA was enacted, one of its justifications was the increasing speed of market innovations and the new types of “‘financing,’ featuring seller buydowns, adjustable rate

²⁹ Heather M. Tashman, *The Subprime lending Industry: An Industry in Crisis*. 124 BANKING L.J. 407, 410(2007). *See, e.g.*, her analysis of Depository Institutions Deregulation and Monetary Control Act; Tax Reform Act of 1986; the Financial Institutions Reform Act; the Gramm-Leach-Bliley Act,.

³⁰ Truth in Lending Act (TILA) (Pub.L. 90-321, Title I, May 29, 1968, 82 Stat. 146), codified in various sections under Title 15, Chapter 41 (15 U.S.C. § 1601-1667). *etc.*

mortgages, and balloon payments.”³¹ With FNMA and FHLMC reforms, more types of mortgages, such as ARMs, graduate-payment mortgages and others,³² expanded the array of loan products as opposed to the fully amortized long-term fixed-rate mortgage that banks the thrifts had traditionally offered.

Hence, with those developments, the Congress passed TILA providing for more informational protection to mortgagors. The Act is basically a part of the Consumer Credit Protection Act targeting a particular stratum of consumers, *viz.*, home loan borrowers. Among other things, the Act also governed advertising by lenders. These information and “educational” measures should be of particular interest for such countries like Russia, where the new federal statute “On Advertising” has only sketchily delineated what information may be generally included in advertising of financial services. No specific information on the particulars of loan origination or any accompanying legend is required from a lender.³³

TILA was, apparently, a necessary statutory disclosure mechanism. However, as the market has evolved with time, it became only somewhat helpful as a prevention device. Currently, the Federal Reserve conducts a review of TILA with respect to more disclosure

³¹Dee Pridgen and Richard M. Alderman, *Part C. Truth in Lending Disclosures, Real Estate*, CONCREED § 9:1(2006).

³² For an overview of the types of MBS and mortgages, see, e.g., FRANK J. FABOZZI, *THE HANDBOOK OF MORTGAGE-BACKED SECURITIES*, 5th ed., McGraw-Hill (2001), 3-75.

³³ See the Federal Statute “On Advertisements” [*“O reklame”*] of 03.13.2006 No. 38-Ф3 (the latest amendments are of 07.21.2007 No. 193-Ф3). Under art. 28 of the statute, an advertisement of banking, insurance or other financial services should contain the name of a person or an organization providing such services. “If an advertisement of services associated with granting a loan, using it or discharging it contains at least one clause having an impact on the costs of the loan, then such advertisement should include all other terms, determining the actual costs of the loan for a borrower and affecting those.” [*“Если реклама услуг, связанных с предоставлением кредита, пользованием им и погашением кредита, содержит хотя бы одно условие, влияющее на его стоимость, такая реклама должна содержать все остальные условия, определяющие фактическую стоимость кредита для заемщика и влияющие на нее.”*]

The language of the statute is extremely vague to say the least. How it may be possible to include “all other terms” that may have an impact on loan costs in an advertisement, for instance, a one-minute TV ad, is an interesting puzzle.

requirements, misleading advertisements and other provisions.³⁴ In fact, in order to keep pace with the inventions of new market instruments, the regulators should adopt a practice of recurrently reviewing disclosure requirements protecting individual mortgagors under TILA or other statutes that may be enacted in the future. Consumer protection is one of the areas where public authorities cannot afford to act retrospectively, as they often do in response to a crisis.

Predatory mortgage financing has been flourishing for years despite numerous consumer protection, usury, and anti-predatory lending statutes.³⁵ The scope of the subprime and predatory lending problem was acknowledged only lately as it was spilling over from targeted customer groups³⁶ to the practices of general avoidance of consumer protection laws.³⁷ The variety of predatory lending practices is hardly identifiable. Generally, it includes loan flipping, originating mortgage loans based on the LTV ratio without taking into consideration the PTI and the ability to repay a debt obligation in general, high prepayment penalties, *etc.*³⁸ The term “predatory

³⁴ *Policy Statement on Financial Market Developments*, The President’s Working Group on Financial Markets (March 2008), at 12.

Available at <http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf>.

³⁵ Often, standardization of mortgage terms and federal preemption of state usury, disclosure and other mortgage-related laws are sometimes perceived as elements of modern development of finance, where law plays a much lesser role in mortgage origination. See Ann M. Burkhart, *Real Estate Practice in the Twenty-First Century*, 72 MO. L. REV. 1031, 1037-1039 and 1046-1047 (2007). On the practices of trapping borrowers to remain with inequitable loans, see, e.g., Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 518 (2002).

³⁶ See, e.g., Regina Austin, *Of Predatory Lending and the Democratization of Credit: Preserving the Social Safety Net in Small Loan Transactions*, 53 AM. U. L. REV. 1217 (2004); Cecil J. Hunt, II, *In the Racial Crosshairs: Reconsidering Racially Targeted Predatory Lending Under a New Theory of Economic Hate Crime*, 35 U. TOL. L. REV. 211, 313 (2003); Kurt Eggert, *Lashed to the Mast and Crying for Help: How Self-Limitation of Autonomy Can Protect Elders from Predatory Lending*, 36 LOY. L.A. L. REV. 693 (2003).

³⁷ Those were state usury laws and federal statutes, such as the Home Ownership Equity Preservation Act (Pub.L. 103-325 (1994)), amending the Truth in Lending Act (“TILA”), and others. For a discussion on TILA, HOEPA and other consumer-protection statutes see, e.g., Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2226-2229 (2007). The author argued that “most federal statutes have narrow technical causes of action and/or relatively insignificant remedies.” *Id.*, 2237.

³⁸ Eric C. Bartley, *And Federal Regulation for All: Federally Regulating the Mortgage Banking Industry*, MICH. ST. L. REV. 477, 481-484(2006).

lending” *per se* is context-based and lacking a precise and uniform definition,³⁹ which is partially due to the constant evolution of the phenomenon in theory and practice.⁴⁰ Among its features are rent seeking, the lack of transparency and proper reporting, waivers of legal redress and generally unfavorable covenants depriving mortgagors of the remedies that would normally be available under the common or statutory law.⁴¹ The system demonstrated either the negligent indifference to the potential harm inflicted by borrowers and loan purchasers or the fraudulent intent to trigger further foreclosures and rip off the equity accumulated by the borrowers.

Even being enhanced by regulations and other statutes, such as, *e.g.*, the Real Estate

³⁹ See Office of the Comptroller of the Currency, U.S. Dep't of the Treasury, Working Paper, *Economic Issues in Predatory Lending* 6 (July 30, 2003). The report mentions that given the current disagreement as to the nature and essence of predatory lending and “without a precise definition, many of the published figures on predatory lending abuses become less convincing.” Available at <<http://www.occ.treas.gov/workingpaper.pdf>>.

⁴⁰ For instance, Azmy’s analysis of literature summarized the following core features generally attributed to predatory lending: (i) credit is provided when it is not needed or on terms not justified by a borrower's credit risk or in order to exact rents; (ii) there is a subjective intent of a broker or lender to mislead, deceive, or exploit a financially unsophisticated borrower; and (iii) the terms of the credit or practices of the lender put a borrower at unreasonable risk of default or foreclosure.” Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States as Laboratories of Experimentation*, 57 FLA. L. REV. 295, 320 (2005).

California Association of Mortgage Brokers was among the first professional organizations in that industry expressing prodigious concern about the proliferation of abusive lending practices. Predatory lending is defined as “intentionally placing consumers in mortgage loans with significantly worse terms and higher costs than loans offered to similarly qualified consumers, by the majority of mortgage brokers or lenders in the region, for the primary purpose of enriching the loan originator and with little or no regard to the costs to the consumer.”

The Association also proclaims predatory lending “unethical” and often in violation of law and provides the following examples of such practices:

“Fraud: Forged loan documents, falsified tax returns or other documents, overstating income or assets to qualify borrowers for loans they cannot afford, inflated appraisals.

Discrimination: Charging higher rates and fees, with less favorable terms, to borrowers based on their race, national origin, age, marital status or neighborhood, than would be charged according to traditional factors such as employment history, credit record, and sufficient income to make required mortgage payments.

Misrepresentation: The costs or loan terms at closing are not as advertised, or as presented at the time of application, and which are not properly disclosed prior to closing as mandated by law.

Bait and Switch: Qualified borrowers are steered away from affordable options for the express purpose of increasing fee income to the unethical loan originator.

Non-Disclosure: Key costs, fees, and terms are not disclosed, or inaccurately or only partially disclosed in violation of law and State and Federal lending regulations.”

Available at <<http://www.cambweb.org/main/page/BestPractices>>.

⁴¹ Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1260-1261 (2002).

Settlement Procedures Act (hereinafter “RESPA”),⁴² TILA, obviously, had limited efficiency in furthering disclosures preventing predatory lending. Therefore, state law initiatives are often more unswerving proscribing certain high-cost loans. The statutory movement was launched in the late 1990s by North Carolina,⁴³ whose 1999 mortgage statute addressed high interest rate loans and was applied to all possible types of lenders. Due to the regional concerns about the competition among local and national banks, of the two dozens of states that followed NC’s suit, many linked their legislation to the federal standards.⁴⁴

Some novel departures and variations of federal standards may be found in, for example, the New York (NY) Banking Law, that establishes thresholds for determining whether a loan is high-cost and, thus, encumbered by certain restrictions.⁴⁵ Those include, *inter alia*, prohibitions on negative amortization, balloon payments, modification or deferral fees, “loan flipping,” “no lending without due regard to the repayment ability,” various kickbacks to mortgage brokers, and others. A set of special notices to the borrowers and a legend indicating that the loan is high-cost should also be provided. The civil liability of lenders, brokers or “any person found by a preponderance of the evidence” to have violated the law is far-reaching and the remedies under the statute are not exclusive.⁴⁶ Compared to the discussed below Georgia Statute of 2003,⁴⁷ the NY Statute is more specific and, most importantly, is more welcome in light of the current

⁴² Real Estate Settlement Procedures Act of 1974 (RESPA) (Pub.L. 93-533, Dec. 22, 1974, 88 Stat. 1724). Codified at 12 U.S.C. §§ 2601-2617. *See also, e.g.*, George J. Wallace, *Explicit Pricing, 'Fraud and Consumer Information: The Reform of RESPA*, 12 RUT.-CAM. L. REV. 183 (1981) (the author also analyzes contract adjacent to primary mortgage loan agreements, such as, for instance, insurance contracts).

⁴³ N.C. Gen. Stat. Ann. §§ 24-1.1E, 24-10.2. The statute governed a broad range of market participants including all lenders acting within the state jurisdiction, such as banks, thrifts, credit unions, all mortgage brokers, mortgage bankers, and finance companies, etc.

⁴⁴ The federal standards are quite comprehensive, albeit general. For instance, “[a] creditor shall not engage in extending credit to consumers based on the consumers’ collateral without regard to the consumers’ repayment ability.” 15 U.S.C. § 1639(h).

⁴⁵ *See, e.g.*, McKinney’s Banking Law § 6-1 (1), (2).

⁴⁶ The remedies include actual damages, rescission, recoupment, reasonable attorney’s fees and others and are supported by statutory damage provisions. *See McKinney’s Banking Law § 6-1 (7), (8), (9), et seq.*

⁴⁷ *See the discussion infra at 20.*

market turmoil. To date, the US law, especially, at the federal level, generally abstains from direct intervention into high-cost and subprime loans except for greater disclosure requirements to mortgagors and encouraging more market discipline by investors and asset managers.⁴⁸

Legislative Dangers: Overregulation v. Underregulation

The present market havoc spotlighted that more government actions are required. Proponents of the regulatory intervention highlight the market inefficiencies resulting from the informational asymmetry⁴⁹ and the disparity of high costs of the borrowers vis-à-vis the exorbitant profits of the lenders [at the very least, until last summer]. Trumping the Coase theorem by excessive transaction costs associated with the subprime market, it appears that the subprime cannot be self-regulated efficiently. The question is where the golden mean between a blind regulatory response to the subprime and predatory lending problems and more efficient market regulation is.⁵⁰

Prior to the crisis, a concern was that the government might affect the availability of mortgage capital for many strata of population.⁵¹ The following credit crunch revealed that the propensity to rent-seeking behavior against the backdrop of insufficient regulations and the lack of uniformity in financing standards affected the availability of capital anyway. Under the market and social pressure, the lenders started deliberating over lessening mortgage terms.⁵² Evidently, new structural market and regulatory changes are imminent, what is furthermore instigated by

⁴⁸ *Policy Statement on Financial Markets Development*, PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS (DEPARTMENT OF TRESUARY, BOAR OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, SECURITIES AND EXCHANGE COMMISSION COMMODITY FUTURES TRADING COMMISSION) (March 2008) [hereinafter: the Policy Statement], 3 and 4.

⁴⁹ See Engel and McCoy, *supra* note 41, at 1280-1289.

⁵⁰ The federal government is extremely concerned about potential overregulation of the financial industries. The Policy Statement, *supra* note 48.

⁵¹ Robert E. Litan, *Unintended Consequences: The Risks of Premature State Regulation of Predatory Lending* (2003), 34-35, available at <<http://www.aba.com/NR/rdonlyres/D881716A-1C75-11D5-AB7B-00508B95258D/28871/PredReport200991.pdf>>.

⁵² See, e.g. Laurie P. Cohen, *Citigroup Feels Heat to Modify Mortgages*, WSJ (November 26, 2007), at A1.

the presidential campaign.⁵³ The only concern is that public authorities need to avoid such repercussions of overregulation as the further market stagnation.

The issue of overregulation versus underregulation is always a dilemma for politicians, although it is more perceptible in some countries than others. The MBS crisis is unique in a sense that it is accompanied by painful political and social ripples. Were it credit-default swaps - which, as some believe, share similar traits with the subprime mortgage securities and are also unregulated – consumers would be less worried about, *e.g.*, the Citibank’s exposure.⁵⁴

Yet, foreclosures and social ramifications, however important those may be, are only the tip of the mortgage iceberg. No doubt, that “tip” will be much greater in developing economies, including Russia, with much less judicial and social protection than exists in the US. However, one cannot focus on the social side of the market problems. To no avail anti-predatory lending advocates for years voiced their opposition to mortgage-backed securitization.⁵⁵ Market “socialism” simply does not work. The political agenda, therefore, should focus on how to limit predatory lending practices, which come back to haunt financial institutions and investors. One of the answers is better risk assessment.

⁵³ Amy Chozick and Damian Paletta, *Obama Calls for Oversight, Stimulus in Detailed Speech on Economic Plans*, WSJ (March 28, 2008). Sen. Obama called for a 30-billion economic stimulus plan and new plan to help homeowners.

See also Transcript: *Clinton on Economy, Mortgage Crisis and Trade*, WSJ (March 27, 2008).

⁵⁴ “No one knows how troubled the credit swaps market is, because, like the now-distressed market for subprime mortgage securities, it is unregulated. But because swaps have proliferated so rapidly, experts say that a hiccup in this market could set off a chain reaction of losses at financial institutions, making it even harder for borrowers to get loans that grease economic activity. Commercial banks are among the biggest participants — at the end of the third quarter of 2007, the top 25 banks held credit default swaps, both as insurers and insured, worth \$14 trillion, the currency office said, up \$2 trillion from the previous quarter. JPMorgan Chase, with \$7.8 trillion, is the largest player; Citibank and Bank of America are behind it with \$3 trillion and \$1.6 trillion respectively.” Gretchen Morgenson, *Arcane Market Is Next to Face Big Credit Test*, NY TIMES (February 17, 2008).

⁵⁵ On the federal response to growing predatory lending practices, see, *e.g.*, Laurie A. Burlingame, *A Pro-Consumer Approach to Predatory Lending: Enhanced Protection Through Federal Legislation and New Approaches to Education*, 60 CONSUMER FIN. L.Q. REP. 460, 461-462.

3. Market Inefficiencies: Moral Hazard, Lack of Disclosure and Risk Assessment

The puzzle of risk assessment is manifold. A part of it is how to incentivize the lenders to do more responsible underwriting and due diligence, and assure compliance. Then, a dilemma is voluntary information disclosure by market participants.⁵⁶ Investors, obviously, could not evaluate the risks properly. One of the reasons was elaborate credit enhancements that gave them the false feeling of safety.⁵⁷ It might be true for small investors, although that does not explain MBS purchases made by sophisticated corporate and institutional investors,⁵⁸ who are no novices at financial investment strategies. The present circumstances are illustrative of the fact that overinvestments in formerly triple-A-rated securities and subprime MBS were based on the investor reliance on the rating of the securities, instrument complexity and unavailability of analytical data.

Rating Agencies as the Primary Market Gatekeepers

The information on potential delinquencies of triple-A MBS was unavailable and their downgrading exceeds the worst estimations.⁵⁹ Using synthetic derivatives, CDOs and other numerous products in securitization⁶⁰ and unreliability of the pool information make the need for adequate information disclosure and transparency more pressing. The major rating agencies have

⁵⁶ See, e.g., Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing*, 44 HARV. J. ON LEGIS. 123 (2007). The author criticizes the present state of affairs and mentions that the current system of disclosure is outdated as it was designed primarily for prime mortgage markets.

⁵⁷ “As a result, investors [could] safely invest in top-rated subprimemortgage-backed securities without worrying about losses, even when the underlying loan pools [were] replete with questionable loans.” Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007).

⁵⁸ For instance, such huge corporations as Smucker, Garmin Ltd., Microsoft Corp. and others sustained MBS-related losses. Karen Richardson, *Why Firms Like Smucker May Feel Pinch of Debt Crunch*, WSJ, (September 19, 2007), at C1.

⁵⁹ “S&P’s rating actions touched on \$534 billion in mortgage-related investments, including 47% of the U.S. subprime mortgage bonds rated in 2006 and the first half of 2007.” Aaron Lucchetti, *S&P Ramps Up Mortgage Downgrades*, WSJ (January 31, 2008), Page A3.

⁶⁰ For an overview of the new changes, see, e.g., Gary Barnett, *Synthetic Securitization and the Use of Derivatives in Securitizations*, 1653 PLI/Corp 489 (2008).

apparently acknowledged some RMBS problems, including the limited scope of performance reports and disclosure at the loan level, and the lack of transparency.⁶¹ That, however, happened only recently. Up until early 2007, Standard & Poor's annually reported the reverse stating that it “tend[ed] to overestimate the credit risk of senior subprime tranches.”⁶² Today, however, downgrading of the very securities and conduits that had the same rating as the US government securities proliferates and write-downs continue.⁶³

Rating agencies play the indispensable role in structured finance as they are designed to absorb the costs of screening out risky loans. Their primary function is to analyze “both credit and property conditions for at least the most sizable or significant loans to be included in the loan pool”⁶⁴ and to provide recommendations on obtaining a higher investment-grade rating. The raters⁶⁵ are the engine of private-label securitization and the suppliers of low-cost information to investors.⁶⁶ Scrutinizing large mortgage pools was laden with prohibitive costs for lenders-issuers and, ultimately, for individual mortgagors.⁶⁷ Investors soon accepted the agencies’ blessings and excommunications, making a bad or absent rating “a death sentence”⁶⁸ for an

⁶¹ See *Moody’s Investors Services, Structured Finance Special Reports*, submitted by David Teicher, 899 PLI/COMM 15, 31 (2007).

⁶² Kathleen C. Engel and Patricia A. McCoy, *supra* note 57, at 2055.

⁶³ “Banks are bracing for another chapter in the unfolding story of their mortgage-market problems,” wrote Tanya Azarchs, an S&P analyst, in a report released yesterday after the market closed.” Lucchetti, *supra* note 59.

⁶⁴ Carl J. Seneker, *How to Document Securitized Commercial Real Estate Mortgage Loans*, SN001 ALI-ABA 1175 (2007).

⁶⁵ Those are S&P, Moody’s and Fitch. SMMEA-qualified securities and mortgage-related securities within the meaning of the 1933 Act were defined with the reference to “nationally recognized statistical rating organizations.” (See 15 U.S.C. § 78c(a)(41)).

⁶⁶ The privileged raters serve the role of “private suppliers of information, [whose opinions] in theory they can facilitate the raising of capital by providing information to investors at a lower cost [...] and] greatly influence the ability of [...] issuers to raise capital by lowering their costs and the decisions of some fiduciaries to invest.” Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 341-342 (2006).

⁶⁷ The pools of residential mortgage loans are assessed by national rating agencies starting from 1975, while the first single-property and pools of commercial mortgage loans were rated in 1985 and 1987 respectively. For more information, see, e.g., Shenker and Colletta, *supra* note 10.

⁶⁸ David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. St. U. L. Rev. 985 (2006), 1056.

RMBS offering. The countries, where MBS is still under way, recognize that the system of rating is the key for successful securitization.⁶⁹ The privileged raters exert considerable influence on the mortgage market forging more standardized products and enhancing certain market trends,⁷⁰ arguably, assuring the safety of investors.

One should not close eyes to the role that the credit raters play for law. Their strong opposition⁷¹ to the Georgia's anti-predatory lending statute⁷² that originally provided for liability of lenders and assignees⁷³ caused the legislature to amend the statute. The state's apprehensions were that the refusal to rate GA-originated mortgages would make them unmarketable. The agencies clearly perceived the statute as excessively harsh as to most subprime loans, resulting in punitive damages, potential class actions and the liability imposed on *bona fide* purchasers who did reasonable due diligence prior to loan acquisitions.⁷⁴ For large lenders buying loans *en*

⁶⁹ See, e.g., Oleg Ivanov, *Legal Aspects of Securitization* ["Zakonodatelnie Aspekty Sekiyurizatsii"], INFORMATIONAL PORTAL "IPOTEKA". Available at <<http://www.rusipoteka.ru/publications/ivanov-3.htm>>

⁷⁰ See, e.g., Andrew R. Berman, "Once a Mortgage, Always a Mortgage" – *The Use (and Misuse) of Mezzanine Loans and preferred Equity Investments*, 11 STAN. J.L. BUS. & FIN. 76 (2005). The author argued that: At first, mortgage financings helped fuel the development of the secondary mortgage market and commercial mortgage backed securitizations. With the meteoric growth of the CMBS market, the power and significance of national rating agencies also began to grow. As the rating agencies became more involved with real estate finance, however, they inadvertently caused the decline of traditional junior mortgages and created the dramatic expansion of mezzanine financings and preferred equity investments.

Id., at 125.

⁷¹ *Press Release, Standard & Poor's, Standard & Poor's to Disallow Georgia Fair Lending Act Loans* (Jan. 16, 2003), available at <<http://www.mortgagebankers.org/NewsandMedia/PressCenter/32153.htm>>.

Fitch Ratings Declines to Rate Georgia Loans in RMBS Pools Considers Impact to Other Predatory Lending Legislation (Feb. 5, 2003), available at

<<http://www.mortgagebankers.org/NewsandMedia/PressCenter/32158.htm>>.

Press Release, Moody's Investors Services, Moody's Expands Consideration of Assignee Liability for Residential Mortgages in Securitizations (Jan. 30, 2003), available at

<<http://www.mortgagebankers.org/industry/news/03/0130a.pd>>.

⁷² Fair Lending Act, Ga. Code Ann. § 7-6A-1 et seq.

⁷³ *Id.*

⁷⁴ Ga. Code Ann. § 7-6A-2(6). The APR (4%) and point and fees (3%) triggers were much lower than those of HOEPA.

One problem was that the original statute covered not only high-cost mortgages, but also a broad range of "covered home loans" with clearly subprime - although not excessively high-cost and predatory - provisions. The statute also provided for punitive damages and class actions and did not fully or partially exempted from potential liability *bona fide* purchasers who exercised reasonable due diligence when buying loans.

masse, the statute was extremely hazardous due to the risks of inadvertent calculation errors.⁷⁵

Most overreaching provisions were corrected by GA within a year.⁷⁶

Other Supposed Gatekeepers and Lines of Defense

Another alleged “line of defense” of market “gatekeepers” is the lawyers. The legal expertise is a part of every securitization transaction accompanied by numerous comfort letters, “true sale,” “non-consolidation” opinions, *etc.* The significance of legal opinions was also emphasized by the American Institute of Certified Public Accountants.⁷⁷ A legal counsel advises not only the issuer, but also, in some cases, other parties to the transaction⁷⁸ exercising due diligence in rendering all opinions, drafting and negotiating purchase agreements, all necessary representations and warranties by the sellers of mortgage assets and other documents.⁷⁹

⁷⁵ Most states, however, offer lenders good faith defenses in case lenders exercised reasonable due diligence in loan origination and inadvertently committed a simple bona fide calculation error in originating high-cost mortgages. Reformation of mortgage agreement and the corresponding restitution to the borrower solve the matter.

See, e.g., N.J. Stat. Ann. § 46:10B-29(c), *etc.*

⁷⁶ Ga. Code Ann. § 7-6A-6(c) and (b).

⁷⁷ The Institute issued guidance named “The Use of Legal Interpretations as Evidential Matter to Support Management’s Assertion That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9 (a) of Statement of Financial Accounting Standards No. 140.” The American Institute of Certified Public Accountants guidelines offer “extracts of legal opinions, which provide persuasive evidence (in the absence of contradictory evidence) to support management’s assertion that the transferred assets have been isolated. For an entity that is subject to the U.S. Bankruptcy Code, a “would” opinion, not a “should” or “more likely than not” opinion must be obtained. This represents the highest level of assurance counsel is able to provide on the question of isolation.” The example follows:

“We believe [or it is our opinion] that in a properly presented and argued case, as a legal matter, in the event the Seller were to become a Debtor, the transfer of the Financial Assets from the Seller to the Purchaser would be considered to be a sale [or a true sale] of the Financial Assets from the Seller to the Purchaser and not a loan and, accordingly, the Financial Assets and the proceeds thereof transferred to the Purchaser by the Seller in accordance with the Purchase Agreement would not be deemed to be property of the Seller’s estate for purposes of [the relevant sections] of the U.S. Bankruptcy Code.”

Moreover “[a]lthough not required by the auditing interpretation, the lawyer may also be providing an opinion on the second step of a two-step structure involving a bankruptcy remote SPE, if requested by his client or the rating agencies.” Mary Rosenblatt, Jim Johnson and James R. Mountain, *Securitization Accounting: the Ins and Outs (and Some Do’s and Don’t’s) of FASB 140, FIN 46R, IAS 39 and More*, 891 PLI/COMM 847 (2006), 874.

⁷⁸ Shenker and Colletta, *supra* note 10, 1376.

⁷⁹ The expertise of legal counsels should be extensive enough to cover, for instance: [E]nsuring that desired legal priorities are achieved, that security interests are properly perfected, and that subordination agreements are enforceable; that indenture covenants are not violated and that covenant protections adequately balance debtor and creditor needs; that commercial-law remedies made available upon insolvency or default work in harmony with debtor-creditor law protections; that legal entities are established in the form (e.g., corporation, trust, partnership,

Securities law compliance, prospectuses, private placement memoranda all depend on detailed data on the underlying collateral and the projected yields on assets. These gatekeepers, working in cooperation with accountants, also seemed to fail performing up to the standard as well.

Yet, it would be absurd to blame lawyers for the subprime debacle. In fact, it is not clear what a lawyer working on a securitization deal might do, for instance, with respect to appraisals of collateral. Obviously, there is always a potential for fraud on the part of, *e.g.*, predatory lenders and their attorneys, but it is hardly a separate issue requiring additional liability for lawyers. As a part of the legislative response to the corporate scandals several years ago, the Sarbanes-Oxley Act imposed a reporting duty on lawyers in corporate settings. However, a similar approach in multiparty MBS transactions seems unrealistic.

Regulatory Responses

The “arsenal” of statutory and judicial responses roughly includes

- the enhanced oversight by regulatory agencies,
- changing the general standards of liability, as applied to both categories of financiers and the “gatekeepers,”
- introducing temporary emergency programs for financial institutions and borrowers in distress,
- and designing profound modifications in regulatory policies.

limited liability company) and with the governance characteristics most effective for the task, given such competing constraints as the tradeoff between equity-holder and creditor rights, bankruptcy law, tax law, and accounting; that guaranties and other credit supports are legally enforceable; that any special-purpose entities achieve the applicable legal requirements of rating agencies and investors, such as “true sale,” “non-consolidation,” and other “bankruptcy remoteness” criteria; that cross-border legal demands are complied with; and that any securities law requirements are met. Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J.L. BUS. & FIN. 486, 501-502 (2007).

Out of all four, the first and third alternatives appear to be the most feasible. As Prof. Coffee suggested, promoting formalized gatekeepers' responsibility⁸⁰ may come from disclosure mechanisms by dint of the extension of the SEC's disclosure regimes. Furthermore, professional standards may be raised by the self-regulatory organizations.⁸¹ Disclosures may be reviewed by independent outside counsels⁸² and SEC can regulate the rating agencies. That seems more realistic than the expansion of the standards of liability for the rating agencies for mistaken ratings.⁸³

The Congress acknowledged the prominent role of credit rating for securities markets⁸⁴ and the need for competition among the agencies in enacting the Credit Rating Agency Reform Act of 2006.⁸⁵ The SEC already has the power to register⁸⁶ rating agencies that intend to be nationally recognized statistical rating organizations.⁸⁷ The SEC continuously extends its

⁸⁰ JOHN C. COFFEE, JR., *GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE*, Oxford University Press, USA (2006), 232.

⁸¹ The Policy Statement, *supra* note 48.

⁸² Coffee, *supra* note 80, 231-232.

⁸³ Coffee, *supra* note 30, 306. *Id.*, 302-303. In fact, Prof. Coffee points at several downsides of enhanced liability of the agencies and increasing litigations, although he concedes that “[r]ealistically [...] a number of factors suggest that credit-rating agencies will not face astronomic liabilities for flawed rating, even if its issuer/client becomes insolvent.” *Id.*, 303.

⁸⁴ Information is a tradable commodity and, therefore, the legislature tend to support the equilibrium between market demand for information and maintaining proper incentives for the producers of information to act in good faith. Onnig H. Dombalagian, *Licensing the Word on the Street: The SEC's Rule in Regulating Information*, 55 *BUFF. L. REV.* 1, 2 (2007).

⁸⁵ The Act was purported to “improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry.” S.3850, *An Act to Improve Ratings Quality for the Protection of Investors and in the Public Interest by Fostering Accountability, Transparency, and Competition in the Credit Rating Agency Industry*, 891 *PLI/COMM* 1099, 1101 (2006).

⁸⁶ 15 U.S.C.A. § 78o-7. Among the data and information required for the registration, there are statistical data on the performance of the applicant, his methodologies in evaluating ratings, internal information as to rules of ethics and conflicts of interest and other. *Id.*

⁸⁷ “(62) **NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION.**--The term ‘nationally recognized statistical rating organization’ means a credit rating agency that--
“(A) has been in business as a credit rating agency for at least the 3 consecutive years immediately preceding the date of its application for registration under section 15E;
“(B) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix), with respect to--
“(i) financial institutions, brokers, or dealers;
“(ii) insurance companies;

regulatory reach. ABS and MBS are often placed with institutional investors. However, “securitized securities” may be marketed through securities exchanges. A significant number of no-action letters has accumulated since the 1990s. Some of them target disclosures, others - the structure and covenants related to SPVs and other aspects common for almost every securitized issue.⁸⁸ In addition, the SEC’s securitization guidelines⁸⁹ comprehensively covered most securitized issues due to the principle-based definition of ABS. Extensive disclosure and loss screening issues, mostly based on delinquency and loss statistical data, are the core of the Regulation AB.⁹⁰ By and large, this regulatory screening is warranted by not only the market meltdown, but more so by the methodological innovations in rating. The SEC needs to

“(iii) corporate issuers;

Id., 1103 -1104.

⁸⁸ *E.g.*, “[i]n 1997, Commission staff issued a no-action letter clarifying that an asset pool having total delinquencies of up to 20% at the time of the proposed offering may still be considered an “asset-backed security.” [...] In 1997, Commission staff issued a no-action letter clarifying that an asset pool having total delinquencies of up to 20% at the time of the proposed offering may still be considered an “asset-backed security.” In addition, there also exists a longstanding staff interpretive position that no non-performing assets may be included as part of the asset pool at the time of the proposed offering. We are codifying these interpretations, with modifications from our original proposal.” *Id.*

Most materials should evaluate the “data about the potential payouts of [...] the asset-backed securities using various prepayment and other assumptions as well as disclose information about the structure of the offering or about the underlying asset pool.”

The new regulations also mandate certain specifics of SPVs, chiefly reiterating the well-accepted covenants required in commercial MBS/ABS transactions, such as, e.g., the passive nature of SPVs and the common restrictions on their activities. “The first condition is that neither the depositor nor the issuing entity is an investment company under the Investment Company Act, nor will either become one as a result of the asset-backed securities transaction. If either was the case, we continue to believe that the regime for asset-backed securities that we are adopting today would not be appropriate. The second condition relates to the passive nature of the issuing entity in that its activities must be restricted to the asset-backed securities transaction.” *Id.*

⁸⁹ 17 CFR §§ 210, 228, 229, 230, 232, 239, 240, 242, 245 and 249 . [Release Nos. 33-8518; 34-50905; File No. S7-21-04].

⁹⁰ Definitions and treatment of delinquent and non-performing pool assets, and the distinctions between lease-backed transactions as opposed to true-sale pools were also clarified. The imperative catch-all feature of the rules is the new disclosure requirements. “Before today, there were no disclosure items tailored specifically to asset-backed securities. We are adopting, with modifications in response to comment, a new principles-based set of disclosure items, “Regulation AB,” that will form the basis for disclosure in both Securities Act registration statements and Exchange Act reports.” *Id.*

The screening problem associated with the pooled assets is also addressed through “requiring for the first time that certain statistical information on a ‘static pool’ basis [such as delinquency and loss data, and prepayment data] be provided if material to the transaction.” *Id.*

accumulate more expertise in the rating technologies, what need to be bolstered by a corresponding extension in its authority.⁹¹

There are several potential problems with this regime. The *first* is that the SEC is not a rating agency in the sense that its methodologies will never be as effective and as proactive as S&P's and Moody's, although the Commission clearly enjoys the benefit of hindsight. Yet, for instance, Moody's policy changes on loan level disclosure and transparency of pool performance⁹² can be more effective than the SEC's screening. As a part of future methodological modifications, Moody's unveiled its plan to consider using a "different rating scale for structured securities [that] could provide greater clarity about differences" among bonds "and could encourage market participants to consider the potentially different characteristics of structured and nonstructured securities."⁹³ This, indubitably, will improve monitoring of MBS in the future, alas, at present, the existing securities are continuously downgraded proving that MBS "risk-based pricing [was] a misnomer."⁹⁴

Secondly, in light of the liability issues, the SEC's approval of a rating method *a priori* exonerates an agency using it. In sum, if the approved rater acts in good faith in rendering a totally flawed opinion, as we have witnessed in the past, it cannot be held liable through either a private or a public action. The latter will, probably, be precluded by the SEC's endorsement. At the same time, the SEC seems to be the only regulatory agency with sufficient expertise in securities markets and which has the capacity to monitor the accuracy of ratings and screen out

⁹¹ Dombalagian, *supra* note 84, 50.

⁹² *Moody's*, *supra* note 61, 31. The agency changes its methodologies requiring MBS servicers to submit loan-level information on monthly basis.

⁹³ Aaron Lucchetti, *Moody's Weighs Warning Labels For Its Ratings*, WSJ (February 5, 2008); Page C1.

⁹⁴ McCoy, *supra* note 56, at 127.

the conflicts of interest in the name of investor protection and public interest.⁹⁵

Out of the four aforementioned courses of action, the temporary anti-crisis proposals are the most prevalent and flow from all divisions of the government. The Secretary of Treasury, for instance, repeatedly called for more unification and standard licensing of mortgage brokers⁹⁶ what had been also recognized in scholarly writings.⁹⁷ New York, ahead of time, already designs a public record database of mortgage brokers involved in criminal investigations that would allow other state regulators to monitor the brokers. Educating consumers or advocating on behalf of borrowers is another segment of many state programs. The New York State Banking Department recently announced a request for proposals for \$1.5 million available for the provision of foreclosure prevention counseling, advocacy and legal services throughout New York State.⁹⁸

Some federal programs expected to stabilize the market are built on the existing foundation of the conforming mortgages, the very same foundation that evolved and remained sound and solid since the first MBS issues in the 1970s. One of the examples is *FHASecure*, whose major goal is to offer refinancing to borrowers who defaulted on their loan payments due

⁹⁵ The SEC may “censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding 12 months, or revoke the registration of any nationally recognized statistical rating organization if [it is found] necessary for the protection of investors and in the public interest.” 15 U.S.C.A. § 78o-7. *See, e.g., Securities/Section20/Broker-Dealer*, 26 NO. 7 BANKING & FIN. SERVICES POL’Y REP. 16 (2007). *See also* Elliott R. Curzon, Stuart J. Kaswell, Alan Rosenblat, *SEC Proposes Rules for Registration of Credit Rating Agencies*, 124 BANKING L.J. 438 (2007).

⁹⁶ Particularly, his remarks were on the unification of regulatory standards in the mortgage industry as he complained that “[s]ome of the conduct and practices that I have learned about are shameful. [...] It is no secret that, while not the norm, some fraudulent activity on behalf of mortgage brokers occurred.” *Uniform Monitoring for Mortgage Brokers?* WSJ (October 16, 2007).

⁹⁷ Eric C. Bartley, *And Federal Regulation for All: Federally Regulating the Mortgage Banking Industry*, 2006 MICH. ST. L. REV. 477, 480-486 (2006).

⁹⁸ *See, e.g. Banking Department Announces Request for Proposal for \$1.5 Million in Foreclosure Prevention Counseling Services Grants* (February 13, 2008). Available at <<http://www.banking.state.ny.us/sapr.htm#Speeches>>.

to the resets in interest rates.⁹⁹ The Program was recently announced to be expanded to cover ARMs, where borrowers were late on two or three consecutive payments or defaulted on scheduled payments two or three times during the preceding 12 months.¹⁰⁰ Similar programs were proposed by congressmen, such as Senator Dodd's "HOPE for Homeowners Act"¹⁰¹ and others.¹⁰²

Most of the programs are either short-term or incomplete. For instance, the Administration's proposals, unfortunately, ignore some crucial amendments to the current FHA program that may amplify its coverage even further.¹⁰³ Namely, the expansion could also target not only *ARMs*, but also *delinquent conventional fixed-rate mortgages*. The new program is focused on rate resets, although there is no reason why it should allow refinancing to ARMs, but not to high-cost fixed-rate mortgages, provided a mortgagor has made certain timely monthly payments since the loan origination. I do not dispute that many subprime loans were ARMs, used teaser rates and provided for significant rate resets, but, given the recessionary economic environment, foreclosures clearly hit fixed-rate mortgages as well. In any case, it is self-evident that, again, taking into account the present state of economy, prior delinquency should not automatically disqualify all borrowers from participation in the Program as it may not be a

⁹⁹ See HUD No. 07-123 (August 31, 2007). Available at <<http://www.hud.gov/news/release.cfm?content=pr07-123.cfm>>.

¹⁰⁰ Steve O'Halloran, HUD No. 08-050 (April 9, 2008). Available at <http://www.hud.gov/news/release.cfm?content=pr08-050.cfm>

¹⁰¹ See statements and press releases by Sen. Christopher J. Dodd at <<http://dodd.senate.gov/index.php?q=node/3033#p>>.

¹⁰² Remarks by Treasury Secretary Henry M. Paulson on Current Financial and Housing Markets at the U.S. Chamber of Commerce, WSJ (March 26, 2008). The Secretary mentioned that such programs as HOPE NOW and FHA Secure are constantly being monitored and the authorities consider possible ways to further improve the programs.

¹⁰³ For a critical analysis of the old FHA Secure, see, e.g., Kate Berry, *HUD Mulling How to Widen FHA Refi Net*, AMERICAN BANKER VOL. 173, NO. 33 1 (2008).

definite indicator of future defaults.¹⁰⁴

Foreclosure may become a more expensive option for lenders and servicers of securitization vehicles, than entering into *FHASecure* refinancing. It gradually loses its appeal as the real estate prices hit record low and the net proceeds can turn out to be significantly less than the original loans, particularly, in the areas experiencing significant numbers of foreclosures. Subprime and predatory mortgage origination was characterized by imprudent property assessments and, in some cases, the absence of verification of borrowers' income, what made mortgage-backed securities significantly mispriced.¹⁰⁵ A corresponding advantage of employing the FHA technologies is their income and property appraisal verification techniques through which loan mispricing will be corrected or at least mitigated, thus, making loan payments more affordable to mortgagors.

From the point of view of lenders and investors, government insurance continuously supports a vibrant secondary market for FHA loans.¹⁰⁶ Compared to most non-conforming loans and collateralized securities, FHA loans and securities are currently priced almost at par. A simple expansion of the existing government insurance programs may achieve two goals simultaneously: to support the secondary market and to help more borrowers avoid foreclosure.

An interesting observation is that proposals from the Congress and the federal regulators envision more government entities being involved in the mortgage market. The project of

¹⁰⁴ As to the original program, FHA explained its "credit policies for refinance transactions involving non-FHA adjustable rate mortgages where the homeowner's mortgage payment history during the 6 months prior to the reset showed no instances of making mortgage payments outside the month due." FHA MORTGAGEE LETTER 2007-11 (September 5, 2007). Available at <<http://portal.hud.gov/fha/reference/ml2007/07-11ml.doc>>.

¹⁰⁵ For an overview of the securities and mortgage litigation, parties involved and causes of action, see Jeff Nielsen (with Scott Paczosa and William Schoeffler), *Subprime Mortgage and Related Litigation: 2007: Looking Back at What's Ahead*, NAVIGANT CONSULTING, at 2-4. Available at <http://online.wsj.com/public/resources/documents/WSJ_NavSbPrimeLit022108.pdf?mod=relevancy>.

¹⁰⁶ Nick Timiraos, *FHA Draws More Interest Amid Crunch*, WSJ (March 12, 2008); Page B6. ("That scene is playing out across the country as hundreds of struggling mortgage brokers and lenders -- some of which were on their deathbeds a few months ago -- are being revived thanks mainly to FHA.")

Senator Dodd calls for creating a yet another government overseeing entity¹⁰⁷ that would control the details of the project execution and the distribution of the new \$20 billion federal subsidy. Similarly, the Treasury Blueprint plans for establishing a special office responsible for mortgages and for the general overhaul of the administrative system. It is questionable how well new entities will work and how expediently can they build up expertise in their related regulatory areas. Merging various regulatory agencies and creating new ones is an old proposition, which currently looks slightly out of place, when consumer finance and the mortgage market call for more expedient and effective modifications. To recapitulate, more disclosure and the temporary extension of the existing quasi-market facilities, such as FHA, may bring about tangible results much more expediently than devising theoretical innovations.

At the same time, the subprime MBS failures, obviously, can be mitigated, but cannot be solved by addressing a series of dispersed problems and a unified public policy agenda should be developed. To some, the US has a crazy-quilt regulatory system, although it is highly unlikely that there will be a sole financial supervisor akin to, *e.g.*, the British FSA, in the foreseeable future. It appears that the Treasury Blueprint will be a partially futile endeavor and it remains to be seen which of the proposals will actually be brought to life, if any. As opposed to structural reforms, concerted actions of all regulators of financial industries and mutual information exchange can result in more immediate and effective outcomes.

Consumer Protection and the Need for Regulatory Cooperation

In light of the significant federal preemption of state banking law and visitorial powers

¹⁰⁷ The plan calls for establishing a joint oversight Board including the Secretary of HUD, the Secretary of the Treasury, and the Chairman of the Federal Deposit Insurance Corporation (FDIC). The speech is available at <http://dodd.senate.gov/index.php?q=node/4324/print>

with respect to national banks,¹⁰⁸ the cooperation of federal and state bank supervisors becomes a pressing issue. At the state level, New York Banking Department has already initiated roundtables with state prosecutors and the Treasury on the predatory lending and mortgage fraud.¹⁰⁹ Also, in July 2007, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, the Federal Trade Commission, and state agencies¹¹⁰ planned on launching a joint program aimed at supervising banks, thrifts with the emphasis on subprime lenders and their mortgage brokers. The cooperation was supposed to improve the supervision over mortgage lending across various participants of the subprime industry. Even rating agencies – which only three years ago resisted anti-predatory lending programs of state regulators - embrace more state supervision in the belief that “the securitization market would benefit from oversight authorities addressing lenient underwriting and the potential for fraud through more stringent licensing and additional supervision of mortgage brokers.”¹¹¹

The “potential for fraud” is not fraud as such, even though a layman can think so. In March 2007, several bank regulatory agencies¹¹² issued a Statement on Subprime Mortgage Lending in which they indicated that subprime mortgage lending is not illegal or hazardous *per se*, but should be balanced in view of public policy considerations and safe and sound banking

¹⁰⁸ See, e.g., *Office of the Comptroller of the Currency v. Eliot Spitzer, Attorney General of New York*, 05 Civ. 5636 (SHS)(S.D. N.Y. Oct. 12, 2005); *The Clearing House Association, L.L.C. v. Eliot Spitzer, Attorney General of New York*, 05 CV 5629 (SHS) (S.D. N.Y. Oct. 12, 2005).

¹⁰⁹ An example is Mortgage Fraud Forum organized by New York State Banking Department and New York Prosecutors Training Institute, Inc., on April 17, 2008.

¹¹⁰ Those are represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. *Bank Regulation/Thrift Regulation*, 26 NO. 10 BANKING & FIN. SERVICES POL'Y REP. 13, 19 (2007).

¹¹¹ *Moody's Report*, *supra* note 61, 30.

¹¹² Those are Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; National Credit Union Administration; Office of the Comptroller of the Currency; Office of Thrift Supervision. See Joint Press Release (03/02/2007).

Available at <<http://www.federalreserve.gov/newsevents/press/bcreg/20070302a.htm#fn1>>.

and underwriting standards.¹¹³ All these proposals go along with the broad notion of disclosure at all levels: investors, servicers and mortgagors.

A yet another strategy is expanding the remedies available to borrowers under TILA and state law on high-cost loans. For instance, New York State imposes restrictions on the terms of high-cost loans, including, *inter alia*, interest, finance charges, and prohibits certain practices with respect to such loans.¹¹⁴ Through limiting the proportionate share of various charges as to the total amount of a home loan, the law does not undermine the banks' sources of profits as did Regulation Q, for example, but, potentially, assures a lesser portion of delinquent loans and foreclosure actions for lenders or servicers of MBS. In fact, the statutory limitations protecting mortgagors may be conducive to the long-term sustainability of the financial markets and promoting the safe and sound banking practices. That may be particularly evident when the foreclosure risks become more systemic as the market deteriorates.

Running a few steps ahead, for Russia, where the general concern is that a specter of another banking crisis is looming over the industry as the portion of bad debt in the banks' portfolios keeps mounting,¹¹⁵ a duet of information disclosure accompanied by restrictions on

¹¹³ The agencies recommended several strategies, including prohibitions of deceptive practices - particularly, with regard to endless loan refinancing – the underwriting standards evaluating borrowers' ability to repay mortgage loans, providing timely information to mortgagors and establishing internal control mechanisms. The proposed Statement relied on several concomitant standards, e.g., the Interagency Guidelines for Real Estate Lending, and called for closer scrutiny of federal regulators over the lenders and their associated mortgage brokers violating the proposed principles. Thomas P. Vartanian, *Bank Regulators' Statement on Subprime Lending: A Roadmap to Potential Enforcement Actions*, 26 NO. 4 BANKING & FIN. SERVICES POL'Y REP. 4 (2007). "On the same day that the Proposed Statement was issued, Fremont General Corporation announced in an SEC filing on March 2, 2007, that it expects to enter into a voluntary cease-and-desist order with the FDIC, under which it would agree to cease operating its brokered subprime mortgage lending and commercial real estate construction lending businesses with inadequate underwriting criteria and without effective risk management policies and procedures. The order will also require Fremont General to take a number of steps, including revising its lending and disclosure policies and implementing improved internal controls." *Id.*, 5.

¹¹⁴ See the discussion *supra* at 15-16.

¹¹⁵ For statistical market data and analyses on delinquent debts in Russia, see, for instance, Anastasia Skogoreva, *Retail Lending – Double Growth as the Overall Result of the Year* ["*Potrebitelskoe kreditovanie – dvukratny rost po itogam goda*"], JOURNAL OF BANKING REVIEW ["*JURNAL BANKOVSKOE OBOZRENIE*"] (March

high-cost loans may be more effective than any one of the foregoing measures alone. Clearly, what suffices for a mature market experiencing a short-term stagnation may not be enough for a developing market. In Russia, which, despite the lengthy Mortgage Statute,¹¹⁶ *de facto* offers much less protection to mortgagors, solely educational and disclosure provisions may be inadequate.

One characteristic of the US law that is unique and untransplantable to other jurisdictions is the federal preemption and the regulatory discord in the banking industry. Under the National Bank Act and the Home Owners Loan Act¹¹⁷ federally-chartered banks and thrifts are in many respects beyond the regulatory reach of state authorities. The preemption has been supported by judiciary and the Supreme Court.¹¹⁸ Both the OCC and OTS¹¹⁹ traditionally promoted the preemption of state laws in many areas, including real estate loans.¹²⁰ The 2004 decision by the 2nd Circuit further limited the visitorial powers of states, including in the course of criminal

2006) №3, available at <http://bo.bdc.ru/2006/3/potreb_kredit.shtml>. See also Anna Kaledina, *Retail Lending Turns to be a Trap* [*“Potrebitelskie kredity stanovitsia lovushkoy”*], FINANCIAL NEWS [*“GAZETA FINANSOVYE IZVESTIA”*] (March 21, 2006) at <http://fin.izvestia.ru/cfin/tmpl-art/id_art-995572>.

¹¹⁶ The Federal Law “On Hypothec (Pledge of Immovables)” [*“Ob ipoteke (zaloge nedvijimosty)”*] No. 102-Φ3 of July 16, 1998 (the latest consolidated version is of December 30, 2004, No. 216-Φ3) (hereinafter: the Mortgage Statute)

¹¹⁷ 12 USCA §§ 1461, 1462, 1462a, 1463, 1464, 1466, 1466a, 1467, 1467a, et seq.

¹¹⁸ In *Tiffany*, the Supreme Court held that:

It cannot be doubted, in view of the purpose of Congress in providing for the organization of the National banking associations, that it was intended to give them a firm footing in the different States where they might be located. [...] National banks have been National favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the General government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the States, or to ruinous competition with State banks. *Tiffany v. National Bank of Missouri*, 85 U.S. 409, 412-413 (1873). For example, the court in *Phipps* stated that all closing costs were within the meaning of “interest” under federal law as defined by law and the OCC.” *Phipps v. Guaranty National Bank of Tallahassee*. 2003 WL 22149646 (2003), 417 F.3d 1006 (8th Cir. 2005)

¹¹⁹ 12 U.S.C. § 1464(a).

¹²⁰ *First Nat. Bank v. California*, 262 U.S. 366, 369 (1923). 12 C.F.R. § 34.4(a)(2) In its regulations, the OCC stipulated that a “national bank may make real estate loans [...] without regard to State law limitations [, including those related to] schedule for the repayment of principal and interest.” Those concern, in particular, “processing, origination, servicing, sale or purchase of, or investment or participation in, mortgages,” as well as interest rates on loans. 69 Fed. Reg. 109; 12 C.F.R. § 34.4(a)(10), (12)

investigations by Attorney Generals.¹²¹

Outside of courtrooms, regulators usually accuse each other of market failures attempting to demonstrate the need to take away/return their authority. In February, in a response to accusatory comments by the former New York Governor Eliot Spitzer, the Comptroller issued a press release arguing that the worst abuses came from mortgages originated by state-licensed mortgage brokers and lenders,¹²² not the OCC-regulated banks. The validity of these statements is dubious and statistics do not support either accusation.

It is a fact that the predominant majority of key financial institutions are under the federal charter. Let us take a perfunctory look at some 10Ks. Wells Fargo & Company is a corporation organized under the laws of Delaware and is a financial holding company and a bank holding company registered under the Bank Holding Company Act.¹²³ Washington Mutual, Inc., is incorporated in the state of Washington and is a savings and loan holding company subject to the regulation by OTS. Its banking subsidiaries – such as, *e.g.*, Washington Mutual Bank - are also within the jurisdiction of federal regulators and FDIC.¹²⁴ CitiFinancial Credit Company (hereinafter: CCC) is a component of the U.S. Consumer Lending business and an indirect wholly owned subsidiary of Citigroup held through Associates. Associates First Capital Corporation is a wholly owned subsidiary of Citigroup.¹²⁵ Based on their 2006 10K, JPMorgan Chase & Co. is a financial holding company incorporated under Delaware law. JPMorgan Chase's principal bank subsidiaries are JPMorgan Chase Bank, National Association, a national

¹²¹ See *supra* note 108.

¹²² *The OCC Press Release* (February 14, 2008). Available at <<http://www.occ.treas.gov/ftp/release/2008-16.htm>>.

¹²³ Available at https://www.wellsfargo.com/pdf/invest_relations/2006_10k.pdf

¹²⁴ See, *e.g.* Washington Mutual web site at <<http://investors.wamu.com/Cache/3491344.pdf?FID=3491344&O=3&IID=102028&OSID=9>>.

¹²⁵ The Citigroup 10K is available at <<http://www.citigroup.com/citigroup/fin/data/k07c.pdf>>.

banking association with branches in 17 states, and Chase Bank USA, National Association.¹²⁶ So, unless the OCC believed that all of them had nothing to do with the origination of subprime mortgages or if they referred in their press release to only state lenders and brokers who committed fraud, the statement lacks validity. Obviously, no one accuses the aforesaid financial institutions in law violations as subprime does not equal predatory, although one may lead to another.

Some sort of political bickering may continue for some time in the future. Yet, more constructive voices are also heard. In one of his recent speeches, New York Superintendent of Banks Richard Neiman, for instance, called to “embrace a new form of federalism, one which highlights states in their traditional role as overseers of the real estate market in their jurisdictions. The preemption debate implies another underlying question: is it more appropriate for the mortgage business to be supervised predominantly at the federal level, or also at the state level as it is currently? I’d like to give an unequivocal answer: effective regulation of this industry absolutely necessitates a balanced partnership with an engaged and proactive state government.”¹²⁷

Conclusions

A better cooperation among various agencies should not signify that the lending industry is about to become over-regulated. That would clearly run contrary to the legislative tendencies of the last decades, including the lessening of the regulatory regime, the repeal of the Glass-

¹²⁶ Chase 10K is available at <http://files.shareholder.com/downloads/ONE/244957876x0xS950123-07-3015/19617/filing.pdf> >.

¹²⁷ *Superintendent Neiman Addresses the Exchequer Club on State and Federal Cooperation in Resolving the Subprime Crisis* (January 16, 2008). Available at <http://www.banking.state.ny.us>.

Steagall Act¹²⁸ and other novelties. It is more probable that the enhanced disclosure rules and transparency would become the key tools of regulatory agencies. Some measures, such as *FHASecure*, will remain temporary, others, like state mortgage counseling may become embedded into state law permanently. It is evident that given the speed of financial innovations, such statutes as TILA, consumer protection laws, the disclosure requirements in mortgage and securities law and monitoring of rating agencies should be subject to systemic, not *ad hoc*, reviews by the authorities responding to business cycles. Finally, it is also clear that the present crisis hardly necessitates a substantial overhaul of the regulatory structure, what would be both protracted and costly in terms of time and financial resources.

4. History Lessons and Market Periodization of the US Mortgage-Backed Securitization

Let us now turn to the transplanting issues and the lessons that other jurisdiction can learn from the history of securitization and the described above anti-crisis policies. Before the current crisis erupted, it was widely acknowledged that, for real estate markets, MBS were a positive innovation in terms of both social and market policies. MBS made mortgages more affordable through providing mortgage originators with easier access to secondary mortgage and capital markets. It should be emphasized that, the evolution of US mortgage-backed securitization was a century long. The periodization of the development of this instrument may be outlined through the following periods: (1) from the 19th century through the Great Depression, (2) from 1940s until the late 1960s, (3) the 1980s-1990s and (3) the past several years.

¹²⁸ 12 USCA §§ 24a, 248b, 1820a, 1828b, 1831v to 1831y, 1848a, 2908, 4809; and 15 USCA §§ 80b-10a, 6701, 6711 to 6717, 6731 to 6735, 6751 to 6766, 6781, 6801 to 6809, 6821 to 6827, 6901 *et seq.*

The *first* stage exhibited the two main traits, namely, wide-range market innovations against a comparative lack of regulation on the part of state authorities and insufficient market discipline. In that time period, the early market-driven experiments were made with securities used for financing construction projects. Those occurred from approximately the mid 19th century to the Great Depression. The geographical distribution of such novelties was very uneven with the concentration around New York City real estate projects.¹²⁹ The most fundamental criterion differentiating this period is that it was the market initiative as such that procreated new ways to access cheap capital and to turn mortgages into liquid securities.

This is the time period when one can discern some similarities between the US before the Depression and emerging markets, such as was Russia from the collapse of communism to the major Russian financial crisis of 1998. The relative federal statutory and *institutional vacuum* existing in both countries, as well as the lack of market discipline instigated market agents and spawned innovative fraud and trust schemes.¹³⁰ The proponents of the post-communist shock-therapy approach, as well as many moderate reformers all agreed that in the early 1990s the “anxious state of affairs thus raise[d] the question whether commercial law reforms designed to enforce market discipline in Russia were too late.”¹³¹ As history proved,¹³² it was a disastrous

¹²⁹ See, e.g., Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 500 (1989).

¹³⁰ Whatever were the reasons of the hasty and quite precipitate Russian reforms, the end result was that a species of institutional vacuum appeared and as a general rule “[e]conomic revolutions that destroy existing institutions before new ones can be built are similarly likely to founder, as those without scruples take advantage of [such] vacuum.” Bernard Black, Reinier Kraakman and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?* 52 STANFORD LAW REVIEW 1731, 1803 (2000).

¹³¹ Patricia A. McCoy, *Levers of Law Reform: Public Goods and Russian Banking*. 30 CORNELL INT’L L.J. 45 (1997).

¹³² Today, it is a widely accepted convention that the institutional reform is a prerequisite of successful transition and prosperity and that it should ideally “precede or at least accompany enterprise privatization,” albeit the probability of such reforms in a particular country under transitional conditions is not always certain. Bernard S. Black and Anna S. Tarassova, *Institutional Reform in Transition: A Case Study of Russia*. 10 SUP. CT. ECON. REV. 211, 220 (.2003). See also O. Lee Reed, *The Rule of Law, and Property: A Foundation For the Private Market and Business Study*. 38 AM. BUS. L.J. 441, 442 (2001). Lee Reed also refers to the UN Secretary-General Kofi Annan who noted that “without rules governing contracts and property rights; without confidence based on the rule of law; without trust

havoc as the party believing that “economic liberalization had to precede market discipline laws”¹³³ had taken over and the necessary statutes were developed only later, particularly, after the 1998 crisis. In fact, the atmosphere of lawlessness intertwined with the *laissez-faire* public policies were similar in both the US before the Depression¹³⁴ and the RF before 1998.

The *second* time-period of securitization in the US is signified by the emergency measures introduced *via* direct government involvement in a salvation attempt during the Great Depression and later on. As I have mentioned above, the present credit crunch cannot be denoted as a “depression” and the government policies represent more a variation of the existing statutory templates and federal programs. The only possible exception is more state regulation of high-cost loans and closer regulatory scrutiny of rating agencies, auditing firms through the SOA and other statutes.

Some legislative securitization landmarks are explained by the interest-group cycle theory. The theory may be organically embedded into a more general taxonomy of business cycles by Arthur Schlesinger. The general hypothesis is based on the alterations of private interest and public actions, where the latter coincides with social or economic instability in the country, namely, 1832, 1860, 1900, 1932, and the 1960s preceded by private actions flourishing around the 1890s, 1920s, 1950s and 1980s.¹³⁵ Business is sometimes portrayed as “the most

and transparency-there could be no well-functioning markets.” (Secretary General Kofi Annan, Address Before the United States Chamber of Commerce (June 10, 1999), in M2 Presswire, June 10, 1999, at 1, available in LEXIS, News Group File.) Id. at 43.

¹³³ Patricia A. McCoy, *supra* note 131, 46.

¹³⁴ For the development of theoretical underpinnings of the economic schools in the 19th and early 20th centuries in the US and Europe, *see, e.g.*, ALFRED WILLIAM COATS, ON THE HISTORY OF ECONOMIC THOUGHT, British and American Economic Essays. Routledge (1992). *See, in particular*, Part III: *Late 19th Century British Economics* (213-340) and Part IV: *American Economics* (341-450). The last section of Part IV is devoted to new theories emerged from the 1920s and introduced starting from the Great Depression to the 1970s. The section is more concerned about developing Keynesianism in the US.

¹³⁵ ARTHUR M. SCHLESINGER, JR, THE CYCLES OF AMERICAN HISTORY. Boston, Mass.: Houghton Mifflin (1986), 31-32.

powerful social force with the possible exception of the federal government.”¹³⁶ The timing of ebbing power of market producers correlates with new regulatory reforms and the growth of counterpoising social movements. The Great Depression and the New Deal initiatives in mortgage financing depicted that trend.¹³⁷

The crash of the banking system of the 1930s disrupted the customary practices of localized mortgage financing as the mortgagors were distrustful of local banks sensitive to the contagion of financial breakdowns of “money-center” banks.¹³⁸ For local banks, mass defaults by borrowers were one of the major concerns calling for government’s attention. The Congress soon responded by establishing the Federal Home Loan Bank System,¹³⁹ particularly, in order to support local lenders. The US government also temporarily accepted the role of “the lender of last resort” towards the US citizens when the Congress introduced short-term measures provided for by the Home Owners' Loan Act.¹⁴⁰ The newly created Home Owners’ Loan Corporation (hereinafter “HOLC”)¹⁴¹ helped out about one million mortgagors unable to make mortgage

¹³⁶ Andrew S. McFarland, *Interest Groups and Political Time: Cycles in America*, BRITISH JOURNAL OF POLITICAL SCIENCE, VOL. 21, NO. 3. (Jul., 1991) 257, 273.

¹³⁷ On the continuous power plays among various interest groups in the housing market, particularly FHA and FHLB see, for example, David M. French, *The Contest for a National System of Home-Mortgage Finance*, *The American Political Science Review*, Vol. 35, No. 1. (Feb., 1941) 53, 55. The author further referred to some statistics revealing that about 50% of the F.H.A. insured mortgage were held by national and state banks and trust companies; about 20 % were purchased by life insurance companies, while the savings and loan associations hold only some 11 or 12 per cent as of 1940.

¹³⁸ Those, as mentioned earlier, were actively involved in risky transactions linked to NYSE operations and felt the economic shock of the Depression among the first. See, e.g., George G. Kaufman, *Bank Contagion: A Review of the Theory and Evidence*, JOURNAL OF FINANCIAL SERVICES RESEARCH, Vol. 8, No. 2 (April, 1994), 123. In an earlier publication, Kaufman et al. studied the number and significance of bank insolvencies and the role Federal Reserve and FDIC in historical perspective. The authors strongly argue in favor of strengthening market discipline as opposed to state intervention. GEORGE J. BENSTON, ROBER A. EISENBEIS, PAUL M. HORTVITZ, EDWARD J. KANE, AND GEORGE G. KAUFMAN, *PERSPECTIVES ON SAFE AND SOUND BANKING: PAST, PRESENT, AND FUTURE*, Washington: American Bankers Association, Cambridge, MA: MIT Press and London (1986).

¹³⁹ The Federal Home Loan Bank Act (July 22, 1932, c. 522, § 1, 47 Stat. 725.); 12 U.S.C. §§1421-1449.

¹⁴⁰ Home Owners' Loan Act (HOLA) (June 13, 1933, ch. 64, 48 Stat. 128); 12 U.S.C. §§1461-1468. HOLA was perceived as granting the “occupying the field” regulatory powers, what is also incorporated in the OTS view.

¹⁴¹ The HOLC ceased its lending activities in around 1936. On its general history, see, e.g., C. LOWELL HARRIS, *HISTORY AND POLICIES OF THE HOME OWNERS’ LOAN CORPORATION*. National Bureau of Economic Research

payments under preexisting terms.¹⁴² The HOLC's rate of foreclosures was quite low considering the riskiness of its activities and amounted to approximately 20% of the total mortgages refinanced.¹⁴³ Most of the sales occurred in the late 30s and early 40s, what showed the central purpose of HOLC: to stabilize the market and to delay the sales until the economy and the financing industries have coped with the recession.¹⁴⁴

Another nearly immediate administrative response by the Congress came as the Federal Housing Administration¹⁴⁵ (FHA) and the Federal National Mortgage Association (FNMA)¹⁴⁶ in 1938. The latter, until the reforms of the late 1960s, dealt primarily with conforming mortgages, *i.e.*, mortgages insured by FHA. One of the main purposes of FNMA was providing liquidity for mortgages by buying and selling mortgages in times of a shortage and a surplus of real estate lending capital on the market.

Financial Research Program: Studies in Urban Mortgage Financing. New York: National Bureau of Economic Research, Inc. (1951).

¹⁴² The bulk lending occurred in 1934 and 1935 totaling \$3.1 billion Id., at 1. HOLC helped refinancing mortgages. In some cases, banks also received from the debtors a second mortgage on the property with the hope to recoup the difference between the bond price and the original mortgage in case the debtor pays off the second mortgage upon discharging its first mortgage payment obligations to HOLC. For an analysis of the related practices of HOLC and mortgagees, *see, e.g.*, Roy L. Steinheimer, *Contracts: Illegality: Collateral Agreements under Home Owners' Loan Act*, Michigan Law Review, Vol. 38, No. 4 (Feb. 1940), 508. HOLC dealing with distressed mortgages often offered mortgagees HOLC bonds in full settlement of the mortgagors' debt obligations. The bonds might be severely discounted in relation to the original mortgage being refinanced. On the opposite mortgagor-side, banks - burdened by potentially large-scale foreclosures, the consequent need to maintain foreclosed property, and the omnipresent capital shortages and insolvencies - also benefited from HOLC programs. *See, e.g.*, KENNETH T. JACKSON, *CRABGRASS FRONTIER: THE SUBURBANIZATION OF THE UNITED STATES*, Oxford University Press, USA (1987), 194-196. Notably, HOLC offered the terms of refinancing that were very novel for the time and extremely favorable to borrowers, such as 15-year term of amortization, lower mortgage rates compared to those offered by commercial banks and thrifts before the Great Depression, etc. *Id.*

¹⁴³ HARRIS *supra* note 141, 197.

¹⁴⁴ In the 1930s, Title I of the National Housing Act granted FHA the power of insuring mortgages for building and purchasing residential real estate or refinancing existing properties. The primary rationale behind this was not only to assuage the societal upheaval, but also to stimulate continuous lending to the building industry provided by mortgage banks and other financial institutions. David French, *e.g.*, even argued that the first housing programs were even more market-oriented than some equality advocates may argue as “[h]ome-owner debtors attracted public attention because their salvation would not disturb the status quo – as would public housing – and because their interests were linked for the moment both with the plight of the nation’s creditors and with the prospects of recovery for a distressed realty market.” *Supra* note 137, 53.

¹⁴⁵ National Housing Act (also Federal Housing Act) (June 27, 1934, ch. 847, 48 Stat. 1246). Codified in various sections under Title 12 USC.

¹⁴⁶ *See* 12 U.S.C. §§ 1716, 1717, 1718, 1719, 1723.

The US system of the government mortgage insurance through FHA has been the nucleus of securitization for long time since its inception in 1934. The experience of FHA, FNMA and HOLC may be valuable examples for Russia. In addition to the general susceptibility of the Russian economy to the global credit crunch, there are, as mentioned above, growing domestic concerns regarding “bad debt” in bank portfolios. Hence, some form of government mortgage insurance may be advisable for Russia, where structured finance is taking off.

In the US, the “evolution” of structured finance took some time and only the 1970s witnessed the changes in the secondary mortgage market significant to such an extent that the trade of the two preceding decades was outshone as quite trivial.¹⁴⁷ The *third period, the period of growth*, started approximately in the late 1960s with introducing more government’s innovations and continued through the boom of the markets for real estate and MBS to the instability of 1983-1987, when the market emergency caused another series of legislative innovations. This period can be characterized as a successful realization of the project conceived about thirty years ago, *scilicet*, when FNMA was broken down to two agencies - FNMA and GNMA - FHLMC was created and both launched new MBS programs and were allowed to deal in conventional mortgages. Finally, with the first private issuance of collateralized securities by Bank of America in 1977, the private market infiltrated the field of securitization.¹⁴⁸

The 1960s were a troubling period for the Federal Reserve and the US Government. *First*, inflation was rising with quite disturbing speed from the mid 1960s,¹⁴⁹ what caused a series of credit crunches in the 1960s and disturbed the mortgage industry. *Second*, the

¹⁴⁷ See, e.g., Shenker and Colletta, *supra* note 10, 1383.

¹⁴⁸ See, e.g., Peter M. Carrozzo, *Marketing the American Mortgage: The Emergency Home Finance Act of 1970, Standardization and the Secondary Market Revolution*, 39 REAL PROP. PROB. & TR. J. 765 (2005).

¹⁴⁹ For a brief overview of the theories explaining the sharp rise of inflation from the mid 1960s to 1980s, see, e.g., Kevin J. Lansing, *Exploring the Causes of the Great Inflation*, Federal Reserve Bank of San Francisco, Economic Letter 2000-21 (July 7, 2000). Available at <<http://www.frbsf.org/econrsrch/wklyltr/2000/el2000-21.html>>.

international ambience contributed to the national economic stagnation. Inasmuch as the US dollar became substantially overvalued as a result of the Bretton Woods Agreement and the affiliated policies, American export suffered, while inflation kept growing.¹⁵⁰ *Third*, the mortgage industries experienced a severe lack of capital. Given the shortage of mortgage lending funds, the government found a solution in capital markets as a potential source of financing real estate. *Fourth*, the countries-producers of crude oil were about to change the nature of the oil industry ousting the “Seven Sisters” from the Middle East.¹⁵¹ *Fifth*, the demographic alterations helped undermine the common equilibrium of deposit-lending practices by thrifts. Particularly, this was due to several reasons. One the one hand, the so-called baby boomers had grown up by the 1970s, thus, increasing the demand for residential real estate. On the other hand, while the main source of mortgage capital remained the savings made by local community members - who, by and large, were older and more prosperous than those borrowing to purchase first homes – that could not meet the demand of younger generations. The concurrent problem was that, before the reforms in the early 1970s, mortgage lending was geographically segmented and inexorably connected to local savings and loans associations and banks. The “spread banking” dominated the business of banking.¹⁵²

The Senate Committee on Banking and Currency intended to expand FNMA purchasing

¹⁵⁰ See, e.g., John H. Makin, *Swaps and Roosa Bonds as an Index of the Cost of Cooperation in the “Crisis Zone,”* THE QUARTERLY JOURNAL OF ECONOMICS, VOL. 85, NO. 2 (May 1971), 349.

See, also, BARRY EICHENGREEN, *GLOBALIZING CAPITAL: A HISTORY OF THE INTERNATIONAL MONETARY SYSTEM*. Princeton University Press (1996). See, in particular, Ch. 4. “The Bretton Woods System” and Ch. 5. “From Floating to Monetary Unification.”

¹⁵¹ The Sisters included the group of the largest international oil companies mainly headquartered in the US (such as Exxon Mobil, Texaco, Gulf and Socal, now merged with Chevron Corporation), the Netherlands (Shell) or Great Britain (BP). Blessed by the Ministries of Foreign Affairs and the US State Department the Sisters operated in the Middle East and Arab countries with “[t]he appearance of neutrality encouraged the oil companies to treat governments cavalierly, and to present themselves as the guardians not only of the security of the West, but of the peace of the world.” The formation of OPEC put a halt on this system. See ANTHONY SAMPSON, *THE SEVEN SISTERS: THE GREAT OIL COMPANIES AND THE WORLD THEY MADE*. VIKING ADULT (1975). See, in particular, Ch. 9 “Sisters Under Stress.”

¹⁵² See, e.g., Shenker & Colletta, *supra* note 10, 1389.

authority to conventional mortgages¹⁵³ and to charge FNMA with the responsibilities to issue mortgage-backed securities, what the agency had been long planning to do. The proposed Senate bills were later signed into the Emergency Home Finance Act of 1970.¹⁵⁴ *First*, the Bill expanded the customer base of FNMA to conventional mortgages and established quite solid safeguards for diminishing the risks of the entity. *Secondly*, the Bill proposed establishing the Federal Home Loan Mortgage Corporation¹⁵⁵ with the purpose to purchase mortgages - instead of providing mortgage warehousing facilities only - from the federal home loan banks¹⁵⁶ subject to the same requirements as were established for FNMA conforming mortgages. FNMA and FHMLC obligations are not backed by the full faith and credit of the US government, but they have close ties with the government. Since the inception of the securitization programs, FNMA and FHMLC enjoyed an exemption from federal securities registration and other requirements imposed by SEC in accordance with the Securities Act of 1933.¹⁵⁷

Generally, in the 1970s and 1980s, the development of the secondary market for PMBS was hampered as “without a GSE issuer and the credit enhancement from a government guarantee, the Wall Street market would not consider a Private Label MBS to be equivalent to a GSE issued MBS.”¹⁵⁸ Today, PMBS are once again deemed risky securities compared to government-insured MBS. In the 80s, it was acknowledged that GSEs crowded out private MBS. That was before standardized documentation, proper credit enhancements and investment grade

¹⁵³ *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*, US Department of the Treasury (1996), 17.

¹⁵⁴ Emergency Home Finance Act of 1970 (Pub.L. 91-351, July 24, 1970, 84 Stat. 450). Codified at 12 USCA §§ 1451-1459.

¹⁵⁵ 1970 U.S.C.C.A.N. at 3495

¹⁵⁶ Leibold, *Uniform Conventional Mortgage Documents: FHLMC, Style, 7 REAL PROP. PROB. & TR. J.* 435, 438 (1972).

¹⁵⁷ 15 USCA §§ 77a-77aa.

¹⁵⁸ Forter, J. Ph., *Capital Markets Mortgage: A Ratable Model for Main Street and Wall Street*. SM008 ALI-ABA 345 (2007), 347.

ratings became the common characteristics the PMBS market in the late 1980s and through the 1990s. The absence of standardized loan and underwriting criteria and “the lack of a well-developed secondary market for commercial mortgage loans”¹⁵⁹ also contributed to a slower growth of PMBS.¹⁶⁰ Overall, until the late 1980s, private label securitization lagged behind its government-sponsored counterpart what, taken together with the wretched state of the mortgage financing industry,¹⁶¹ aggravated by inflationary pressures, warranted further reforms.

In summer 1982, the 22-member Presidential Commission on Housing and a rival task force appointed by the House of Representatives started independent investigations of the residential real estate market and mortgage financing. The goals of the Presidential Commission were to find the ways to lessen the burdens of the federal budget and to reorganize federal housing programs, on the one hand; and to examine financial condition of the savings and loan industry, on the other. The approaching thrift crisis, which erupted later, in the late 1980s and continued through the early 1990s, “placed enormous stress on the statutory and administrative system for resolving depository institutions failures, a lazy backwater of the law since the 1930s.”¹⁶²

The forthcoming increase in commercial securitization was encouraged by several factors, including the well-tested use of credit enhancement mechanisms – such as, *inter alia*,

¹⁵⁹ See Schenker and Colletta, *supra* note 10, 1398.

¹⁶⁰ For a statistical reference, in 1990 only 5% of non-GSE commercial and multifamily mortgages were securitized in the US. By 2004, 20% were already used in private issues of securities. S.J. Gordon, *CMBS: New Rules for an Old Asset Class*, SJ090 ALI-ABA 153, 156 (2004).

¹⁶¹ “The chairman of the Federal Home Loan Bank Board, Richard T. Pratt, [...] estimated that [by 1981] about 80 percent of all savings and loans [were] experiencing operating losses and that about a third ha[d] serious financial problems that could lead to failure.” Cited at Andre Shashaty, *Housing Ills Under Federal Review*, THE NEW YORK TIMES (August 9, 1981). Available at <<http://query.nytimes.com/gst/fullpage.html?res=9D03EEDB143BF93AA3575BC0A967948260&sec=&spon=&pagewanted=1>>.

¹⁶² Macey, Miller and Carnell, *supra* note 18, 723. The scope of the crisis was so overwhelming that “bank failures depleted the reserves of the FDIC’s Bank Insurance Fund and left the fund \$7 billion in the red.” *Id.*

bank guarantees, letters of credit, surety bonds, over-collateralization and others - the new trends in bankruptcy and corporate law facilitating bankruptcy remoteness of the SPVs, and easier registration requirements for private issues of MBS.¹⁶³

It was indispensable to increase investors' base for private MBS by means of legislative reforms. The Secondary Mortgage Market Enhancement Act of 1984 worked in this direction improving marketability of private-label MBS by creating SMMEA-qualified securities, which were MBS assigned a double-A rating or higher by the nationally recognized credit rating agencies. The demand side for such private securities was then expanded reaching out to federal banks, credit unions and thrifts, which were allowed to invest in private mortgage-related securities.¹⁶⁴ State regulations and investment laws with regard to state-chartered depository institutions and insurance companies were preempted¹⁶⁵ and state financial institutions were

¹⁶³ Among the legal reforms that backed Bankruptcy Reform Acts of 1978 and of 1994, changes in the federal regulations under Rules 144 and 145, Securities Act Release, repeal of the Glass-Steagall Act, Gramm-Leach-Bliley Act Financial Modernization Act of 1999 and others.

¹⁶⁴ The Securities Exchange Act of 1934 defines that "[t]he term "mortgage related security" means a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization, and either:

(A) represents ownership of one or more promissory notes or certificates of interest or participation in such notes (including any rights designed to assure servicing of, or the receipt or timeliness of receipt by the holders of such notes, certificates, or participations of amounts payable under, such notes, certificates, or participations), which notes:

(i) are directly secured by a first lien on a single parcel of real estate, including stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure, on a residential manufactured home as defined in section 5402(6) of Title 42, [...];

(ii) were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution which is supervised and examined by a Federal or State authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 1709 and 1715b of Title 12, or [...] section 1703 of Title 12; or

(B) is secured by one or more promissory notes or certificates of interest or participations in such notes (with or without recourse to the issuer thereof) and, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, on notes meeting the requirements of subparagraphs (A)(i) and (ii) or certificates of interest or participations in promissory notes meeting such requirements." (15 U.S.C.A. § 78c).

¹⁶⁵ 15 U.S.C. § 77r-1.

allowed to invest in MBS, as defined in the Securities and Exchange Act, in a similar way they were entitled to invest in Treasury securities and GSE MBS under legal investment laws.¹⁶⁶

The major objective of the reforms was to level the playing field for public and private MBS issuers, lessen the federal government insurance risks and draw more private capital in mortgage financing. The regulatory flaw that transpired recently was that the reforms did not account for market innovations, which require seasonal reviews and alterations in disclosure requirements, consumer protection laws, including TILA, and banking regulation and oversight. This approach seemed justified for several decades. GSEs and private-label MBS were for years seen as instruments furthering the American dream.

As a relatively new phenomenon, securitization was perceived as a positive “neologism used to describe the transformation of illiquid financial claims, often held by depository financial intermediaries, into tradeable”¹⁶⁷ standardized commodities only 20 years ago. Recently, securitization was still seen as an intensively developing phenomenon “reputed to be by far the most rapidly growing segment of the U.S. credit markets, and its use [was] rapidly expanding worldwide.”¹⁶⁸ To recapitulate, liquidity, or more correctly “illiquidity” inherent to the nature of mortgages, was among the underlying stimuli of mortgage-backed securitization. The reasons were that “like an interest in an unincorporated business, each mortgage was unique [and its

¹⁶⁶ 15 U.S.C. § 77r-1(c). Within a seven-year term stipulated in SMMEA for the states to override its provisions, some states indeed availed of that option. Id. “As of January 1, 2007, the following seven states regulate the sale of SMMEA securities: Arkansas, Indiana, Louisiana, Minnesota, New Mexico, Oklahoma and Utah. In those states, issuers of mortgage related securities are required to comply with state securities laws relating to the registration or qualification of such securities, or exemptions therefrom.” COMMON TERMS IN STRUCTURED FINANCE, 2nd ed., Thacher Proffitt (2007), at 25. Available at < <http://www.tpw.com/>> and <http://www.tpw.com/PublicDocs/2nd_edition_Common_Terms_in_Structured_Finance.pdf>.

¹⁶⁷ Stuart I. Greenbaum and Anjan V. Thakor, *Bank Funding Modes: Securitization versus Deposits*, 11 J. BANKING & FIN. 379 (1987).

¹⁶⁸ Steven L. Schwarcz, *The Impact of Bankruptcy Reform on “True Sale” Determination in Securitization Transactions*, 7 FORDHAM J. CORP. & FIN. L. 353 (2002).

contractual terms] tended to vary greatly from lending institution to lending institution,”¹⁶⁹ and that “the investor risk in each mortgage varied according to the strength of the mortgage collateral and the ability of the borrower to pay.”¹⁷⁰ With the rise of GSEs and new regulatory policies,¹⁷¹ the latter group of risks became less pronounced for conforming mortgages.

Later on, private mortgage markets offered investors higher yields, secondary market liquidity, and “more protection by way of collateral overages and/or guarantees by entities with high and stable credit ratings,”¹⁷² as well as an assurance that the structural credit enhancements are sufficient safeguards testifying the appropriate quality of the collateral. These structural “warranties” decreasing costs to investors appeared “the single largest factor in the growth of the structured finance market.”¹⁷³ In view of the present crisis, that eulogy now seems hazardously exaggerated. The actions that the US government may undertake in collaboration with the market in the next several months will be determinative as to not only the domestic markets, but the global financial markets in general.

The methods how the US has been addressing the problems of financial markets in the past three decades are the most important for the developing countries in search for the best transplantable models. Particularly, it concerns the potential dangers concomitant to mortgage-backed securitization, such as predatory lending, over- or under-regulation of private securities and banking sectors, which may require urgent state measures such as, *inter alia*, SMMEA or changes in the federalization principles as applied to national banks, the evolution of judicial

¹⁶⁹ Joseph C. Long, *Chapter 2. What Is a Security? VIII. Miscellaneous Securities*, SECBLUE § 2:90 (2006).

¹⁷⁰ *Id.*

¹⁷¹ Greenbaum and Thakor, for instance, mentioned that securitization springs from regulatory developments and “[i]t is often argued that securitization represents a form of regulatory arbitrage arising from increased deposit insurance fees and related regulatory taxes.” Greenbaum and Thakor, *supra* note 167, 383.

¹⁷² *Asset Securitization, Comptroller's Handbook*, Comptroller of the Currency, Administrator of National Banks (November 1997), 4. Available electronically at < <http://www.occ.treas.gov/handbook/assetsec.pdf> >. Last time accessed on 07.07.2007. Hereinafter: The OCC Handbook.

¹⁷³ *Id.*

thinking depicted through such problematic cases as *Clarke*¹⁷⁴ or *Kingston Square Associates*¹⁷⁵ or the Sarbanes-Oxley Act post-Enron. The range of responses to the current crisis is still an open question.

Today, we are in the *fourth* critical period of the development of structured finance products. The changes in mortgage law, securities regulations or business associations law introduced through the government policies and self-regulatory organizations continuously affect the methods of financing.¹⁷⁶ Even though legal transplanting is no panacea for most countries and, as Profs. Pistor and Richard pointed out, “unreceptive” transplants, *i.e.*, those where a foreign model does not produce the same effect as in the country of origin, occur more often than not,¹⁷⁷ general methods of financing and regulation are unambiguously converging.¹⁷⁸ The Russian nascent MBS practices clearly demonstrate that.

¹⁷⁴ *American Insurance Association v. Robert L. Clarke et al.*, 656 F.Supp. 404 (D.D.C.,1987), 885 F.2d 1034 (1989).

¹⁷⁵ *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

¹⁷⁶ For example, the model and uniform acts of the National Conference of Commissioners in some form influenced state law. Yet, for instance, neither was Uniform Land Transaction Act (ULTA) of 1974, nor the further Uniform Land Security Interest Act of 1985 enacted by state legislatures. *See, e.g.*, Ronald Benton Brown, *Whatever Happened to the Uniform Land Transactions Act?* 20 NOVALR 1017 (1996); Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1371 (2006). However, the model laws are occasionally cited by courts. *See, e.g.*, Steven L. Good and Celeste M. Hammond, *Real Estate Auctions – Legal Concerns For an Increasingly Preferred Method of Selling Real Property*, 40 REAL PROP. PROB. & TR. J. 765, 809 (2006), where the authors mention that in cases related to auction sales of real estates – where case or statutory law is scarce - “some courts have relied on treatises, while other courts have looked to Article 2 of the Uniform Commercial Code (UCC), and some courts have mentioned the Uniform Land Transactions Act (ULTA).”

¹⁷⁷ *See, e.g.*, works by Pistor, Berkowitz and others on legal transplanting (Daniel Berkowitz, Katharina Pistor and Jean-Francois Richard, *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003), Katharina Pistor, *The Standardization of Law and Its Effect on Developing Economies*, 50 AM. J. COMP. L. 97 (2002).

¹⁷⁸ Jonathan R. Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L.J. 1353, 1375 (2003).

5. The Russian and US Mortgage Financing Models

Certain traits of the Russian structured finance remind of the US mortgage financing in the 1980s-1990s. *First*, mortgage financing is clearly on the public agenda.¹⁷⁹ *Secondly*, there is a juxtaposition of a relative stability of banking and the perceptible lack of mortgage capital. Gradually, while the public appetite for investments is growing, the banks give up their nearly monopolistic positions as capital providers to mutual funds, insurance companies and other financial companies.¹⁸⁰ The origins of that lack of bank capital are, clearly, distinct in both countries. In Russia, unable to tap the sources of consumer finance, national banks are outplayed by globalization, as large commercial borrowers prefer to address international markets, while foreign financial institutions are entering into the RF.¹⁸¹ Even supposing that Russian mutual funds and investment vehicles are not yet mature enough to compete with banks, international competition increasingly impacts the Russian markets and becomes hard-edged forcefully calling for more financial innovations.¹⁸² In the US and globally, banking products are converging, what includes the methods of procuring more bank capital through structured finance products and other innovations. There is a conspicuous need for expanding product boundaries of traditional banking in Russia, as there was in the US until the Gramm-Leach-Bliley Act.

¹⁷⁹ The Strategy of the Development of the Unified System of Refinancing of Residential Mortgage Loans in Russia [“*Kontseptsiya razvitiya unifikirovannoy systemy refinancirovaniya ipoteknikh zhilishnih kreditov v Rossii*”]. Agency for Housing Mortgage Lending (2006), 26.

¹⁸⁰ For an analysis of the upsurge of institutional investors, through which most households held stocks and other securities in the US, see *Worker Capitalism*, Wall St. J. (Nov. 30, 1999), at A 26. For the growth of the mutual fund industry and the development financial products by insurance companies, see, e.g., E.S. Browning, *What Moves Markets – New Forces Are Now Powering Surging Stocks – Ordinary Joes Move Market Toward Dow 10000 Mark With Aid From TV, Internet*, WSJ (Mar. 15, 1999), at C1; Pui-Wing Tam & Karen Damato, *The First 10,000 Points, Mutual-Fund Cash Did Much to Wag the Dow*, WSJ (Mar. 30, 1999), C14. Bridget O’Brian, *Variable-Annuities Business to Get Boost As More Price Competition Is Introduced*, WSJ (Sept. 8, 1999), at C1.

¹⁸¹ See, e.g., V. Zrazhevsky, *Today and Tomorrow of the Russian Banking System*, QUESTIONS OF ECONOMICS [“*VOPROSY EKONOMIKY*”], NO. 10 108 (2006). The article is published in Russian.

¹⁸² See, e.g., Novoselova Y.G., *An Evaluation of the Demand for Bank Products of the Real Economic Sector in Russia*, “*EKO*” *VSEROSSIISKII EKONOMICHESKII ZHURNAL*, NO. 005 (2006), 42. The article is published in Russian.

Thirdly, for the purposes of housing finance, Russia, similar to the US, is, theoretically, able to provide direct guarantees or mortgage insurance.¹⁸³ Even though the origins of the aforementioned economic traits and the corresponding histories of the markets are inherently different in both countries, legal transplanting and globalization make financial practices formally analogous. As closer examined, attempting to stimulate the mortgage market, Russia has adopted the general securitization template designed in the US.

Mortgage Financing In Russia: Adaptation of the US Securitization Model

In 2006, the share of mortgage transactions in the residential market was about 8.6%, while the rest were cash-based transactions.¹⁸⁴ Mortgage loans were and still are unaffordable to many Russian citizens¹⁸⁵ due to high interest rates, substantial down payments required by banks and rigid payment schedules. Russia did not have a baby boom like in the US, in fact, the Russian population is decreasing.¹⁸⁶ The origin of the housing demand for more affordable loans proceeds from the transfer from Soviet public housing to privatized dwellings and from higher standards of living effecting consumer preferences of younger generations. Government authorities and housing agencies on several occasions noted that the structural problems of

¹⁸³ Mikhail Kopeykin, *Stabilization Fund* [“*Stabilizatsionnyy Fond*”], *IZVESTIA* (March 28, 2008).

¹⁸⁴ THE FINAL REPORT: HOUSING MORTGAGE LENDING IN RUSSIA, 2006, AGENCY FOR HOUSING MORTGAGE LENDING (2007), 34.

¹⁸⁵ First Vice-Prime-Minister Dmitry Medvedev observed in an open Internet-conference devoted to the national economic projects, “the mortgage interest rate does not suit us all, it is very high.” See the transcripts of the Internet-Conference: *Dmitry Medvedev on Realization of National Projects* [“*Dmitry Medvedev o Realizatsii Natsproektov*”] held on 03.05.2007. See publications of REALTYPRESS, an electronic database of analytical reviews and news on hypothec and real estate financing. The transcript of the Internet-Conference is available at <<http://www.realtypress.ru/intervjyu/19-03-2007.html>>.

¹⁸⁶ *The Population of Russia 2000* [“*Naselenie Rossii 2000*”], ed. A.G. Vishnevskiy, Institute of Economic Prognosis of the Russian Academy of Science, Moscow (2001). Available at <http://demoscope.ru/weekly/knigi/ns_r00/sod_r.html>.

mortgage markets may be resolved through promoting securitization,¹⁸⁷ what was the case in the US in the 1970s.

The mounting attention of the Russian government to MBS appeared approximately from the year 2000 with the enactment of the Strategy “On Residential Mortgage Loans”¹⁸⁸ followed by the initiatives of the Russian GSE – the Agency for Home Mortgage Lending (hereinafter: AHML). AHML developed the first Standards of originating, refinancing and servicing mortgage loans in 2002 and issued the first MBS in 2003 in accordance with the new Statute on MBS.¹⁸⁹ A series of new statutes necessary for securitization, such as the Statute “On Banks and the Business of Banking,”¹⁹⁰ “On Bankruptcy,”¹⁹¹ “On Bankruptcy of Credit Institutions,”¹⁹² the new strategies of banking development and the regulations of the Central Bank, were amended in line with the new Statute. The early initiatives of AHML, however, ended up in a failure.

The federal government soon corrected the structural flaws and approved in 2005 the Guidelines [“*Kontseptsiya*”] for the Development of the Unified System of Mortgage Refinancing. Finally, in May 2007, the first private placement of Russian AHML signified the new era in housing policies. Similar to the US, the national securitization markets are produced through the state support. National PMBS issues are rare in Russia, while several foreign transactions with Russian MBS date back to July 2006. Most of those international transactions

¹⁸⁷ The Strategy of the Development of the Unified System of Refinancing of Residential Mortgage Loans in Russia, *supra* note 179, 6.

¹⁸⁸ The Strategy of the Development of Residential Mortgage Lending in the RF [“*Kontseptsiya razvitiya systemy ipotechnogo zhilishnogo kreditovaniya v RF*”] endorsed by the Government Decree of 01.11.2000 No. 28.

¹⁸⁹ The Federal Statute “On Hypothecal Securities” [“*Ob ipotechnikh tsennih bumagakh*”] of 11.11.2003 No. 152-Φ3. The latest amendment of 07.27.2006 No. 141-Φ3.

¹⁹⁰ The Federal Statute “On Banks and Banking Activities” [“*O bankah i bankovskoy deyatelnosti*”] of 12.2.1990, No. 395-1 (the latest amendment is of July 27, 2006).

¹⁹¹ The Federal Statute “On Bankruptcy” [“*O nesostoyatelnoy (bankrotstve)*”] of October 26, 2002, No. 127-Φ3 (the latest amendment is of July 18, 2006).

¹⁹² The Federal Statute “On Bankruptcy of Credit Institutions” [“*O nesostoyatelnoy (bankrotstve) kreditnih organizatsiy*”] of February 25, 1999, No. 40-Φ3 (the latest amendment is of August 20, 2004).

were structured by foreign SPVs – those are mainly registered in three jurisdictions: the Netherlands, Luxembourg or Ireland - and were placed through foreign underwriters.¹⁹³ One of the first successful Russian MBS were sold through *Gazprombank* in November 2006.¹⁹⁴ “As of 31 December 2006, 332,030 USD of the mortgage loan portfolio were securitized by the [*Gazprombank*] Group by means of several issues of mortgage backed securities,”¹⁹⁵ most of them were cross-border MBS.¹⁹⁶ That issue was closely followed by the first AHML’s MBS issued in May 2007 and assigned a higher credit rating due to, *inter alia*, a state guarantee of the issue.¹⁹⁷

It is too early to identify explicit *indicia* speaking to the presence of a local MBS market or a national PMBS market. *First*, only a few successful issues have been placed so far. *Secondly*, even though *Gazprombank* is a private commercial bank, it also has close ties with the Government through OAO *Gazprom*¹⁹⁸ and about 8% of its stock is owned by the Treasury.¹⁹⁹

¹⁹³ Within the past 18 months, the *Moskommertsbank* (a Dutch SPV) placed securities through HSBC Bank PLC, *Raiffeisen Zentralbank Österreich AG (RZB)*, *Sovfintrade* (two SPVs in Luxembourg) – via *Gazprombank* (which is its mother company); Barclays Capital, with participation of Lehman Brothers International (Europe) and HSBC Bank PLC for the second issue; Delta-Credit (an Irish SPV) - *Societe Generale*; *Gorodskoy Ipotechny Bank* [City Mortgage Bank] (a Dutch SPV) - VTB Bank Europe (acquired by *Vneshtorgbank* in 2006), Greenwich Financial Services; *Vneshtorgbank* (an SPV registered in Luxembourg) - Barclays Capital, HSBC Bank PLC. All transactions are listed in retrospective order starting from July 2007 to July 2006. Source: The Analytical Portal “*Rusipoteka*.” Available at <<http://www.rusipoteka.ru/issue.htm>>.

¹⁹⁴ *Sovfintrade* was acquired by *Gazprombank* in March 2006. The MBS were rated Baa2 by Moody's and provided for 30-year term till redemption. *Id.*

¹⁹⁵ Consolidated Financial Statements. Independent Auditor’s Report (ZAO Deloitte and Touche CIS), *Gazprombank* Group (December 2006), 35. Available at <http://www.gazprombank.ru/media/papers/annual_reports/2006/ar06.pdf>.

¹⁹⁶ Namely those were “domestic Ruble-denominated residential mortgage backed securities [...] in the amount of USD 113,934 thousand and [...] both Euro- and Ruble-denominated cross-border RMBS issue in the amount of USD 218,644 thousand.” *Id.*, 46.

¹⁹⁷ Class A was rated A3, Class B – Ba1 by Moody's. Subordinated class C was unrated. See *Pre-Sale Report. First Mortgage Agent of AHML*. Moody’s Investors Service (April 2007). Available at <<http://www.ahml.ru/agent/analysis.shtml?path=analysis070515-2.html>>.

¹⁹⁸ AOA *Gazprom* holds 41.73% of shares of the bank, while 42.89% belong to ZAO “Leader” on behalf of *Gazfond*. *Id.*, 1.

¹⁹⁹ The Treasury stock is 8.34%. *Id.*

Therefore, delimiting the private and public camps in the nascent MBS markets in Russia is quite complicated.

Hypothetically, the general taxonomy of the MBS markets in any country can be divided into agency and private MBS, what predetermines the nature of issuers operating in those market segments and the risks of investors. In the US, the issuers of private-label MBS are special purpose conduits of banks, thrifts, investment banking firms, and a variety of non-bank financial companies, which are either non-existent or less prominent in the Russian national finance compared to banks. The other group of issuers in both countries should be government agencies. GNMA, FNMA and FHLMC are linked to the US government and, as mentioned above, initiated and spearheaded the whole process. To recapitulate, FNMA and FHLMC are not government entities, but corporate instrumentalities of the government. As quasi-private corporate entities they do not enjoy the government protection against credit risks associated with their securities. They pay taxes as any regular corporation and do not receive government subsidies; and their shares are traded at NYSE.²⁰⁰ The third agency – GNMA – is a governmental one included in the Department of Housing and Urban Development. Limited in their programs by guaranteeing securitized pools of mortgages, GNMA's obligations carry the full faith and credit of the American government.²⁰¹

AHML is, in principal, similar to FNMA before its privatization in 1968. Today, the Agency is on the list of the federal state strategic enterprises and is 100% owned by the federal government. Yet, the Agency has its own legal personality and is not a government instrumentality. The state is not liable under the obligations of the Agency, unless it has

²⁰⁰ See the official web-sites of the GSEs at <http://www.fanniemae.com/> and <http://www.freddiemac.com>.

²⁰¹ See the official web-site of GNMA at <http://www.ginniemae.gov>.

explicitly undertaken such obligations.²⁰² The state support of AHML MBS is based on state guarantees granted for the purposes of separate MBS issues. Under the current law on state guarantees, budget, tax law and contract law, the lack of blanket state insurance can lead to protracted bureaucratic delays as to *ad hoc* insuring specific tranches or issues and to an increase in costs associated with MBS.²⁰³

As opposed to AHML, the market for conforming mortgages in the US provides for a two-tier credit enhancement to the investors. *First*, the mortgages are insured by FHA. *Second*, the pools of mortgages collateralizing securities are guaranteed by GSEs. In Russia, AHML's standards, instead, require several layers of private insurance, the costs of which are totally borne by the mortgagors. The general structure of the origination of Russian "conforming" mortgages, *to wit*, conforming to the requirements of AHML, looks as follows. Mortgagors address primary lenders, servicing agents, or the so-called regional "operators." Those pool the mortgages and address AHML for refinancing their loans, which should comply with certain criteria.²⁰⁴ The Agency offers a list of mandatory documents including a standard loan agreement and a mortgage note, a sale agreement, a mortgage deed ("zakladnaya"),²⁰⁵ property assessment forms and others.²⁰⁶ Several types of obligatory private insurance policies should be acquired by the

²⁰² Art. 1.8 of the Constitutive Charter of AHML. Revised version No. 4, 03.26.2007. Available at <<http://www.ahml.ru/about/docs.shtml>>.

²⁰³ The Strategy of Unified System of Refinancing of Residential Mortgages in Russia (AHML), *supra* note 179, 26-27.

²⁰⁴ In addition to the aforementioned LTV and PTI ratios, the other criteria include detailed methods as to how to verify the income – such as income from private businesses, pensions, dividends, lease payments, etc. - of a potential borrower, methods purported to verify the validity of mortgage loan documents, such as notarial deeds, and others. The Standards of the Procedures of Mortgage Origination and Refinancing [*Standarty protsedur vidachy, refinansirovaniya i soprovozhdeniya ipotechnih kreditov (zaymov)*"], Part I, endorsed by the Order of the Director General of AHML No. 07, of 03.01.2004 (the latest amendment of 06.22.2007 No. 56-од), Part I § 2.

²⁰⁵ A mortgage deed is subject to registration with a public registrar and is not a mandatory provision in a mortgage agreement under the Mortgage Statute, *supra* note 116, Title III, art. 13.

²⁰⁶ See The Standards of the Procedures of Mortgage Origination, *supra* note 204, Part I, § 4.1 and Appendix 5.

borrower covering the risks related to property itself, the health and life of the borrower and a potential loss of income.²⁰⁷

In general, the Agency's requirements stipulate very strict and narrow boundaries as to conforming mortgages. The mortgage term to maturity, for instance, should be between 12 - if the remaining balance is not less than 100,000 Rubles or, approximately, 4,000 USD - and 360 months and all mortgages must be originated in Russian Rubles only – although some banks offer products in foreign hard currencies - with an interest rate defined strictly in accordance with the AHML standards.²⁰⁸ Notably, the outstanding balance on a mortgage should be between 30% and 90% of the value of the collateral residential real estate and the payment schedules should accommodate only the fixed-rate mortgage structure,²⁰⁹ unless the Agency grants a preliminary consent to other structures of debt amortization.²¹⁰ Obviously, fixed-rate mortgages dominate the market in Russia, as it was in the US until the 1970s-1980s.²¹¹ I believe that limiting AHML standards to fixed-rate mortgages at this point is counterproductive as it restricts product diversification. Moreover, individual negotiations with AHML as to every single non-fixed-rate MBS will be complicated, time-consuming, and, potentially, increasing the costs of an issue and underlying mortgages.

The Agency, as an open joint-stock company, which is “independent of public authorities in its decision-making except when it is provided for by federal laws,”²¹² albeit owned by the federal government, makes every effort to avoid excessive risks. In doing so, it acts in the way fundamentally different from the methods of GNMA, FNMA and FHLMC. For instance, all

²⁰⁷ *Id.*, § 4.2.

²⁰⁸ *Id.*, Part II, § 2.3.

²⁰⁹ See Appendix 5 to The Standards “The Loan Agreement,” art. 3 “The Order of Using and Repayment of the Loan” [“*Poriadok pol'zovania zaymom i yego vozvrata*”], *supra* note 204.

²¹⁰ *Id.*, Part II, § 2.3.

²¹¹ FRANK J. FABOZZI, HANDBOOK OF MORTGAGE BACKED SECURITIES, 5th edition, McGraw-Hill (2001), 3- 25.

²¹² The Constitutive Charter of AHML, art. 1.11. Available at <<http://ahml.ru>>.

mortgages sold by regional operators, lenders or servicing agents to AHML are accompanied by option agreements to sell the mortgages back to an originator.²¹³ Moreover, being aware of the peculiarities of Russian public law, the Agency requests local authorities enact regional statutes on subsidizing mortgagors through the so-called “Special-Purpose Long-Term Programs.”²¹⁴

The May 2007 transaction was the second Ruble transaction²¹⁵ and revealed significant structural and product developments. It was the first tranching MBS issue, including three classes (A, B and C) of MBS. Tranching in this case served a two-fold purpose of appealing to investors with diverse risk preferences and providing an internal credit enhancement. The other credit enhancements used were also internal and structural, namely, those were an excess spread and a special reserve account. That model was cardinally different from the first abortive securitization attempts in 2003, when the Agency solely relied on a government guarantee. From the point of view of the US market, the transaction was straightforward and might be classified as pass-through with *pari passu* and *pro rata* distribution of cash flow among security holders within separate tranches.

In the US, similar types of pass-through MBS – where an investor owns an undivided interest in the collateral mortgages, which are predominantly fixed-rate fully amortized mortgages, and receives a *pro rata* share of cash flow – is still the main primary product of FNMA. Yet, there are more than half a dozen of MBS structures backed by various types of mortgage loans and offering numerous hybrid structures and multiple derivative products, some

²¹³ The Standards, *supra* note 204, Part II, § 2.8.

²¹⁴ *Id.*

²¹⁵ *Moody's Legal Opinion Letter*, AHML. Available at <<http://www.ahml.ru/index.shtml>>.

of which are issued through REMICs and grantor trust templates. Only to some extent, do the AHML experiments seem to be modeled after the FNMA prototype.²¹⁶

One of the distinctions between the US GSE system and the Russian one is the new element including the participation of regional “market operators” as intermediaries verifying the validity and correctness of mortgage documents and performing the primary pooling functions. This component is not mandatory, as banks may perform the same task in certain cases, and is justified by the geographical dispersion of mortgages and the lack of AHML resources necessary to perform the primary screening on the spot.

AHML, contrary to the US GSEs, does not usually guaranty payments of either principal or interest on MBS. Mostly structural credit enhancements are currently employed along with the application of the AHML eligibility criteria to all mortgage collateral²¹⁷. In order to provide asset fencing and eschew potential commingling of assets, SPVs in the May 2007 issue have a two-tier structure. Two Dutch SPVs are the sole shareholders of the First Mortgage Agent of AHML, which is registered in Russia and under the laws of the RF.²¹⁸ Such two-tier SPVs are commonly unnecessary for GSEs in the US. They generally rely on well-known securitization vehicles, such as REMICs, for achieving bankruptcy remoteness and for tax purposes. In Russia, however, the bankruptcy law is not yet clear enough with regard to potential bankruptcy of an SPV or an originator.²¹⁹ Neither is there any entity similar to REMICs. Instead, the tax status of Russian SPVs has not been laid out yet, while the legal form that they must use at registration is a “joint-

²¹⁶ For instance, the refinancing programs of AHML are akin to retained mortgage programs of FNMA.

²¹⁷ AHML Memorandum for Investors. Available at <<http://www.ahml.ru/index.shtml>> .

²¹⁸ See the Minutes No. 1 of the Constitutive Meeting of Shareholders of 09.25.2006. Available at <<http://www.ahml.ru/agent/documentation.shtml>>.

²¹⁹ *Securitisation in Russia: Some Legal Issues*, MAYER, BROWN, ROWE & MAW LLP (2006). Available at <http://www.mayerbrown.com/publications/article.asp?id=2966&nid=6>

stock company.”²²⁰ Some of these hurdles cannot be directly eliminated by AHML *per se* and may require extensive lobbying efforts by AHML and the market.²²¹

The Russian financial system is comparatively stable today, but substantially underdeveloped compared to the first world countries, what implies the need for further reforms in law and regulations. Quantitative and qualitative characteristics of the Russian financing illustrate that it is very much behind many developed countries.²²² Statistics reveal that short-term financing still prevails in banking practices²²³ and that lending operations and issuing securities do not exceed 7% in the structure of investments in the RF.²²⁴ That is hardly surprising, because most large companies, mostly in oil and gas businesses, address international financial markets, while local lending operations, consumer financing and mortgage programs of national and regional banks are relatively trivial.

A potential market stimulus – competition – was precluded by high market concentration of banking capital in Moscow²²⁵ and uneven distribution of financial resources. In fact, Russia is currently moving to a sort of financial market oligopoly.²²⁶ More than 80% of bank assets and 70% of capital are controlled by Moscow banks, while 90% of GDP are produced in other regions. A few largest Moscow banks have expanded their national networks immediately seizing the leadership positions in the periphery. Those several market leaders determine what

²²⁰ *Supra* note 189, art. 8(1).

²²¹ That may not be not unfeasible given the fact that the Head of the Supervisory Board of AHML is the Minister of Economic Development and Trade of the RF, G.O. Gref. The list of the members of the Supervisory Board is available at <<http://www.ahml.ru/about/man.shtml?path=man030812-1.html>>.

²²² V.I. Klistorin and N.A. Kravchenko, *Banking System as a Factor of Regional Development on the Example of Novosibirskaya Oblast*, “EKO” *VSEROSSIISKII EKONOMICHESKII ZHURNAL*, NO. 12 (2006), 135. According to various sources, by January 2006, there were 1221 banks (Klistorin and Kravchenko, 138) or 1356, out of which only 1205 were functional (S. Moiseev, *The Optimal Structure of Banking Market: How Many Banks Does Russia Need?* QUESTION OF ECONOMICS [“VOPROSY EKONOMIKY”], NO. 10 75 (2006), 78).

²²³ *Supra* note 182, 4.

²²⁴ Klistorin and Kravchenko, *supra* note 222, 137.

²²⁵ *Id.*, 139.

²²⁶ *See, e.g.*, Novoselova, *supra* note 182, 42.

bank products are offered in most regions.²²⁷ Excessive market concentration is always a problem *per se*. In Russia, it is also coupled with the absence of the dual-banking system, which might have provided some regulatory and other benefits to local banks. Currently, the largest banks in the regions exhibit weak hypothecal and consumer lending, while the secondary market for residential mortgages is sluggish and undersized.²²⁸

Many economists believe that it is urgent for Russian banks to develop new products, expand the current market boundaries through financial innovations, including entering into structured finance transactions and ABS,²²⁹ which are commonly tested through mortgage products and MBS methodologies.²³⁰ Imperfections and discrepancies in the statutory foundations of mortgage securitization restrain the development of primary and secondary markets for mortgages and MBS, what calls for deliberate government policies and more cross-jurisdictional transplanting. Some steps have been already taken in this direction. However, the new law and regulatory requirements are far from being perfect and, what is more, suffer from excessive administrative rigidity, what is very characteristic to Russia and much less so to the US.

The Statute on Hypothecal Securities, for instance, enforces the positions of banks by specifying that MBS may be issued only by the authorized entities,²³¹ including banks,²³² and submits all corresponding regulations to the authority of the Central Bank as the single federal bank regulator.²³³ Under the statute, the Bank of Russia is responsible for determining the ratio

²²⁷ *Id.*, 43.

²²⁸ *Supra* note 182, at 19.

²²⁹ Klistorin and Kravchenko, *supra* note 222, 144.

²³⁰ V. Zrazhevsky, *supra* note 181, 113.

²³¹ *Supra* note 189, art. 6.

²³² *Id.*, art. 7(1)

²³³ The Federal Statute “On the Central Bank of the RF (Bank of Russia)” [“*O Tsentralnom bankke RF (Banke Rossii)*”] of 07.10.2002, No. 86-Φ3.

of the mortgage pools to the total MBS issued and to bank capital, liquidity and risk ratios, and other factors that it may find requisite for MBS issues.²³⁴ The corresponding Guidelines²³⁵ of the Central Bank set forth the requirements for MBS issued by banks supplementing the standards of Russian securities laws.

The Guidelines also mention some structural aspects of bank MBS, including credit enhancements that banks may use for MBS issues. Those include surety agreements,²³⁶ bank and state guarantees,²³⁷ as well as internal credit enhancements, such as tranching, and the general principles of how the tranches need to be issued and redeemed. For instance, simultaneous placement of different tranches of one issue is prohibited.²³⁸ All tranches must be disposed of within one year after the registration date.²³⁹ The Guidelines define the liability of banks in case of unsatisfactory performance or default on their obligations under an indenture, the distribution of profits in case of foreclosure of real estate collateral,²⁴⁰ and many other minute structural points. The Guidelines even outline what should be understood as a material breach of contract - in that case, of an indenture - defined as a delay in payment of the next structural coupon within seven days or a delay in discharging the obligations to pay principal within 30 days or a refusal to make the foregoing payments.²⁴¹

²³⁴ Supra note 189, art. 7(2).

²³⁵ The Guidelines of the Central Bank of the RF “On the Rules of Issuing and Registration of Securities by Credit Institutions on the Territory of the RF” [*“O pravilakh vipuska i registratsii tsennikh bumag kreditniy organizatsiamy na territorii RF”*], of 04.13.2007 No. 7687 (the latest amendments of 03.28.2007 No. 1810-Y) (hereinafter: Guidelines)

²³⁶ Guidelines, § 6.4.4.

²³⁷ Guidelines, § 6.4.5.

²³⁸ Guidelines, § 6.6.4

²³⁹ *Id.*

²⁴⁰ Guidelines, § 6.4.3.

²⁴¹ Guidelines, § 6.7.

Interpreting the Statute on Securities Markets,²⁴² the Central Bank specified additional requirements for a prospectus and a registration statement for MBS.²⁴³ The Guidelines also provide for a closed-end list of grounds justifying the rejection of registration of an MBS issue. In addition to bank capital requirements and provisions of the Federal Statute on Hypothecal Securities (MBS), the Central Bank requires MBS offer a certain coupon, which should be paid at least annually.²⁴⁴ Hence, it is unclear whether, for instance, MBS issuers are permitted to sell zero-coupon securities at discount. Considering the general regulatory spirit of the Guidelines, the answer is, probably, “no”, unless the issuers are not banking and financial institutions falling within the regulatory authority of the Central Bank.

The Future of the Russian Securitization: Lessons from the US

Despite all the *pros* and *cons* of the Russian present regulatory framework and potential overregulation, at the very least, it is certain that policy-makers and financial regulators finally acknowledged that MBS are among the pressing needs of the banking market.²⁴⁵ Nonetheless, this understanding has not yet assured perceptible securitization developments, which should have brought together regulators and private financial institutions. Considering the experience of the US, securitization may seem to be a long-term process. However, the major changes in the US occurred not so long ago, and it was in the past twenty years, when private market entities started working in close cooperation supported by the judiciary and the regulators. The resulting benefits in the form of lower mortgage rates, affordability of credit capital, standardization of mortgage instruments necessary for their marketability are unequivocally financial and legal

²⁴² The Federal Statute “On Securities Market” [“*O rinke tsennikh bumag*”] of 04.22.1996, No. 39-ФЗ.

²⁴³ Guidelines, § § 6.4.6 – 6.6.4. Under §12.4, a prospectus should be signed by a specialized depositary registrar institution testifying that the information in the prospectus is full and correct in accordance with the data of the register.

²⁴⁴ Guidelines, § 13.10.

²⁴⁵ *Supra* note 184.

achievements that cannot be obscured by the happenstance of the present subprime crisis. Developing economies can and should adopt some of the US practices, while attempting to circumvent the undesirable consequences of imprudent market behavior.

Consumer protection is one of such issues. For some countries with strong regulatory authorities, including Russia, the general tendency is to over-regulate market. In Russia, such overregulation is purported to not only protect consumers, but also to prevent market fraud and maintain a firm supervisory grip over the financial industry. However, both supervisory and non-regulatory responses incentivize market discipline and may benefit consumers. The new SEC oversight of rating agencies is one example. New amendments to the existing federal programs, such as, *e.g.*, *FHASecure*, which offer acceptable work-outs for lenders and mortgagors without any statutory changes, and the reconsideration of TILA and similar disclosure mechanisms are another. In fact, in order to preserve and develop MBS as a financial instrument and avoid potential credit crunches, a government can and should effectively address the two concurrent dilemmas of consumer-mortgagor protection and purely market matters avoiding excessive regulatory intervention. How efficiently Russian AHML and law-makers will build up a combination of Russian TILA, high-cost loan legislation and support [or oversee] the free market initiatives, including numerous types of MBS and derivatives, as well as monitor the credit rating methodologies remains to be seen.

Conclusions

The echo of the subprime problems and the ensuing liquidity crisis will be heard throughout the economy for some foreseeable time in the future. As the rating agencies persist in scrutinizing MBS markets, downgrading of funds dealing in MBS and debt securities tied to

supprime mortgages will continue.²⁴⁶ For many firms, the write-downs of now low-grade assets will ostensibly have long-term consequences and capital markets investors will react accordingly.²⁴⁷ Even the invincible quasi-state giants FNMA and FHLMC, who attempted to decrease their exposure to subprime risks *ex ante*, are also in predicament experiencing liquidity crunch.

For instance, Fannie Mae's Annual Report asserts that they "chose to stand back from the frenzy [of subprime markets] and avoid competing for mortgage assets and securitization business [they] thought too risky or unprofitable."²⁴⁸ Yet, last year FNMA announced that in order to continue conservative practices in the current risky environment it needed more liquidity through issuing new stock and cutting dividends²⁴⁹ with plunging stock prices on the background. Freddie Mac is in a similar situation. Its 2006 Annual Report announced that "in order to protect consumers and raise underwriting standards, Freddie Mac took the lead in announcing that after September 1, [it would] not buy subprime mortgages that pose an unacceptable risk of excessive payment shock and possible foreclosure."²⁵⁰ However, the risks were, obviously, not hedged to the necessary extent as was evidenced by, *e.g.*, the \$2.03 billion losses in the third quarter of 2007 and Freddie's proposals to sell shares.²⁵¹ The analysts and the GSEs themselves believe that the losses are short-term and that they will not disturb the segment

²⁴⁶ See, *e.g.*, a recent WSJ article on assaying Citigroup Inc. SIVs. Carrick Mollenkamp, *Moody's Warns Over Ratings of Some SIVS*, WSJ (December 1, 2007), P. B5.

²⁴⁷ Kimberly A. Vlach, *Goldman Says Citigroup Faces \$15 Billion CDO Write-Downs*, WSJ (November 20, 2007).

²⁴⁸ See *FNMA Annual Report 2006*, 4.

Available at

<http://www.fanniemae.com/ir/pdf/annualreport/2006/2006_annual_report.pdf;jsessionid=GVLE2I3OI5E1JJ2FECISFGQ>.

²⁴⁹ Damanian Paletta, *Fannie Looks to Raise \$7 Billion, Cuts Common-Stock Dividend*, WSJ (December 4, 2007).

²⁵⁰ See *Freddie Mac Annual Report 2006*.

Available at <<http://www.freddiemac.com/investors/ar/pdf/2006annualrpt.pdf>>.

²⁵¹ James R. Hagerty and Damian Paletta, *Mortgage Giant Fuels Worries With Steep Loss*, WSJ (November 21, 2007), at A1.

of providing guarantees.²⁵² That is quite possible as Freddie and Fannie Mae were operating in the least risky segments of the mortgage market. Moreover, the government has recently loosened the capital requirements for both GSEs.²⁵³

This paper has argued that the Russian FNMA transplant - AHML – should continue looking at its prototype and expand its practices in terms of providing guarantees, lobbying for the first-tier insurance and diversifying the types of mortgages it works with. The current US mortgage meltdown is not representative of the MBS as a whole. For more than 30 years, the process worked well until the old disclosure regime ceased to adequately assess the financial instruments of grown complexity. Even sophisticated investment banks, like Bear Stearns or Merrill Lynch, and financial holding companies, such as Citigroup, underestimated the risks of the novel structured financial instruments. The Russian market is, by no means, at the stage of affairs where complexity trumps market sophistication and creates a breeding environment for predatory lending and fraud. In fact, as a developing economy, Russia may and, probably, need to adopt the adequate standards of disclosure and consumer protection instead of placing structural limitations on mortgage originators and MBS issuers.

The current model that AHML is implementing appears to be a truncated version of the GSE MBS with some alterations. There are several inadvertent repercussions of this state of affairs. The *first* one is that it tends to ignore the risk of corruption and political risks.²⁵⁴ Those are important at several junctions. At the federal level, the hazard stems from bargaining for *ad hoc* guarantees for every single issue of MBS with federal authorities. At the regional level, the potential for corruption derives from the state ownership of regional operators and the local

²⁵² *Id.* See also, e.g., Tony Cookie, *Fannie Officers Buy, But Is Timing Right?* WSJ (November 28, 2007), at C2.

²⁵³ Damian Paletta and James R Hagerty, *U.S. Puts Faith in Fannie, Freddie*, WSJ (March 20, 2008), at A3.

²⁵⁴ See, e.g., *Moody's Letter*, *supra* note 215.

Special Purpose Programs. Due to this regional political risk and given that the economic development of Russian regions is precariously uneven,²⁵⁵ it may be more prudent to use federal and state resources simultaneously and to provide a blanket first- and second-tier insurance for mortgages and MBS conforming to certain criteria.

Secondly, the very absence of the first-tier government guarantee or insurance analogous to FHA hits, in the first place, the middle class mortgagors. Moreover, in case of a potential financial crisis, the state may be impotent, as there will be no established platform, like *FHASecure* or similar programs, to assist borrowers in refinancing their loans and avoid foreclosure, what also benefits the lenders. As a robust secondary market for mortgages and MBS is yet to be formed, the lenders may be left with no choice but to foreclose on the mortgages.

Thirdly, the Agency has to acknowledge that their MBS structures are more analogous to the GSE issues in the 1980s and early 1990s, than the present MBS programs in the US, and that there is a significant potential for more development. It is crucial for the Russian GSE-AHML to expediently pass through the primary MBS stage. The establishment of cooperation with the US GSEs, the federal and state bank regulators and the SEC will be beneficial for achieving this goal, despite any political impediments and repercussions. The need for the structural diversification of AHML's products following the lead of the US GSEs, which are historically responsive to changing investor preferences,²⁵⁶ is one of the reasons for such cooperation.

²⁵⁵ See the data of the National Corporation of Economic Development [*"Natsionalnaya Korporatsia Ekonomicheskogo Razvitiya"*]. Available at <http://www.nker.ru/>

²⁵⁶ See, e.g., THE HANDBOOK OF MORTGAGE BANKING: TRENDS, OPPORTUNITIES, AND STRATEGIES. ed. JESS LEDERMAN, CHICAGO : PROBUS (1993); *GNMA Program Report on Guarantees of Mortgage-Backed Securities*, Department of Housing and Urban Development (2004).

Instead of rejecting the US MBS experience, Russian policy makers could draw valuable lessons from the present US credit crunch. In any case, MBS is generally acknowledged as the key to resolving many problems of housing markets, particularly, the one concerning availability of housing finance inasmuch as “without securitization one cannot say that financing of long-term loans is sufficient [because] the growth of the demand for mortgages will [necessarily] go along with the need for securitization.”²⁵⁷

In order to forestall potential mass defaults on high-cost subprime loans, as the US witnesses nowadays, several preventive measures have to be introduced. The *first* one is a properly adapted replica of TILA providing for private and public right of action for violations of mortgage disclosure standards. *Secondly*, as mentioned above, placing limitations as to disclosure and particular terms of high-cost home loans are also necessary. As Russian law is a hierarchical system²⁵⁸ and everything under the heading of “civil law” is within the authority of the federal legislature, only concerted actions of the federal authorities, including the legislative branch and the Central Bank, may bring into being these statutory limits and provide for the effective oversight of banks. *Finally*, the SEC’s initiative to verify rating methodologies employed by the national raters is another element that Russian securities regulators²⁵⁹ should look at. Since the Russian regulators has much less expertise of working with rating agencies,

²⁵⁷ *New Year Interviews With the Market Leaders* [“*Novogodniy Opros Liderov Rinka*”] HYPOTHECAL CREDITS AND SECURITIZATION, ANALYTICAL REVIEW [“*IPOTECHNOE KREDITOVANIE I SEKIURITIZATSIA, ANALYTICHESKIY OBZOR*”], INFORMATIONAL ANALYTICAL PORTAL “*RUSIPOTEKA*,” (January 2007) at 5. Available at <<http://www.rusipoteka.ru/review/06-review-RI.pdf>>.

The interview with the Director General of the open joint-stock company “Our Home - Primorie” Marina Lomakina. The original text is in Russian.

²⁵⁸ See, e.g., WILLIAM E. BUTLER, *RUSSIAN LAW* (Oxford; New York: Oxford University Press 1999), 87-92. See also HIROSHI ODA, *RUSSIAN COMMERCIAL LAW* (Kluwer Law International: The Hague, London, New York 2002), 2-20.

²⁵⁹ The authorities of the Federal Agency for Financial Markets are determined by the Decree of the Government of the RF “The Competence of the Federal Service for Financial Markets” [“*Voprosy federalnoy slujby po finansovim rinkam*”] of April 9, 2004, No. 206 and by the Regulations on the Federal Service for Financial Markets” [“*Polojenie o federalnoy slujbe po finansovim rinkam*”] of June 30, 2004 put in force by the Decree of the Government of the RF of June 30, 2004 №317. For more information on this Federal Agency visit its official web-page at <<http://www.fesm.ru/eng>>.

certifications by the SEC are a powerful signal of the high quality of rating that can be taken into consideration in devising Russian regulatory policies. Regulatory and legal transplanting is, obviously, not always the best option for other jurisdictions, because many legal and cultural domestic factors may distort the model.²⁶⁰ Nevertheless, it is the inevitable option for most developing markets as there are not so many cardinally different alternative ideas in finance and banking.

There are several caveats to that, however. US serves as a model jurisdiction for securities regulations and is recognized as the most market-oriented economy. Hence, transplanting its supervisory mechanisms may pose serious challenges to other jurisdictions that do not have “robust private enforcement of law.”²⁶¹ As Prof. Coffee noted, the “panoply of reforms adopted in the United States, culminating in the Sarbanes-Oxley Act of 2002, may not be the appropriate remedy in Europe.”²⁶² The same may be true with respect to the SEC enforcement regime and disclosure requirements. Yet, the US rating agencies dominate international markets, many structured finance transactions are international and involve the US financial institutions. The US will remain the core market and a statutory and regulatory model for many other countries. Therefore, the US response to the crisis may have significant influence on other jurisdictions.

It is obvious that more structural changes in market supervision and self-regulatory methods are needed in the long run. The evidence that the crisis contagion spreads beyond the

²⁶⁰ Pistor and Berkowitz, *supra* note 177.

²⁶¹ Coffee, *supra* note 80, 78.

²⁶² Coffee, *supra* note 80, 81.

US²⁶³ may indicate that the problems are structural and not merely jurisdiction-based. The subprime crisis cannot be attributed to a particular regulatory system *per se*, but to the market asymmetries. Again, it will be the experience of the US that many jurisdictions will be looking at. Currently, the reforms seem to oscillate between the two extremes of the support of free market and the Wall Street and the intensification of government regulations.

One of the first market responses to the crisis was a proposal by Citigroup Inc., J.P. Morgan Chase & Co. and Bank of America Corp. to establish the so-called Master-Liquidity Enhancement Conduit in the amount of approximately \$100 billion. The main underpinnings of the proposed Super-SIV were issuing short-term notes used to buy at discount the highly rated securities of SIVs.²⁶⁴ The idea of the Super-SIV was supported by the Department of Treasury²⁶⁵ and at least not opposed to by the Fed.²⁶⁶ However, that market initiatives waned with the speed proportionate to the growth of bank losses in the forth quarter of 2007 and in 2008. Instead of the market self-help, federal and state regulators expand their oversight, the Fed assists in taking over imprudent investment banks, FHA extends its insurance programs, while state regulators work out their own solutions, such as Home Equity Theft Prevention Act in NY and others.

Theoretically, the liquidation of asymmetries in the wake of the crisis could vest the SEC and other regulators with unnecessary excessive powers that might reduce market efficiency in the future. In real life, disclosure and increasing transparency will, most probably, become the motto of the upcoming reforms. One of the main lessons of the subprime mortgage failure is that

²⁶³ For instance a U.K. building society, Alliance & Leicester PLC, after experiencing troubles with its SIVs, was assisted by a substantial loan from Credit Suisse Group. Duncan Kerr, *Mortgage Lender Gets Help*, WSJ (November 30, 2007).

²⁶⁴ Carrick Mollenkamp, Deborah Solomon and Craig Karmin, *Call to Brave for \$100 Billion Rescue*, WSJ (October 16, 2007), C1.

²⁶⁵ The WSJ even compared Secretary Paulson with J.P. Morgan who “eventually restored order to troubled markets by stepping in with his own capital and those of other banks to buy up undervalued assets and shore up institutions that still had value” in 1907. *House of Paulson?*, WSJ (October 16, 2007), A20.

²⁶⁶ David Wessel, *Fed Says Its Silence on Super SIV Does Not Reflect Opposition*, WSJ (October 23, 2007).

MBS-related disclosure and consumer protection mechanisms must be reviewed by the regulators on the regular basis, sometimes, in response to the concerns expressed by consumer advocates, and not only in the aftermath of another financial or social emergency.

In any case, the current problems are, clearly, relatively short-term. With further corrections of market inefficiencies, the modified MBS will, possibly, remain a viable instrument supporting mortgage markets and capital availability proving that “[c]apitalism [is] by nature a form or method of economic change and not only never is but never can be stationary.”²⁶⁷ Correcting the existing financial instruments will always be a continuous process. Yet, after this credit crunch, the mortgage markets will return to utilizing more CDOs and MBS, albeit after a more cautious risk assessment, better pricing and less exposure to predatory mortgage origination.

²⁶⁷ JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM AND DEMOCRACY*, New York, Harper Torchbooks (1962), 82-83.