The Global Financial Crisis & Asset-Backed Securitization Regulatory Responses Thereto in the EU and the United States*

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In her 2009 article in the Cornell International Law Journal, Georgette Chapman Phillips posits that in order for a debt market in any country to function, one must find the following factors underpinning such market: (i) adequate legal protections, (ii) strong economic foundations and (iii) a low degree of political risk. Phillips discusses general legal protections, such as strong foreclosure laws, the need for stable inflation and real estate values as underpinnings of economic stability and the need for government to respect private property and contract rights. Her

* This research was supported by Kyungpook National University Research Fund, 2010 (이 논문은 2010학년도 경북대학교 신임교수정착연구비에 의하여 연구되었음). This piece also draws upon a decade of private law practice experience in the United States, in which the author specialized in securitization and broader structured finance transactions.
three-pronged focus on legal, economic and political fundamentals serves as the basis for analyzing recent and ongoing regulatory efforts in developed countries that are struggling with the important work of re-establishing stable and useful securitization markets.

Presently, the United States and the European Union ("EU") are at the forefront of financial market re-regulation in the wake of the most recent banking, financial and economic crisis. Since 2007, they, like those regulators in various other jurisdictions around the world, have instituted new regulations on asset-backed securities ("ABS"). Such regulations have been part of a comprehensive, yet fairly disjointed, re-regulation of domestic and international financial markets, including previously lightly regulated areas. While their asset backed securitization ("securitization") regulations have had some positive impact on the functionality of the debt markets in the United States, Europe and beyond, they (1) have thus far failed to provide a coherent legal framework for market participants to rely upon and have (2) increased the political risk associated with involvement in the debt markets.

The disjointed and improperly targeted nature of regulatory efforts thus far are evident in the primary areas of securitization regulation thus far, the so-called "skin in the game" regulations and transparency regulations. In both areas, the United States and the EU have started with similar objectives but are in the process of instituting regulatory regimes that fail to be properly coordinated within their own jurisdictions and across jurisdictions as well. Part of the reasons for this is that regulators, in a bit of panic or maybe opportunism, started the regulatory process before they could fully understand what they were regulating or the true problems they were trying to deal with.

As regulators and market participants around the world endeavor to restart ABS markets or even launch them for the first time, they need to do a better job of understanding the institutions and markets they are seeking to regulate. Additionally, they need to acknowledge that no regulations can make up for prudent underwriting and thorough due diligence. No amount of regulation can force such activities to take place.

Key words: Securitization, skin in the game, transparency, global financial crisis, United States, European Union.
I. Introduction.

Government and industry\(^1\) regulations play a key role in the functioning of all modern financial markets. Unlike the Republic of Korea ("Korea"), which is still developing, both the financial marketplace for asset backed securities\(^2\) ("ABS") and regulations thereof, the United States and the European Union ("EU") are at the forefront of financial market regulation in the wake of the most recent banking, financial and economic crisis. Since 2007, they, like those regulators in various other jurisdictions around the world, have instituted new regulations with respect to ABS related institutions and markets. Regulations of securitization\(^3\) since 2007 in the EU and United States have focused on overcoming two major issues: (1) moral hazard and (2) lack of transparency or informational asymmetry between loan

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1) Not all finance related regulations are promulgated by the government. For example, in the United States the Financial Industry Regulatory Authority ("FINRA"), an industry funded regulatory watchdog, "plays a role in regulating nearly every aspect of the securities business. At FINRA, [they] work to protect investors by registering and educating all brokers, examining securities firms, writing the rules they must follow and enforcing those rules and federal securities laws." Richard G. Ketchum, About the Financial Industry Regulatory Authority; http://www.finra.org/AboutFINRA/ (last visited Jun. 30, 2013). FINRA also provides tools to help educate, and provide transparency about securities to, investors. "In FINRA’s Market Data Center, investors can find information and data on equities, options, bonds, mutual funds and more. [FINRA’s] Trade Reporting and Compliance Engine (TRACE) system helps investors better monitor their bond investments by providing them with timely and accurate pricing information for corporate and agency bonds." Id.

2) "In the U.S. capital market, an artificial distinction is made between mortgage backed securities and asset-backed securities." Frank J. Fabozzi & Chuck Ramsey, Mortgages and Overview of Mortgage-Backed Securities, The Handbook of Fixed Income Securities 572 (6th ed., Frank J. Fabozzi ed. McGraw-Hill 2001). Such distinction is not used herein since commercial and residential mortgage-backed securities are each a sub-class of asset-backed securities. See id.

3) "Traditional securitization can be broadly defined as the process whereby individual bank loans and other financial assets are bundled together in tradable securities, which are then sold to investors." Alper Kara et al., Securitization and Lending Standards: Evidence from the Wholesale Market, European Central Bank Working Paper Series, No. 1362, at 6 (Jul. 2011).
originators and securitization sponsors\textsuperscript{4} on the one hand and investors on the other. In order to overcome these issues, regulations have focused on “skin in the game” requirements and disclosure requirements, respectively. Additionally, regulatory capital requirements have the potential to impact securitization structures and market demand.\textsuperscript{5}

Such regulations have been part of a comprehensive, yet fairly disjointed, re-regulation of domestic and international financial markets, including previously lightly regulated areas. While their asset backed securitization regulations have had some positive impact on the functionality of the debt markets in the United States, Europe and beyond, they (1) have thus far failed to provide a coherent legal framework for market participants to rely upon and have thus (2) increased the political risk associated with involvement in the debt markets. As a result, securitization regulations, when viewed in tandem with broader market and institutional regulations and related government interventions, have failed to provide significantly improved economic foundations for proper utilization of securitization as a tool for efficient and productive debt market intermediation.

In her 2009 article in the \textit{Cornell International Law Journal}, Georgette Chapman Phillips posits that in order for a debt market in any country to function, one must find the following factors underpinning such market: (i) adequate legal protections, (ii) strong economic foundations and (iii) a low degree of political risk.\textsuperscript{6} Phillips discusses

\textsuperscript{4} Originators, sponsors and other parties involved in originating loans (for securitizations of loans), structuring, pooling and otherwise preparing ABS for sale to investors may be referred to as “securitizers” at times herein.

\textsuperscript{5} How securitized assets are treated under central bank collateral eligibility requirements and Basel III liquidity requirements and other similar rules will have a dramatic impact on demand for ABS since the banking sector has “traditionally been the largest investor in [securitized products].” Hans J. Blommestein \textit{et al.}, \textit{Outlook for the Securitization Market}, 2011 OECD J.: Fin. Market Trends 1, 9 (2011).
general legal protections, such as strong foreclosure laws, the need for stable inflation and real estate values as underpinnings of economic stability and the need for government to respect private property and contract rights. Her analysis focuses largely on how stability issues impact the spread of certain types of securitized products to developing countries. Such research is indicative of research relating to international securitization market development beyond established securitization markets in developed countries.\textsuperscript{7) Herein, her three pronged focus on legal, economic and political fundamentals will serve as an underlying point of reference for analyzing recent and ongoing regulatory efforts in developed countries that are struggling with re-establishing stable and useful securitization markets in accordance with Group of Twenty ("G-20") and Financial Stability Board objectives.\textsuperscript{8) Since regulations continue to unfold and continuing uncertainties related to economic fundamentals in Europe, the United States and other parts of the world persist, it has been impossible to fully analyze the impact of regulations or quantitatively in any meaningful way. Therefore, we will focus on reviewing key securitization regulations and conduct an analysis of the status, and engage in a limited comparative analysis, thereof. In order to do that, in \textbf{Part II}, the history of American, EU and Korean asset securitization will be briefly reviewed and contrasted; then the growth and collapse of securitization markets and the broader economy will be discussed. In \textbf{Part III}, key responses in the United States and the European Union will be outlined. In \textbf{Part IV}, the status of central ABS regulations, namely the so-called "skin in the game" regulations and transparency

\textsuperscript{6)} Georgette Chapman Phillips, \textit{The Paradox of Commercial Real Estate Debt}, 42 Cornell Int'l L.J. 335, 340-44 (2009).

\textsuperscript{7)} \textit{See id.} at 335-40.

\textsuperscript{8)} Basel Committee on Banking Supervision, Bank for International Settlements, Report on Asset Securitization Incentives 2 (Jul. 2011) [hereinafter Basel Committee Report].
regulations, formulated in the United States and the EU will be analyzed with respect to how they measure up on the (i) adequate legal protections, (ii) strong economic foundations and (iii) a low degree of political risk metrics.

Notably, while this piece focuses on American and European regulations, comparisons with other regulations will be raised. Some important lessons for market players and regulators in other jurisdictions, including Korea, will also be noted.

II. Use and Misuse of Securitization: Growth, Implosion and Systemic Crisis.

a. Securitization as a Tool.

Asset-backed securitization is a method by which relatively illiquid assets in the form of streams of future payments receivable that are held on a finance company’s balance sheet are packaged and sold to investors as asset backed securities ("ABS") for a lump sum of money "today". Securitization does for banks and other financial institutions what factoring does for companies with large accounts receivable. As a form of funding, securitization attracted banks because it was much cheaper than issuing senior debt as a form of long term financing. Historically, banks could generally save 20 to 100 or more basis points in funding costs by issuing ABS rather than senior debt.\(^9\) Off-balance-sheet securitization also reduces borrowings and thus improves key leverage ratios, such as return on assets and return on equity.\(^10\)

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9) Shahram Elghanayan, *Retail Banks & Economic Capital: Using a Credit Portfolio Model to Rate Securitizations: Part 3*, 89 RMA J. 93 (Dec. 2006/Jan. 2007) (un paginated electronic version cited).

10) Id.
Securitization is a tool that can be used to promote micro- and macroeconomic growth. Indeed, utilization of securitization was a key factor in the growth of both positive and negative uses of sovereign, corporate and personal debt in the United States, the United Kingdom, the Netherlands, Australia, Japan and other advanced economies. Securitization has pumped trillions of dollars into residential and commercial mortgages, credit card facilities, small business loans, automobile loans, student loans and other types of receivables-generating activities.\textsuperscript{11)}

Securitization is ultimately a tool that can be utilized in various industries and facilitate liquidity. One of the key things to understand about securitization is that one needs to look behind each securitization vehicle, to the collateral underlying it, to determine which types of legal and regulatory protections are necessary to protect the parties involved and the broader economy. While there are some commonalities across collateral classes of ABS, the differences are significant and largely attributed to the fundamental differences between the valuation and utilization of the various types of underlying collateral.

b. Origins of Securitization.

i) Securitization in the EU and the United States.

Securitization in its modern form can trace its origins to the establishment of the Government National Mortgage Association ("Ginnie Mae") by the United States Congress in 1968.\textsuperscript{12)}

\textsuperscript{11)} See, \textit{e.g.}, \textit{Summary of Worldwide Securitization}, Asset-Backed Alert (Dec. 30, 2006), http://www.abalert.com/ranking.php?rid=77 (last visited Jun. 25, 2013) (identifying issuance volumes by types of receivables that backed such ABS issuances in 2005 and 2006).

\textsuperscript{12)} Tamar Frankel & Mark Fagan, \textit{Law and the Financial System-Securitization and Asset Backed Securities: Law, Process, Case Studies, and Simulations} 24 (Vandeplas Publishing 2009).
is a government owned corporation that was created during a time of tight credit to "establish secondary market facilities for residential mortgages" by utilizing private capital.\(^{13}\) Ginnie Mae was empowered to buy and sell federally insured residential mortgages and then pool them into securities for sale to investors in order to, \textit{inter alia}, increase mortgage capital available to banks to loan.\(^{14}\)

The United States federal government also chartered the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), both of which were formed as government corporations that became privatized corporations. They were created to encourage the creation of a secondary market for residential mortgages issued by banks and savings and loan associations. They standardized residential mortgage loan terms in order to make the loans relatively fungible for pooling, due diligence and sales purposes. They guarantee and purchase such loans, place them in SPVs and then sell shares therein to public investors.\(^{15}\) The creation of such a mechanism allowed mortgage banks to originate increasingly more mortgages as they could use capital for one mortgage, then sell it to one of the GSEs\(^{16}\) and then use that capital for another mortgage, then sell that mortgage, then use that capital to originate another mortgage, then sell that mortgage, then re-loan the money... \textit{ad infinitum}.\(^{17}\)

\(^{13}\) 12 U.S.C. § 1716 (2011).
\(^{14}\) Frankel & Fagan, \textit{supra} note 12, at 24-5.
\(^{15}\) Id. at 26-7, 33.
\(^{16}\) "GSE" is short for "government sponsored enterprise." Government sponsored enterprises are "[p]rivately held corporations with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy. Members of these sectors include students, farmers and homeowners." Investopedia, http://www.investopedia.com/terms/g/gse.asp#ixzz2J14yRQgRh (last visited Jun. 26, 2013).
\(^{17}\) See Frankel & Fagan, \textit{supra} note 12, at 24-30 (presenting a case study entitled "MBS – Using Capital for One Mortgage and Then Another and Another").
The development of GSE backed mortgages fundamentally changed the function of mortgage banks. It freed them from the institutional risks associated with having to hold mortgages long term in order to be paid back all principal and interest due them.\(^\text{18}\) It allowed them to tap capital beyond that available through traditional means—accepting deposits, collecting interest payments on loans and raising capital via debt or equity issuances. Indeed, this creation of a secondary market for mortgage banks freed them from holding mortgages and improved the efficiency of their intermediary function.

It is important to note that variations of financing schemes like securitization existed before 1970. Indeed, in Denmark there is a mortgage credit system that is quite similar to the American pass-through certificates.\(^\text{19}\) The Germans have also had a secondary mortgage market that pre-dates American securitization; however “securitization in the modern sense only emerged in Europe in the mid 1980s with the issuance of the first … mortgage backed securities.”\(^\text{20}\) European ABS markets have grown significantly over the past 15 years or so. Throughout that time, the United Kingdom has led the way with issuance volume, with other European jurisdictions far behind.\(^\text{21}\)

ii) Securitization in Korea.

The origins and use of securitization in the United States, the EU and Korea have all been quite different. In comparison with the United States and the EU, securitization has played a relatively minor role in Korean financial markets.\(^\text{22}\) This is partly due to the

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18) See id. at 22.
19) Vinod Kothari, Securitization: The Financial Instrument of the Future 16 (John Wiley & Sons (Asia) Pte Ltd 2006).
20) Id.
21) Id.
fact that the Korean securitization market, like that of all Asian nations other than Japan, has had very limited experience in generating consistent deal flow, particularly in the post global financial crisis era.

Paradoxically, mortgage backed securities ("MBS") and other ABS in the United States helped instigate the post 2007 downward cycle in capital markets but asset backed securitization in Korea was originally used to facilitate Korea's emergence out of its financial crisis in the late 1990s. In order to isolate and liquidate non-performing assets at that time, the Korean government enacted the 1998 Asset-backed Securitization Act\(^{23}\) (the "ABS Act") and the 1999 Special Purpose Companies for Mortgage backed Bonds Act\(^{24}\). Such laws were implemented to use securitization as a method to separate asset risk from business risk and thus dispose of troubled, non-performing loans\(^{25}\) as part of an effort to restructure and strengthen financial institutions, financial markets and the broader economy in Korea.\(^{26}\)

In December 2003, the Korea National Mortgage Corporation Act (which

\(^{22}\) See Paul Lejot \textit{et al.}, \textit{Securitization in East Asia}, Asian Development Bank Working Paper Series on Regional Economic Integration No. 12, 1 (Jan. 2008), http://www.adb.org/Documents/Papers/Regional Economic Integration/WPI2 Securitization East Asia.pdf (last viewed Mar. 11, 2011); see, e.g., Yeon hee Kim & Eun hyung Seo, \textit{South Korean Banks Embrace Securitization; Costs Weigh}, Reuters (Aug. 4, 2009), http://www.reuters.com/article/2009/08/04/us korea banks mbs idUSTRE57320020090804 (last viewed Feb. 18, 2013) ("In 2008, only 2 percent of banks' mortgage loans were securitized, out of the total of 236 trillion won.").

\(^{23}\) \textit{자산유동화에관한법률} [Asset backed Securitization Act], Act No. 5556, Sep. 16, 1998, \textit{as amended by} Act No. 9258, Dec. 26, 2008 (S. Kor.), \textit{translation provided via email by Korea Legislation Research Institute} (Jan. 2013).

\(^{24}\) \textit{주택저당채권유동화회사법} [Special Purpose Companies for Mortgage backed Bonds Act], Act No. 5692, Jan. 29, 1999, \textit{as amended by} Act No. 10924, Jul. 25, 2011 (S. Kor.), \textit{translation provided via email by Korea Legislation Research Institute} (Jan. 2013); see Kothari, \textit{supra} note 19, at 169.

\(^{25}\) See Seung Dong You, \textit{Korean Mortgage Markets: Transition to Securitization}, Housing Fin. Int'l, 1 (Mar. 1, 2005) ("[F]rom 1999 to 2001, KRW 17.7 trillion in primary CBOs and CLOs were issued, and KRW 23.4 trillion in [Non-performing loans] were securitized.").

\(^{26}\) See \textit{id.}
is also known in English as the Korea Housing Finance Corporation Act\(^27\) was promulgated and created a legal foundation for the use of securitization to finance non troubled real estate assets. As with GSEs in the United States, such Act paved the way for the creation of government sponsored secondary market distribution of residential mortgages via securitization.\(^28\) Besides the development of residential mortgage backed securities ("RMBS") laws and products, Korean banks also developed consumer debt securitization products.\(^29\) Despite developments in residential mortgage and consumer debt securitization, the relative size of such issuances compared with the overall size of the financial market activity in Korea has been relatively small.\(^30\)

c. Global Pre-2007 Growth in ABS.

From the 1980s until 2007, various classes of assets were securitized on a massively growing scale in the United States and around the world. Up through 2007, growth in ABS issuances really accelerated year over year globally, with the United States leading the way. In 2000,
there was over 1 trillion USD of asset-backed securities outstanding in the USA. Soon annual issuance numbers would dwarf that aggregate to date. From 2000, growth continued unabated and in 2003, over 1.2 trillion USD of ABS were issued worldwide\(^{31}\) - the first of six straight years of global issuances of over 1 trillion USD.\(^{32}\) Three years later, annual global volume of ABS issuance more than doubled, to 2.6 trillion USD.\(^{33}\) Of that amount, 1.5 trillion USD of ABS, approximately 66.2% of the worldwide total, were issued in the United States alone.\(^{34}\)

Compared with the EU and the United States, Asia (not counting Japan\(^{35}\)) has never had any significant securitization activity. At its

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31) *Worldwide Securitization Volume*, Asset-Backed Alert (Dec. 30, 2004), http://www.abalert.com/ranking.php?rid=125 (last visited Jun. 25, 2013).

32) See id. In discussing issuance numbers, the author consulted various Asset Backed Alert data available in the *Rankings of Market Players* link at http://www.abalert.com, primarily annual reports with titles that are approximately as follows: *Worldwide Securitization Volume* (see, e.g., id.), *Summary of Worldwide Securitization* (see, e.g., *Summary of Worldwide Securitization in 2007*, Asset Backed Alert (Dec. 30 2007), http://www.abalert.com/ranking.php?rid=56 (last visited Jun. 24, 2013)) and *ABS Issued Outside the US* see, e.g., *ABS Issued Outside the US*, Asset Backed Alert (Dec. 31, 2011), http://www.abalert.com/ranking.php?rid=2413 (last visited Jun. 24, 2013)). When one or a few reports are the source of a particular set of data, then that particular report will be cited. If large strings of data from across reports are used, then citation will be made to “Asset Backed Rankings”. In all instances where there are multiple sets of data and numbers do not match between the sets, the most recent found source is cited - for example, *Summary of Worldwide Securitization in 2008* states that worldwide ABS issuances totaled $2,265,712,000,000 but the earlier *Worldwide Securitization Volume* report issued on Dec. 30, 2007 reports a slightly lower number of $2,166,075,600,000. The earlier number is based on 2,798 deals reported and the latter number is based on 2,881 deals reported. This is indicative of the authors of Asset Backed Alert and their sister publications continuing to collect annual data after the end of a calendar year in which initial numbers were published at the end of December. See *Worldwide Securitization Volume*, Asset Backed Alert (Dec. 30, 2007), http://www.abalert.com/ranking.php?rid=63 (last visited Jun. 24, 2013); cf. *Summary of Worldwide Securitization in 2008*, Asset Backed Alert, http://www.abalert.com/ranking.php?rid=1751 (last visited Jun. 24, 2013).

33) Id.

34) Id.

35) Japan and Asia are counted as two separate reporting categories in most Asset Backed Alert
peak in 2007, Asian issuance volume was still lower than Africa, amounting to only 3.8 billion USD\textsuperscript{36} or 0.2% of the world total. While there has been some securitization activity in Korea and other Asian countries, it has never played a significant systemic role in providing liquidity.

However, if managed correctly, securitization is a tool that can be used to help businesses in Korea and other Asian nations to improve access to capital, not only from domestic sources but also from international capital markets, and also spread risks associated with Korean assets beyond the Korean Peninsula. As Korean authorities and market players attempt to create and strengthen securitization markets and regulations, Korean authorities should continue to look closely at the recent experiences in the United States and the EU, both with respect to crisis management successes and failures, as well as following regulatory actions, and draw the best conclusions possible. In order to aid such effort, this piece discusses both actions of foreign regulators during or soon after the onset of the global financial crisis and key substantive and procedural actions of regulators thereafter.

As mentioned in Part II.A above, securitization itself is just a tool. In the case of the United States, it was used as a tool to package and sell badly underwritten loans, so-called sub-prime residential mortgage loans, to investors. If the collateral underlying a securitization is poor quality, then the securitization technique cannot magically create high quality assets for all investors. This reality was clearly manifest with the growth of sub-prime loans in the United States. This is a fundamental lesson that must be kept in mind at all times in Korea:

\textsuperscript{36} Asset-Backed Securities Distributed Outside the US, Asset Backed Alert, http://www.abalert.com/ranking.php?rid=1761 (last visited Jun. 26, 2013)).
Securitization cannot change the fundamental capacity of underlying collateral to generate future cash flows underlying any financial products. As shall be explained below, failure to understand the limitations of securitization, and thus focus on the fundamental soundness of underlying collateral, largely led to the implosion of ABS markets in the United States and eventually much of the world.

d. Crisis Part I: The Sub prime Implosion and ABS Collateral Damage.

While securitization has been used in various parts of the world, the United States has been at the forefront of developing securitized products and driving the growth of securitization as a viable alternative for banks to decouple their balance sheets from the risks of holding certain relatively illiquid assets, all while adding the advantage of getting relatively cheap money in exchange for them. During the growth phase, asset backed securitization transactions were growing not only in size and number, but also in diversity of assets covered and national economies involved. Still, even with international growth, other than in 2008, the United States has dominated securitization issuance volumes, ranging from approximately sixty to eighty percent of worldwide volume over the past decade. Naturally its experiences and regulations are critical to understand what has happened in the securitization arena.

In the spring of 2007, due to rising interest rates, decreasing home values and other systemic and regulatory problems, sub prime residential mortgage loans in the United States began to default and threaten default on a systemically significant scale. Thereafter sub prime residential mortgage loan backed securities were devalued and quickly became illiquid. In rapid succession, virtually all American RMBS and CMBS became illiquid - banks could not sell them to investors.
Consequently, banks no longer had as much money available to make mortgages and other loans and they began selling assets, including mortgage backed securities, at fire sale prices.37) The lack of available funding for mortgages further eroded market prices of real estate but the problems quickly spread beyond real estate finance.

Virtually all other forms of securitized products became infected with the sub prime contagion. One of the hardest hit areas was CMBS. When the brunt of the credit crisis hit in 2007 and 2008, the author was working as an attorney in New York City advising and representing Wall Street banks in originating and distributing large CMBS offerings and witnessed the precipitous decline in investor appetite for any CMBS products – even those with conservative underwriting and high quality rental collateral backing them. The collapse of CMBS happened virtually overnight. In May 2007, teams who were working around the clock were originating all types of CMBS loans. By July 2007, CMBS bankers and lawyers were virtually idled.

CMBS statistics from before and after the meltdown demonstrate the magnitude of the drop off in a key part of the economy. Overall, American CMBS originations dropped from their peak of 228.6 billion USD in 2007 to 12.1 billion USD in 2008, then further down to 2.7 billion USD in 2009.38) So, from 2007 to 2009, there was a roughly 99% drop off in distribution and, notably, the only activity that was scheduled in 2008 and 2009 was for originating loans that were pre 2009 contractual obligations of the lenders.39) Beyond the United

37) Fire sales are largely associated with underperforming securities. However fire sales of non-distressed assets also took place in desperate bids to bolster banks’ liquidity. The author personally saw banks sell non distressed, conservatively underwritten, fully cash flowing American CMBS at as low as 35 cents on the dollar in 2008.

38) Summary of CMBS Issuance, Commercial Mortgage Alert (Sep. 30, 2012), http://www.cmalert.com/ranking.php?rid=366 (last visited Jun. 25, 2013).

39) This information came from discussions with CMBS bankers in 2008 while a practicing attorney and from later discussions with research analysts at Deutsche Bank in January and
States, the amount of total CMBS transactions conducted worldwide in 2009 by the top 15 bookrunners was less than $10 billion USD 40 and in the United States, the aggregate amount of CMBS originated by the top 10 bookrunners was under $3 billion USD.41 These numbers are ridiculously low when compared to the historic trends. To put them in perspective, the author worked on originating approximately $6 billion of CMBS loans in the first half of 2007 – in just one law firm and only as a part of the overall work for only two clients in that period.

American CMBS was focused upon herein largely to illustrate that certain intermediary functions of the shadow banking sector froze. While CMBS was probably the hardest hit sector in the United States securitization market (as far as issuances were concerned), overall global ABS issuances fell from their peak in 2006 of 2.6 trillion USD to about 330 billion USD in 2009.42 They are yet to recover, barely reaching over 500 billion USD in 2012, a mere 19.1% of their high.

The trajectory of European ABS issuances was negatively impacted by events in the United States. However, the declines lagged by approximately one year to eighteen months and had a lesser effect on total securitization volumes. Notably, when American ABS volumes collapsed in 2008, Europe experienced its apogee, with issuances of over 1 trillion USD that accounted for over 76% of global output.43)

February 2010, while the author was working in the Legal and Compliance Departments at Deutsche Bank’s 60 Wall Street offices in New York City.

40) *Global CMBS Bookrunners in 2009*, Commercial Mortgage Alert (Apr. 5, 2010), http://www.cmalert.com/ranking.php?id=220 (last visited Oct. 1, 2010).

41) *US Bookrunners in 2009*, Commercial Mortgage Alert (Apr. 5, 2010), http://www.cmalert.com/ranks.php (last visited Oct. 1, 2010).

42) See *Asset‐backed Rankings*, supra note 32.

43) See *id.*
e. Crisis Part II: Picking and Choosing Winners and Losers.

Financial institutions generally have little equity compared to their asset level. For example, the typical bank will have a ratio of equity to assets much lower than 1:10. This type of capital ratio makes it so that financial institutions need their assets to be relatively safe: for even a small percentage decrease in asset value can be devastating to a bank. For example, if a bank with 8 billion USD in equity and 100 billion USD in assets had the book value of its assets fall by 10%, the bank would then be in a negative equity position and thus a "failed bank" ripe for liquidation by an appropriate government oversight authority, such as the FDIC in the United States.

If a bank with 100 billion USD in assets had positions involving 20 billion USD invested in residential mortgages and invested another 12 billion USD in mortgage backed securities and the value of those assets fell in book value by fifty to seventy percent, which was a common book write down required under mark to market regulations in 2008, then all of the bank's equity would have evaporated and

44) Notably mark to market accounting helped turn a real estate valuation and residential mortgage crisis into a systemic liquidity crisis, as the accounting rules forced all banks to mark the value of their RMBS, then CMBS, and so forth down to the prices of the only assets that were selling, which were those being liquidated on a fire sale basis. See Robert Kolb, Lessons from the Financial Crisis: Causes, Consequences, and Our Economic Future 205 (John Wiley & Sons 2010). Such accounting treatment not only hurt bank balance sheets it also scared investors away from buying any assets other than those severely marked down. The SBC, in one of the greatest moments of regulatory stubbornness in history, waited until the end of September 2008, after it was too late, to waive stringent mark-to-market rules and allow firms to estimate the value of assets instead of marking them to the fire sale price levels. See id at 205-06. Ironically, mark-to-market rules, which were billed as a means for better reflecting the real value of assets, actually led to massive market distortions upon their re-introduction in the United States in 2007. First, mark-to-market rules caused write downs of asset values to levels that were dramatically below basic present-value cash flow valuations for the underlying assets. Thereafter, as Professor Vasja Rant at the Faculty of Economics, University of Ljubljana (Slovenia) vehemently emphasized to the author in a discussion concerning our respective research into various aspects of debt markets in regulations
the bank would have become insolvent in the sense of having no equity. As a result, it would no longer be able to get loans to fund day to day operations with debt, as is typically the case with financial institutions. This is the exact scenario that hit various financial institutions in 2007 and 2008, when, at first their subprime mortgage positions (whether holding their own paper or securitized mortgages) collapsed, then the market for other categories of debt owned on their books, including other RMBS and CMBS, froze. When their asset values collapse, financial institutions then have to raise capital.45) Distressed financial institutions typically have three options in order to survive: "sell [their] good assets to quickly raise cash, find a merger partner, or appeal for a government bailout."46)

Prior to the fateful month of September 2008, large financial institutions could still raise capital to offset losses. As the financial crisis started to unfold, each of the options available to distressed financial institutions became more difficult in the United States, as buyers of rapidly freezing asset classes became scarce, then merger partners fled the market and then even the government failed to step in and save some institutions. In the end, a small group of elite bank executives, central bankers, regulators and policy makers took the crisis out of the marketplace and literally decided which financial institutions would survive and under what terms. At that point, securitization was no longer the major problem for financial institutions but appeasing regulators and powerful bankers at rival institutions

45) See, e.g., infra Appendix A, Table 1 (illustrating US subprime related investment losses and capital raised to offset them, as of August 2008).

46) Douglas Hearth, Understanding the Financial Crisis and Its Impact on Contemporary Business: A Supplement to Boone and Kurt's Contemporary Business 13th Edition 14 (John Wiley & Sons, Inc. 2010).
also became an issue. What led to that point were a series of market and regulatory failures that triggered additional market and regulatory failures.

As investor appetites for American mortgage backed securities froze in mid 2007 and then in the summer of 2007 almost all American debt markets collapsed, virtually all American financial institutions started writing down the book values of their assets. By March 2008, Bear Stearns mortgage exposure pushed it into a hastily put together deal by federal regulators who pushed Bear Stearns into being bought out by JPMorgan Chase at a fire sale price. That deal saved Bear Stearns clients and counterparties, as well as broader equity markets, from total collapse but securitization markets remained frozen and other financial markets and institutions would soon collapse.

Given that Fannie Mae and Freddie Mac guaranteed over half the mortgages in the United States and also owned as much as $2 trillion of private label sub prime MBS, they eventually faced the inability to meet their financial obligations and were taken under federal government conservatorship on September 7, 2008. They are still owned and controlled by the United States government and have required over 150 billion USD in government funds to cover their obligations since the government takeover.

47) See Andrew Ross Sorkin, *JPMorgan Pays $2 a Share for Bear Stearns*, NY Times (Mar. 17, 2008), http://www.nytimes.com/2008/03/17/business/17bear.html?pagewanted=all&_r=0 (last visited Jun. 30, 2013) (describing the terms and background of the sale the day it was announced).

48) See id. (explaining how JPMorgan was taking over all client and counterparty obligations of Bear Stearns and the plan seemed to counter massive equity market declines).

49) See Edward Pinto, *Fannie and Freddie’s Subprime Loan Purchases Add Up to Trillions*, FrumForum.com (Oct. 9, 2009, 9:25 AM), http://www.frumforum.com/fannie-and-freedies-subprime-loan-purchases-add-up-to-trillions/.

50) After the Bailout: Few Fans but No Fix for Fannie and Freddie, Reuters (Apr. 23, 2012), http://www.reuters.com/article/2012/04/23/us-usa-housing-idUSBRE8350MS20120423 (last visited Jun. 30, 2013) (discussing and summarizing analysis done showing that the GSEs purchased approximately 1.7 trillion USD of sub prime private label MBS from 2002 through 2007,
September 2008 fatefuly saw United States government and leading finance industry officials fail to reach an agreement on how to save a very significant player on Wall Street: Lehman Brothers. On September 12, 2008, Lehman Brothers realized it could not get needed financing and filed for bankruptcy protection. The Lehman bankruptcy shocked the financial world and had various impacts on other significant financial institutions, both directly via counterparty defaults and indirectly via broader market forces.

Thereafter, in rapid succession, other institutions required bailouts or went under. Merrill Lynch was then forced into being sold to Bank of America for pennies on the dollar. AIG, the largest insurer in the United States, had to be bailed out by the United States government and the Federal Reserve to save the insurer from default swap exposure on September 16, 2008. Then, Washington Mutual (the nation's largest mortgage lender) had its assets transferred via FDIC intervention to JPMorgan under highly unusual circumstances and Wachovia Corporation (then the nation's fourth largest bank) was absorbed by

which amounts to approximately 60% of all sub prime private label MBS issued during that time; thus the GSEs experienced massive valuation losses on their balance sheets with respect to their MBS investments at the same time they were being subjected to massive liabilities on mortgages they guaranteed or for which they otherwise provided liquidity support).

51) The author remembers this day vividly, as the Lehman bankruptcy ended a $200 million real estate finance closing he was participating in that day due to the fact that a Lehman Brothers controlled entity was a minor part owner a few steps up the ownership structure of the borrowing entity. It was one of countless transactions that had ripple effects. In this instance, the financing that did not occur was meant to free up money to make capital calls for a major real estate developer on other property projects. The developer then faced the possibility of a liquidity crisis due to failure of this financing.

52) Hearth, supra note 35, at 15.

53) See Washington Mutual's Final Days — The Deal, Puget Sound Business J. (Dec. 27, 2009), http://www.bizjournals.com/seattle/stories/2009/12/28/story1.html?page=all (last visited Jun. 30, 2013) (detailing the suspect circumstances of JPMorgan Chase's FDIC facilitated takeover of Washington Mutual).
Wells Fargo\textsuperscript{54} after Citigroup passed on acquiring any of its assets. Throughout this period of time, Citigroup, Goldman Sachs and other supposedly healthier institutions received preferential government treatment and were saved.\textsuperscript{55}

The impact of the implosion of sub prime RMBS quickly spread beyond balance sheets of financial institutions, turned into a general liquidity crisis and hit broad equity markets, particularly in the United States. In 2009, "U.S. equity capital deal volume dropped 77\% year on year to $12.7 billion in the [first] quarter, with U.S. IPO volume down 97\% to $828 million…".\textsuperscript{56} Precipitating such drop was the stock market collapse that started in September but was fully actualized in October 2008.\textsuperscript{57} At this point, the biggest problem had shifted from residential mortgages into a general liquidity crisis across financial institutions, real estate companies and other types of businesses heavily reliant on debt financing.

\textsuperscript{54} Wells Fargo, News Release: Wells Fargo and Wachovia Merger Completed (Jan. 1, 2009), https://www.wellsfargo.com/press/2009/20090101_Wachovia_Merger (last visited Jun. 30, 2013).

\textsuperscript{55} Notably, Citigroup had massive sub prime loan exposure, as illustrated in infra Appendix A, Table 1, and faced repeated liquidity crises and required repeated emergency regulatory and financial assistance to survive. Due to attorney client confidentiality issues related to the author’s representation of Citigroup during the timeframe in question, the author is not permitted to disclose the true extent of some of their lesser known but more serious problems in 2007 and 2008. It is safe to say that it was not the fact that Citigroup was better managed or had taken less risk than other financial institutions that made it survive. Of course, size did matter, but it was mostly its connections into the halls of power in the Federal Reserve Banking system and the United States Treasury Department that kept it from being dismantled (which was an option). Ultimately, Citigroup required a 12 billion USD investment from the United States Treasury to survive. Ed Cohen, The Devil, the Details & Dodd Frank, Notre Dame Business Magazine, http://bizmagazine.nd.edu/article/print/index.cfm?id=91 (last visited Feb. 18, 2013).

\textsuperscript{56} Lisa Twaronite, Corporate Investment grade Bond Volume Surges, MarketWatch (Mar. 30, 2009), http://articles.marketwatch.com/2009-03-30/news/30803636_1_dealogic-global-equity-lowest-quarterly-level (last visited Jun. 30, 2013).

\textsuperscript{57} See Dow Jones Industrial Average (1986 - Present Monthly), http://stockcharts.com/freecharts/historical/djia1986.html (last visited Feb. 19, 2013) (showing a drop in the DJIA from a high of 14,164 in late 2007 to 6,547 in early 2009, after a dramatic decline in late 2008).
Ultimately, it was not securitization that was the root of the problem. It was the American housing market and the mortgages collateralized thereby. Nevertheless, securitization helped spread the problem beyond America’s shores.\(^\text{58}\) Due to the global nature of securitization markets, financial institutions throughout the world held American RMBS\(^\text{59}\) and, as a result of such exposure (as well as exposure to other financial instruments that lost significant value or marketability), they had to face insolvency, bailouts and even collapse like their American counterparts.\(^\text{60}\)

Since that time, the American economy and much of the world economy has been stuck in a negative feedback loop where economic fundamentals, regulatory uncertainties and political considerations have kept investors and securitizers from coming back into the securitization markets other than in a very cautious and subdued manner. In the meantime, regulators have stepped into the fray, ostensibly to lessen the risk of a future crisis like that which commenced beginning in 2007 and to guide debt capital markets to a new type and level of full functionality. So far, they have mostly been able to prop up the securitization markets with government programs such as America’s TARP program\(^\text{61}\) and central

\(^{58}\) See infra Appendix A, Table 1 (showing that 7 of the top 15 financial institutions experiencing US sub prime related investment losses in August 2008 were European institutions). For an excellent description of how one foreclosed loan in Washington State hurt global investors, see By Turning Subprime Loans into A rated Investments, Mortgage Securities Spread Risk Widely; Puget Sound Business J. (Mar. 15, 2009), http://www.bizjournals.com/Seattle/stories/2009/03/16/story1.html?page=all (last visited Jun. 30, 2013).

\(^{59}\) See Yalman Onaran, Banks’ Subprime Losses Top $500 Billion on Writedowns (Updated), Bloomberg (Aug. 12, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8sWOn1Cs1Y (last visited Feb. 17, 2013) (listing the financial institutions suffering US sub-prime -related investment losses, including substantial numbers of institutions outside of the United States).

\(^{60}\) Hearth, supra note 46, at 15.

\(^{61}\) “TARP” stands for “Troubled Asset Relief Program,” which was authorized under the Emergency Economic Stabilization Act of 2008. “The original provisions of TARP … focused on a Treasury asset purchase program to buy the illiquid mortgage-backed assets that many
bank activity\(^{62}\): and regulations have been minimally effective in facilitating growth and have more likely become a drag on the recovery.

### III. Regulatory Responses in the United States and the EU.

Despite the global financial crisis that evolved out of the American subprime crisis, it is important to remember that securitization can play a positive role in increasing the quantity\(^{63}\) and quality of loans available to be funded by banks.\(^{64}\) If structured correctly and if market players engage in ethical and thorough diligence and disclosure to involved parties, securitization can come be a useful tool in providing liquidity and spreading risk in Korea and elsewhere in the world. For that to happen, investor confidence in securitized products must return. For confidence to grow, economic fundamentals must become stronger on a global scale, legal protections must be strengthened

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62) See Basel Committee Report, *supra* note 8, at 7 (noting the low number of active investors purchasing securitized products and how “[i]n some regions demand has been significantly supported by government and central bank intervention.”).

63) Kara *et al.*, *supra* note 3, at 10.

64) Ugo Albertazzi *et al.*, *Securitization is not that Evil After All*, BIS Working Papers, No. 341, at 32 3 (Mar. 2011) (demonstrating that securitizations in Italian residential mortgages actually helped improve loan quality).
jurisdiction by jurisdiction and political risks need to be lessened. While regulators cannot control all of these factors, they can play an important role in restoring investor confidence via transparent, coherent and well targeted regulatory actions. Unfortunately, a large degree of regulatory activity in the EU and United States was drawn up in an opaque manner, was fragmented and blanket in nature, and much of it has also been tardy, as shall be discussed below.

a. Regulators Taking Action.

In order to restore investor confidence and overcome some of the faults in past securitization practices that are commonly believed to have triggered certain aspects of the global financial crisis, regulators have made a myriad of proposals, many of which have been enacted. In order for the applicable regulations to be properly understood, the broader context in which they were made must be understood. Various causes have been attributed to the sub prime meltdown and the related credit crisis in the USA and much of the rest of the world post 2007 - including the implementation of mark to market rules;\(^65\) loose underwriting standards for residential mortgage backed securities in particular; the failure of investors, rating agencies, insurance companies and issuers to account for systemic shocks in their modeling;\(^66\) and many other factors.

Since 2007, many scholarly and even more industry pieces have been written analyzing the causes of the 2007 economic meltdown.\(^67\)

\(^65\) See Frank Holmes, *How FAS 157 Mark to Market Helped Slow the Economy* (6 April 2009), http://www.marketoracle.co.uk/Article9892.html (last visited Aug. 3, 2010).

\(^66\) Matesh Kotesha, Founder & President, Structured Credit International Corp., Remarks made on The Future Role of Ratings Agencies Panel at Asset Backed Securities Summit, New York, NY (Jun. 29, 2010) (commenting that ratings agencies failed to model for system market shocks).
Additionally, governmental actors, including highest ranking politicians and regulators, primarily in the United States and Europe, entered the fray with accusations of malfeasance by industry players and the creation of new laws and regulations meant to better regulate asset backed securitizations (as well as other aspects of the once 20 trillion USD “shadow banking” sector, such as swaps and derivatives). They have followed up the accusations with a dizzying spectacle of collectively confounding, oftentimes irrational and sometimes useful regulations.

As chaotic as the meltdown post Lehman bankruptcy became, the reaction of the United States government was even more erratic. The crisis in credit markets that became visible in the spring of 2007 caught regulators unprepared, shocked investors and undercut the solvency of the banking industry, first in the USA, then around the world. Since that time, regulators have been struggling to understand

67) See, e.g., John C. Coffee, Jr., Our National Challenge: A Blueprint for Restoring the Public Trust, 6 U. St. Thomas L.J. 403 (2009).

68) See Christopher Whittall, Lawyers Highlight Grey Areas in Securitisation Regulation (June 2009), http://www.risk.net/risk-magazine/news/1504733/lawyers-highlight-grey-securitisation-regulation (last visited Aug. 3, 2010).

69) Deloitte LLP, Press Release: Deloitte Shadow Banking Index Debuts: ‘Only’ $9.53 Trillion in Size at End of 2011 (May 29, 2012), http://www.deloitte.com/view/en_US/us/press/PressReleases/4db66afde1397310VgnVCM1000001956f00aRCRD.htm (last visited Jun. 30, 2013) (estimating the shadow banking sector at about 9.5 trillion USD at the end of 2011, down from over 20 trillion USD in 2008 and much lower than common estimates of up to 60 trillion USD).

70) See William Perraudin & Shi Wu, Determinants of Asset Backed Security Prices in Crisis Periods, Imperial College of London Working Papers (2008), http://www3.imperial.ac.uk/pls/portallive/docs/1/48859697.PDF (last visited August 2, 2010).

71) The degree to which governments and central banks feigned shock is still amazing to the author given how much regulators and market players knew about the massively inflated housing price bubble supported by cheap money in the United States. As early as 2004 partners and associates in my one law firm were commenting on how unsustainable growth in real estate pricing was at that point. The general consensus in the real estate finance industry was that Miami, Las Vegas, Phoenix, Atlanta and other supposedly strong housing markets would collapse due to overbuilding and overpricing. Rather than try to cool the
so-called shadow banking markets, including tools such as securitization, and actually create regulatory regimes that contribute to market certainty and stability.

Given the breadth and complexity of such regulations,\(^{72}\) it is difficult to isolate any one of them and analyze its effect in a truly meaningful quantitative analysis. Indeed, many are still being written and implemented. Since securitizations were at the heart of the initial economic turmoil, continue to be a focus of regulators and are yet to be utilized in volumes of systemic significance in some key sectors, such as commercial real estate, we will focus herein on analyzing to what extent European or American regulators have met what should be their objective: promoting a more stable and robust global economy, including their own domestic economies.

Among the new constraints impacting securitization are those meant to deal with two key areas of concern that will be the focus herein:

1. issuer incentives; and
2. transparency.\(^{73}\)

Another area of great concern that also impacts the market for securitized products is regulatory capital requirement regulation for financial institutions.\(^{74}\) While there are a myriad of other areas of

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72) See Cohen, supra note 55 (noting that the Dodd Frank Act alone requires that regulators create 243 rules, conduct 67 studies, and issue 22 periodic reports over a 2.5 year period of time).

73) See Global Financial Markets Association [gfma], Global Regulatory Reform Proposals 12 (Sep. 30, 2012) (setting forth, in table format, key areas of securitization regulation in the EU, the US and globally).
concern to regulators, the two above listed are arguably the most important in securitization at this time and they are linked together to a certain extent.\(^{75}\)

They both play into the concept that if better due diligence (including credit screening, which had historically been done mostly by credit rating agencies ("CRAs") had been performed in the securitization process then the collapse of the sub prime RMBS markets and broader securitized debt markets might have been avoided.

Risk retention is ultimately aimed at getting securitizers to better assess risk before selling securitized assets. Transparency requirements are intended to get investors the data they need to better assess risk before purchasing securitized assets. While both objectives are laudable and should be supported, particularly with respect to less homogenous asset classes such as residential real estate backed mortgages, such requirements would have made almost no difference in averting the sub prime collapse. This is the case because the collapse was not brought about only because of poorly structured mortgages but more so because of a real estate price bubble that collapsed on a massive scale that had not been anticipated in risk assessment models of banks, ratings agencies or investors.\(^{76}\)

b. Aligning Securitizer and Investor Interests with Skin in the Game.

Among the alleged culprits that led to the collapse of sub prime

\(^{74}\) Id.

\(^{75}\) See, e.g., Albertazzi et al., supra note 64, at 10 (tying informational asymmetries and transfer of credit risk).

\(^{76}\) Kotesha, supra note 50 (noting that prudent loan underwriting, securitization ratings and securitization credit assessment models prior to 2007 did not contemplate a systemic rational collapses in real estate prices and broader credit markets).
RMBS products is the originate to distribute\textsuperscript{77} model that is prevalent in American RMBS. In a securitization system, the traditional system of lending involving one bank originating, holding and servicing mortgage loans for the life of the loan is replaced with one in which “a number of different agents performing different services, often for fees that could be unrelated to the performance of the securitized pool of loans.”\textsuperscript{78} In pure originate to distribute mortgage loan securitization, the loan originators create loans, then the sponsor conducts due diligence on the originator’s loans, structures the deal, historically in consultation with CRAs, pools them, slices them into tranches of various degrees of risk/return and distributes the various tranches entirely to investors.

Such a system is said to reduce incentives of loan originators to carefully screen borrowers and collateral and thus lead to looser underwriting standards among originators\textsuperscript{79} and the proliferation of available consumer credit, including that extended in residential mortgages that led to the residential real estate valuation bubble in

\textsuperscript{77} ‘Originate to distribute’ refers to a system where mortgage brokers originated mortgages that they intended to sell to other investors rather than be held on the lenders’ balance sheet. To the extent that originators knew they would never own the mortgages, these brokers might not have undertaken the same due diligence as if their own capital were at risk.” Christopher Mayer, Columbia Business School & Visiting Scholar, Federal Reserve Bank of New York, \textit{Housing, Subprime Mortgages, and Securitization: How Did We Go Wrong and What Can We Learn So This Doesn’t Happen Again?}, at 3, fn 2, background reading material for The Weil, Gotshal & Manges Roundtable at Yale Law School (Apr. 11, 2011), available at http://www.law.yale.edu/documents/pdf/cbl/Housing_Subprime.pdf.

\textsuperscript{78} Cem Demiroglu & Christopher James, \textit{How Important is Having Skin in the Game?}, Originator-Sponsor Affiliation and Losses on Mortgage backed Securities, 25 Rev. Fin. Studies 3217, 3217 (2012).

\textsuperscript{79} See Kara et al., supra note 3, at 10 (noting empirical evidence links loan sales to looser credit monitoring and overall underwriting by mortgage lenders); see also Demiroglu & James, supra note 60, at 3217-218 (noting studies that link “significantly higher default rates for mortgages that were securitized” than for those “retained in the original lender’s portfolio”); but see Albertazzi et al., supra note 64, at 10 (finding that securitization actually enhanced underwriting standards in their extensive sampling of Italian mortgages).
the United States. Some argue that it creates improper informational asymmetries between originators and final investors\textsuperscript{80} and facilitates a lack of long term risk appreciation for investors on the part of originators or what economists term “moral hazard.”\textsuperscript{81} Some research supports the notion that originators of loans and sponsors fail to pay proper attention to the risk factors involved with the mortgages they ultimately pool and sell to investors.\textsuperscript{82} Such research has mostly focused on American sub prime RMBS and is yet to be proven applicable internationally, to all types of asset classes or to all securitization structures.\textsuperscript{83}

Despite evidence showing that markets have found “ways to contrast asymmetric information problems” or at least mitigate their effects,\textsuperscript{84} regulators bought into the idea that American sub prime RMBS is somehow indicative of various classes of securitization. Thus the G 20, IOSCO\textsuperscript{85} and other international organizations have pushed for national and regional initiatives to enhance risk exposure of securitizers to the performance of the assets involved in their securitizations.\textsuperscript{86} This requirement to keep some loss exposure with respect to assets they securitize is commonly called keeping “skin in the game.”\textsuperscript{87}

In both the EU and the United States, proposed or final regulations

\textsuperscript{80} See id.
\textsuperscript{81} Christopher M. James, \textit{Mortgage Backed Securities: How Important is “Skin in the Game”?}, FRBSF Economic Newsletter, No. 2010 37, at 1 (Dec. 13, 2010), \textit{available at www.frbsf.org/publications/economics/letter} (last visited Jan. 14, 2013).
\textsuperscript{82} Id. at 2.
\textsuperscript{83} See Albertazzi \textit{et al.}, supra note 64 (criticizing papers on risk retention for “confin[ing] themselves mostly to the US subprime market.”).
\textsuperscript{84} Id. at 25.
\textsuperscript{85} The term “IOSCO” is used to refer to the International Organization of Securities Commissions.
\textsuperscript{86} See gfma, supra note 73, at 12; see also Basel Committee Report, supra note 8, at 2 (summarizing the extensive mandate for risk retention from various international organizations and national governments since the .
\textsuperscript{87} Id. at 1.
have been promulgated requiring originators, issuers or specified others involved in packaging and selling asset-backed securities to investors to retain at least five percent of the credit risk in the assets securitized on their balance sheets, subject to certain exemptions and exceptions. As explained below, EU and American regulators have taken very different approaches but their objective and underlying method are the same: To signal to investors the quality of assets and to align the securitizer's interests with those of investors by making the securitizers hold onto at least some of the poorer quality assets.

Notably, in Korea, originator risk retention is standard, although not a legal requirement, in most securitizations.88) Before Korea institutes legal standards for risk retention, it should analyze whether risk retention poses issues with respect to true sales and also review to what extent it is even necessary in certain trust structures or with respect to bespoke issuances. More than anything, Korea should learn from the experiences of the United States, as it has struggled to come up with a reasonable process of implementing, or substance of, risk retention rules.

1. The American Approach: Delaying Final Rules.

In March 2011, the United States Department of the Treasury, Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency and the Department of Housing and Urban

88) See Emerging Markets Committee of the International Organization of Securities Commissions, Securitization and Securitized Debt Instruments in Emerging Markets: Final Report 23 (Oct. 2010).
Development (collectively, the “Joint Regulators”) issued a notice of proposed rulemaking concerning risk retention rules (the “Notice”). Such rules are required to be promulgated under Section 941 of the Dodd Frank Wall Street Reform and Consumer Protection Act89) (the “Dodd Frank Act”). Under the Dodd Frank Act, a final rule was due from the Joint Regulators by April 15, 2011.90) As of the date of writing, a final rule is yet to be issued. It is unclear when a final rule will be issued. Nevertheless, the Notice was issued in March 2011. While comments were due in August of that year, comments were still being submitted through 2012.91)

In 2010, two reports on risk retention required by the Dodd Frank Act were released. They recommended that “the U.S. risk retention regime be flexible and not overly restrictive.”92) However, when proposed rules were made, they were perceived by industry players to be overly broad and restrictive, with “the overly restrictive requirements of the proposed risk retention ... most likely [going to] limit the real world feasibility of much of the proposed flexibility.”93) Despite the fact proposed rules and comments have been in process, we do not yet know the final contours of the American risk retention regulation two years after it was required under the Dodd Frank Act. As a result, regulatory uncertainty still continues to plague the American securitization market.

Despite the lack of final Section 941 risk retention rules, we do have some idea what they are likely to look like in a broad sense.

89) Pub. L. 111 – 203 (2010), codified in various locations.
90) American Securitization Forum, Timetable of Securitization Related Rulemaking Prescribed by the Dodd Frank Wall Street Reform and Consumer Protection Act 10 (Jan. 2, 2013 Update).
91) See id. (detailing dates and topics of comments from the American Securitization Forum).
92) Ed De Sear & John Hwang, Risk Retention: The Journey Thus Far, 17 J. Structured Fin. 31, 32 (2011).
93) Id.
This is partly due to what we have seen in proposed Section 941 rules, which would require securitizers to maintain five percent of most securitizations, and proposed Regulation AB II rules pertaining to shelf eligibility requirements for ABS issuers, which would require them to maintain a five percent risk retention position. 94) This approach is quite different from the EU approach, which focuses on investors as the parties required to comply with purchasing only ABS that comply with risk retention requirements, as discussed below herein.

Before discussing the European approach, one issue that is truly troubling about the American risk retention scheme is that it will exempt certain RMBS comprised of mortgages defined as "qualified residential mortgages" ("QRM") from risk retention requirements. 95) Given that failures with respect to residential mortgages triggered the global financial crisis, the notion of exempting any category of RMBS from risk retention is questionable at best. For due diligence on residential mortgage originations, regardless of whether they are QRM or sub prime are tied to non homogenous collateral, real estate, that demands a higher level of initial review than more homogenous types of assets, such as credit cards or student loans. If any RMBS category is exempt, logic dictates that virtually every other type of ABS, other than non QRM RMBS should be exempt as well. However, risk retention regulations are being driven by political considerations related to the ongoing policy of the United States government to promote home ownership via various policies, including mortgage liquidity support and favorable tax treatment of interest payments, as well as the interests of federal agencies that have financial stakes in the

94) Id.

95) Simpson Thacher & Bartlett LLP, Mortgage Reform Update: CFPB Issues Final Rule on Residential Mortgage Lending Requirements 1, fn. 1 (Jan. 29, 2013), available at http://www.stblaw.com/siteContent.cfm?contentID=4&itemID=80&focusID=1570 (click downloads link).
residential real estate mortgage finance market, including the GSEs (which are effectively federal agencies at this time).

2. The European Approach: Regulate Certain Investors.

Starting in March 2008, the EU commenced deliberations of risk retention requirements and approved them in mid 2009. Amendments of the EU Capital Requirements Directive,96 now located in Article 122a thereof, went into effect on January 2011 for new securitizations.97 So, unlike the United States, Europeans at least have a legal framework to work under. However, that framework is riddled with rigidity and blanket provisions that are troubling, particularly with respect to failures to distinguish between asset classes. Equally as troubling, it does not mesh well with what will most likely emerge from American regulators.

Unlike in the United States, Article 122a requires regulations of investors instead of securitizers in ABS transactions. Under the requirements, regulated credit institutions may only invest in securitized assets only if the originator, sponsor, or original lender discloses to investors that such originator, sponsor, or original lender "will retain a material net economic interest of not less than 5% in the transaction."98 Such exposure may not be lessened or counteracted by hedging or selling the securitizer's required position.99

If the whole world operated as the EU, then the EU risk retention

96) Directive 2009/111/EC of 16 September 2009, amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management.
97) Blommestein et al., supra note 5, at 9.
98) Committee of European Banking Supervisors, Consultation Paper on Guidelines to Article 122a of the Capital Requirements Directive (CP 40) 2 (Jul. 1, 2010).
99) Id.
regime would at least be coherent. However, investor focus on the part of EU authorities makes it so that non-European securitizers, such as those in markets as small as Korea or as large as the United States, must comply with the EU regulations unless they are willing to exclude EU regulated credit institutions from investing in their securities.100) While there would be no direct penalty on a non-EU ABS issuer that failed to comply with EU risk retention requirements, such issuer would likely face reduced liquidity from investors as a result of missing out on one of the largest ABS investment markets by virtue of EU credit institutions not risking penalties they would face for investing in non-compliant securities.101)

In the end, the EU is in a slightly better position than the United States in that it has at least promulgated a directive that must be complied with in across all member states. As we watch and analyze the impact and effectiveness of the federal regulations, we must keep in mind that almost all EU securitizations take place in the United Kingdom ("UK").102) Over time, it will be most useful to watch the impact of EU risk retention requirements on UK securitizations, with respect to volume, added costs and changes in practices of market participants, as well as their legal advisors. When watching for impact of the EU rules, it will be important to see to what extent regulations change to conform with realities of asset classes and market conditions. Another key feature of EU regulations to watch will be to what extent member states impose restrictions that vary from the baseline EU directive. Of course such variations are expected in the EU due to the nature of the directive process.

Variations between final United States and EU regulations will also

100) De Sear & Hwang, supra note 92, at 32-3.
101) Id.
102) See Asset-backed Rankings, supra note 32.
be critical to note once final US regulations have been issued. Many variations are expected, including American QRM exemptions and determinations about whether B piece buyer\textsuperscript{103} positions will be treated as qualified risk retention positions in CMBS transactions. For now, we must wait to see how well American and EU risk retention regulations will mesh in order to determine their impact on institutions involved in ABS markets, as well as their impact on the markets themselves.

b. "Transparency" and Related Due Diligence Regulations.

One of the concerns that has been a driving force in improving securitizations is making sure that investors have access to the information they need at, and prior to, closing in order to make good initial investment decisions and also thereafter - throughout the life of the applicable ABS. Historically, access to such data has been mostly a matter of disclosure requirements under securities laws and a matter covered under representations and warranties within the private contract relationship of securitizers and investors. The basic theory behind the need to enhance transparency regulations stems from the lack of data available to RMBS investors in the United States, particularly when delinquencies of, and foreclosures upon, collateral underlying RMBS occurred.

Another related issue is that many investors relied upon the due diligence of others, including CRAs and securitizers, instead of

\textsuperscript{103} "B piece buyers are the investors who buy the below BBB rated (i.e. the riskiest) tranches in CMBS, and who typically have more power than the other investors in carrying out due diligence on the borrowers, rejecting proposed loans from the pool, and ordering servicers in how to handle workouts for loans in default." Cardiff Garcia, \textit{CMBS Issuance Update and the B piece Buyer Problem}, FT Alphaville (Apr. 13, 2011 4:58 PM), \url{http://ftalphaville.ft.com/2011/04/13/543966/cmbs-issuance-update-and-the-b-piece-buyer-problem/} (last visited Feb. 19, 2013).
conducting their own credit analysis and broader collateral diligence. Indeed, according to a broad survey of ABS investors conducted by the Basel Committee on Banking Supervision, "interviews confirmed that many investors chose to respond to growing product complexity ... by relying heavily on credit ratings rather than conducting appropriate diligence."\(^{104}\)

Regulators have been exploring ways to enhance access to, and quality of, information provided to investors, as well as to give them incentives to conduct better due diligence and credit screening of their own. In certain types of securitizations where large numbers of small pieces of collateral were pooled together, such as RMBS, regulations requiring improved data dissemination are necessary. In other instances, even where there are even larger numbers of individual loans pooled together, such as credit card receivables securitizations, requiring loan level data is relatively useless\(^{105}\) or even unnecessary.\(^{106}\) For most esoteric securitization categories, such regulations are also largely unnecessary.\(^{107}\)

Regulations concerning "transparency" issues and other matters concerning information asymmetries between securitizers and investors

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104) Basel Committee Report, supra note 8, at 15.
105) Gregg Silver, CFO, First Financial USA, Evaluating the Opportunities in the Credit Card ABS Market, remarks made at Asset Backed Securities Summit, New York, NY (Jun. 30, 2010) (noted that granular loan level data is of little to no use to investors in credit card securitization issuances due to the sheer volume of them and the fact that credit card issuances are generally premium assets).
106) See Mayer, supra note 77, at 28 9 (contrasting credit card and student loan securitizations with other types of securitizations as performing well and noting that a key reason for this is with respect to credit card securitizations has been that, like covered bonds, they "operate with a master trust structure, where the buyers of securities always paid a lot of attention to issuer credit quality when purchasing bonds.").
107) See Ronald Borod, Bespoke ABS – The Flight to Quality, 36 Int'l Fin and Treasury 1, 1-10 (Sep. 30, 2010) (discussing, inter alia, how bespoke ABS transactions have historically involved in depth diligence of underlying assets and how such methods have been effective).
have been of great concern to regulators. Ultimately, they all have to do with trying to figure out how to provide investors with enough information to make proper investment decisions and to try to make sure they actually use the information to make appropriate investments. While the first part may seem simple enough, the latter is nearly impossible. Getting parties to conduct due diligence when they think they can rely on others’ results is the preferred route of many investors - not just in asset - backed securities. That is why research analysts and CRAs have historically made so much money. Ultimately, it is almost impossible to regulate most purchasers of securities into conducting thorough due diligence prior to investing. That is also why securities market regulators have historically focused on regulating issuers with disclosure, as opposed to forced investor due diligence, requirements.

1. Disclosure Requirements.

Given the large emphasis on the American RMBS experience, in order to facilitate enhanced due diligence and collateral monitoring capacities, both the EU and the United States have been working to create regulatory regimes that provide enhanced data reporting from securitizers to investors. With respect to enhancing data availability and diligence though required granular loan - level reporting, it appears that American regulators will be taking the more aggressive approach and requiring extensive reporting of collateral performance data throughout the life of ABS products. This includes requirements to provide ongoing loan - level data on student loans and some mortgages to investors.

While such measures may help improve investors’ confidence in the performance of underlying assets, such requirements will drive some securitizers and investors out of the marketplace due to additional
costs.\textsuperscript{108}) The loss of such parties should be of little concern, as long as the data that is being required pertains to the types of assets for which underlying performance data is useful (unlike credit card loans).

In the EU, along with risk retention obligations shifting to investors, the responsibility for increased due diligence also shifts to investors.\textsuperscript{109}) Additionally, while not applicable to all EU members, the European Central Bank ("ECB") has instituted a loan level data reporting requirement to determine if ABS are acceptable as collateral in Eurosystem credit operations. This reporting requirement is meant to "increase transparency and make available more timely information on the underlying loans and their performance to market participants in a standardized format."\textsuperscript{110)\textsuperscript{11}} Granular, loan level information requirements (granularityRMBS) began on January 3, 2013.\textsuperscript{111}) On March 1, 2013, the loan by loan reporting requirements started for CMBS and they will start on January 1, 2014 for “the remaining asset classes, i.e. for consumer ABS, auto loan ABS and leasing ABS[,...]”\textsuperscript{112)\textsuperscript{11}}. While this requirement should improve timely and accurate disclosure of information on single loan exposures and thus aid in ongoing diligence efforts by all interested parties, such blanket regulations of all types of ABS collateral types is the type of blunt instrument that will result in delivering unnecessary data in credit card securitizations, bespoke transactions of various types and possibly other types of ABS transactions. Despite being overly broad, the ECB approach is relatively simple and should aid most investors and interested third parties in receiving needed data in a uniform format. Nevertheless, cost benefit analyses

\textsuperscript{108)\textsuperscript{11}\textsuperscript{11}} Basel Committee Report, supra note 8, at 17-8.

\textsuperscript{109)\textsuperscript{11}} See gfma, supra note 73, at 12.

\textsuperscript{110)\textsuperscript{11}} European Central Bank, ABS Loan level Initiative, http://www.ecb.int/paym/coll/loanlevel/html/index.en.html (last visited Feb. 18, 2013).

\textsuperscript{111)\textsuperscript{11}} Id.

\textsuperscript{112)\textsuperscript{11}} Id.
should be undertaken in the future and exemptions made as a result thereof.

Like the ECB imposed system, Korea’s ABS Act takes a substantial step towards transparency, and provides a natural platform for enhanced transparency, in that it requires asset backed securitization plans be filed by special purpose companies.\textsuperscript{113)\textsuperscript{113}} Such plans must include not only basic information on the issuer but also on the types, total amount and valuation of the underlying assets; fundamental details of the securities and other “[m]atters concerning the administration, operation, and disposition of the securitization assets.”\textsuperscript{114)\textsuperscript{114}} However, Korean law does not appear to require any significant ongoing reporting requirements with respect to underlying asset performance or other material events, such as securities repurchases by securitizers.\textsuperscript{115)\textsuperscript{115}} Thus, the same lack of real-time data that plagued American RMBS is still a real possibility in Korea. As regulations continue to develop in Korea, these ongoing reporting issues should be addressed and reference to emerging American and European requirements should prove useful in developing transparent and efficient securitization markets in Korea.

2. CRA Regulations.

A key area of difference between the EU and the American regulators is with respect to how CRAs are being dealt with. Section 939A of the Dodd Frank Act attempted to lessen investor reliance on CRAs requiring regulatory agencies “to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit worthiness as each respective agency shall determine as

\textsuperscript{113}See ABS Act, ch. II.
\textsuperscript{114}See id., ch. II, art. 4.
\textsuperscript{115}See id.
appropriate for such regulations.\textsuperscript{116} The effect of this is that securities of various types will not have to have ratings of certain types attached to them. Instead, investors will have to perform diligence, including credit screening, that might otherwise be the purview of CRAs.

While the EU agrees with the objective of reducing reliance on CRAs, they have found the American approach to be problematic in that it is difficult to replace CRA functions.\textsuperscript{117} The EU has taken a very different approach in that it initially stiffened the requirements for CRAs and continues to make CRA ratings required and central to the evaluation of ABS. However, European regulators are now looking at ways to reduce reliance and references to CRAs, but is taking a much more cautious approach than that of the Dodd Frank Act.\textsuperscript{118} The European Commission is taking a two step approach: "First, the Commission will propose to remove all references which trigger mechanistic reliance on ratings, and in a second step, the Commission will report to the European Parliament on alternatives to external credit ratings with a view to removing all remaining references by 2020."\textsuperscript{119}

Such a process and timeframe demonstrates that the EU is much less concerned about removing CRAs from being relied upon than it is concerned about creating uncertainties involved in removing CRAs while having no viable alternative in place. This is a key area of substantive and stylistic regulatory divergence between the United

\textsuperscript{116} Dodd Frank Act, Sec. 939A.

\textsuperscript{117} See European Commission, New Rules on Credit Rating Agencies (CRAs) – Frequently Asked Questions (Jan. 16, 2013), available at http://europa.europa.eu/rapid/press-release_MEMO-13-13_en.htm (last visited Feb. 19, 2013) (implying that the American experience in trying to replace CRAs has led to legal uncertainty that the EU wants to avoid).

\textsuperscript{118} See id.

\textsuperscript{119} Id.
States and EU. Frankly, Korea would be better off to take a more judicious, EU like approach to finding the appropriate role of the various parties involved in credit analysis, including CRAs.

While it is yet to be seen if the American or European approach will better insure the quality of investor diligence and the assets underlying ABS structures, the EU approach to removing CRA references seems much more prudent than the American approach. Regardless of the approaches taken, reliable and affordable alternatives to CRAs need to be identified and fostered in the evaluation of credit risks involved in ABS and other debt product transactions. To what extent American and European experiences under their divergent regulations tell us that CRAs or other third parties may be relied upon for, or should be mandated to be involved in, evaluating any aspect of assets, originators or other aspects of the securitization process is something that Korean legislators and regulatory authorities should carefully watch over the coming years.

I. A Better Way to Regulate ABS.

Regulation alone cannot return securitization or even the broader debt markets to optimal levels of performance. Economic fundamentals must improve and political certainty must also return in the regulatory arena. Additionally, market players need to engage in prudent, intelligent behavior, including more effective diligence. If we have learned anything about securitization in the past six years it should be that securitizers and investors need to know the assets that are at the foundation of any securitized products. Fundamental assumptions about credit ratings and homogeneity of underlying assets can no longer excuse prudent credit screening and wider due diligence.

American and EU Regulators appear to have the intent to do as much as they can to help investors make intelligent decisions. Ironically,
there are serious questions about how intelligent the decisions made by securitization regulators have been in trying to assist the creation of better diligence processes since 2007. For regulators in both the EU and the United States started with the premise that securitization is something that can be understood and regulated. However, their approach to regulation have been undertaken in a manner that has demonstrated a failure to understand the differences and intricacies of securitized products.

While some of the regulations discussed herein will likely make some positive difference in with respect to some asset classes, some key proposed securitization regulations have been fundamentally flawed. These flaws stem from faulty premises, flawed processes and unprepared personnel.

a. Faulty Premises.

One key flaw in both the risk retention and enhanced transparency regulation processes is the premise upon which regulators have pursued them - that securitization, or at least originate to distribute securitization, is itself a problem. Securitization itself was not the problem that led to the financial crisis, as the vast majority of asset classes and securitization vehicles have performed extremely well. The real problems started with improper evaluation of underlying assets, by residential mortgage originators, sponsors, CRAs and investors. These problems occurred in the very areas where securitization was supposed to be most effective: in the supposedly homogenous American residential mortgage market.

As Ronald Borod, a prominent American securitization attorney noted in 2010:
A central irony that has not received much attention over the past five years is that in those sectors of the ABS market where the underlying assets were considered individually insignificant because they were considered sufficiently homogeneous to support a statistical approach to rating the probability of default when large pools of these assets were aggregated, egregious errors were committed and massive defaults resulted.\(^{120}\)

In other words, perceived homogeneity of collateral prompted inadequate diligence. We know that corrections in both securitizer and investor diligence and credit evaluation processes need to be made, at least with respect to residential mortgages in the United States. Improving such processes should have been the central focus of regulators starting in 2006 or 2007, when problems first surfaced. Instead, American regulators have been, to put it mildly, wasting a lot of time by focusing resources and attention on less central problems. This is partly due to the structure of the Dodd Frank Act, which seemed to pick up on a wide variety of academic theories on how to improve financial markets and attempt to implement them all at once. As a result, financial regulatory authorities in the United States have been attempting to write and implement over 200 new rules under that Act\(^{121}\) and have been woefully late in writing many of them. This combination of volume and tardiness has added significantly to legal and political uncertainty,\(^{122}\) undermining the

\(^{120}\) Borod, supra note 107, at 10.

\(^{121}\) See id.

\(^{122}\) See Cohen, supra note 55 (noting that Congress spent 1 year debating Dodd Frank and then allowed 1.5 years to write the rules thereunder [which US regulators have failed to do], creating 2.5 years of uncertainty); see also Carter Wood, Dodd Frank Whence Uncertainty Springs, BRT Blog (Sep. 27, 2012), http://businessroundtable.org/blog/dodd frank whence uncertainty springs (last visited Feb. 18, 2013) (noting that "Business Roundtable member CEOs consistently cite the policy uncertainty that stems from inaction by federal policymakers as a chief cause of the sluggish economy" and that the failure to
capacity for economic growth.

The major underlying problem with pre 2008 securitization was ultimately a problem with one sub class of securities due to asset classes underlying them - those assets. American sub prime residential mortgage loans, were collateralized by properties that were valued utilizing price bubble appraisals and the price bubble popped. Other parts of the securitization market did not have such over-valued collateral underlying their securities and thus they did not experience similar problems. Instead, they experienced delinquencies and defaults as a result of, first, economic uncertainty and, second, resulting political risks inherent in the shadow banking regulation project. Instead of focusing on sub prime loans, they have extrapolated from experience with sub prime loans a set of regulations that impact student loans, credit cards, commercial mortgages and an array of other asset classes.

Thus it appears both American and European regulators are seeking to regulate parts of the financial sector that did not lead to any problems in 2007 or 2008, but were actually negatively impacted by large economic forces unleashed by the sub prime meltdown. In a bit of regulatory over zealousness, they have engaged in regulating sectors of the financial markets that were not problematic. As a result, the regulators added political uncertainty on top of economic weakness as impediments to recovery of securitization debt markets. This has left market participants in a state of uncertainty attendant with perceptions of heightened political risk. This has been a destabilizing factor in some asset securitization markets.

In the practice of secured finance law, if you want to understand how to write and negotiate any structured product, including a

implement Dodd Frank has been the biggest regulatory uncertainty problem due to the difficulty of quantifying the impact of unknown regulations).
securitized one, you have to start with the legal and market principles that impact the collateral. The same thing should be true with writing securitization regulations. One should start with the underlying classes of collateral and then see how securitization principles layer on top. Regulators in Europe and the United States have not done that. Instead, they have engaged in a duel "shotgun" and "blanket" approach to regulating, in which they have attempted to regulate almost every aspect of the securitization process, as well as almost every aspect of the financial industry and markets using RMBS as the point of reference.\(^\text{123}\) By engaging in so much regulatory activity at once, the regulators have clearly engaged in over-regulation and, worse yet, misregulation of segments of the financial markets they clearly do not understand. By making so many changes at once, it will be difficult for regulators and researchers to determine causal links to future performance of securitized products and related collateral markets.

Before Korean regulators or those in other jurisdictions follow the example of the two leading ABS regulatory jurisdictions and further regulate due to misunderstanding the problem they are trying to solve, they should realize that securitization is just a tool. While the tool does need rules for proper use, one must always look behind the tool to see who is using it and what the particular purpose that it is being used for. Ultimately, for example, when regulating ABS, credit card securitizations and residential mortgage securitizations should be treated differently: Since the nature of the underlying assets themselves, including the related risks, securitization structures and types of institutions involved in issuing them are so different, they demand tailored regulations except with respect to basic securities disclosure requirements.

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\(^{123}\) See Adam J. Levitin, *Skin-in-the-Game: Risk Retention Lessons from Credit Card Securitization*, 81 Geo. Wash. L. Rev. 813, 855 (2013).
b. Faulty Processes.

1. The Need for Segmented Regulations.

Beyond failure to use correct premises as the basis of their regulations, there are three broad issues surrounding the method of regulation undertaken in the United States and Europe since the onset of the financial crisis. First are the problems that arise due to the fact that Congress passed the Dodd-Frank Act and the EU settled on comprehensive directives before they had properly assessed where there were problems and where they should leave aspects of the securitization markets alone. The second problem, which is primarily an American one, is that regulators had to promulgate regulations under Dodd-Frank but have failed to finalize many central provisions for years. These problems of process have led to the third major problem: failures of substance, such as making blanket rules in a manner that ignore differences between not only such major categories of ABS collateral as credit cards and student loans, as discussed above.124) Additionally, at times regulators have also demonstrated a surprising lack of understanding of, or disregard for, the different types of financial institutions involved in, for example, financial markets as huge as the trillion dollar student loan market.125)

124) See id. (noting that “the Dodd-Frank Act’s solution to moral hazard in securitization was crafted to broadly and with the mortgage securitization market, rather than other securitization markets, in mind.”).

125) See Letter from Vince Sampson, President, Education Finance Council, to Office of the Comptroller of the Currency et al. (Nov. 12, 2012), available at https://www.sec.gov/comments/s7-14-11/s71411-354.pdf (commenting on credit risk regulations “as described in the ‘Credit Risk Retention; Proposing Release, 76 F.R. 24090 (April 29, 2011) and seeking to get the regulators to correct an ‘erroneous distinction between those nonprofit lenders that use tax exempt ‘qualified scholarship funding bonds’ as defined in section 150(d)(2)
If regulators had approached securitization regulations correctly - by first attempting to isolate troubled areas and regulate those areas - then they could have made much more useful and coherent regulations. Focusing on American sub prime RMBS should have been the first priority. Instead, American regulators decided to try to regulate the entire securitization field, which, incidentally, overlaps with almost every type of asset financing and industry possible. As a result, they have issued proposed rules that have required industry after industry to explain repeatedly to regulators why their proposed regulations are too broad or otherwise misguided when applied to their industry.

To have regulated correctly, they should have promulgated regulations for credit card ABS, student loan ABS, CMBS, RMBS and all other asset classes separately and only after educating the regulators about the impacted financial market segments. If one thinks about it for a moment, it is quite amazing that there are accountancy rules that specify depreciation for different types of equipment worth thousands of dollars, maybe worth millions of dollars across a national economy, but regulators have had to be dragged by industry against their will to come up with regulations to differentiate between different types of asset classes worth billions or even hundreds of billions of dollars. Segmenting securitization regulations in a coherent manner from the outset could have saved a lot of time and frustration on the part of industry and regulators. More importantly, it could have led to a better set of regulations and in less time.

The need to address the differences between (1) institutions that originate and invest in ABS, (2) fundamental differences in underlying asset qualities and (3) industry customs and capabilities are key factors that Korean regulators need to address as the Korean financial markets expand into more complex and diverse structured finance
products. Furthermore, they need to do a better job of interfacing with market players in affected industries before they promulgate regulations that do not fit the markets and institutions they are seeking to regulate.

2. The Need for International Coordination.

As a result of the backwards regulatory processes in the EU and the United States, we now see a lack of consistency between the two leading ABS regulators. This inconsistency places a drag on cross-border securitization and thus creates a drag on debt finance markets. Given the ever increasing interdependence of international financial markets and institutions, particularly between the EU and the United States, the governments involved in both jurisdictions should seriously consider creating a treaty relationship that governs international credit market rulemaking. They should include other leading international players including Australia, Japan, Canada and Korea.

Until that time, developed and emerging country regulators should coordinate their rulemaking so as to require the same types of institutions to engage in the same types of improved securitization diligence and credit screening practices. Furthermore, they should make their best efforts to exempt the same types of entities from enhanced diligence and related reporting requirements. While such coordination is not always politically possible, actions should be taken to enhance lines of communication, not just between administrative agencies that regulate ABS but also between legislators who are involved in overseeing the lawmaking processes.

Page 346

Unprepared Regulators Have Struggled to make Reasonable and Coherent Regulations.
Many of the problems discussed herein stem from the fact that American Congressional committees, EU authorities and existing regulatory agencies that have been given authority to regulate ABS and various other aspects of the shadow banking sector had never before significantly regulated the products or markets they have been attempting to regulate since 2008. They have been directed to regulate institutions, markets and financial products that they hardly understood when they commenced their regulatory processes. This is evident from the way they approached regulations and the substance of them, too.

EU and American regulators started out by, for example, confusing a tool - securitization - with assets classes that serve as collateral. Not only have they failed to understand the different uses of the tool but they have also failed to consistently demonstrate in their regulations that they realize that by regulating securitization, they are regulating credit cards, student loans, automobile loans, structured settlements, residential mortgages, commercial mortgages and a myriad of other important sectors of the broader financial markets. Casting simple regulations across so many different market segments without proper understanding of such segments has been a massive mistake, which has caused delay in promulgating and finalizing regulations in the US and making overly broad rules in the EU. American delays have caused market uncertainties that have increased both legal and political risk, while also undermining the capacity of the financial sector to tap securitization markets for long term capital. This problem stems from having people involved in crafting regulations (or writing laws and directives mandating them) not having sufficient understanding of debt capital markets and the roles of the various classes of assets involved in securitization.

This inability of regulators to make coherent and carefully crafted
ABS regulations was well known and foreseeable to those of us involved in the securitization industry. In a panel discussion with the Federal Reserve Bank of New York's chief economist over securitization matters at a conference on June 30, 2010 in New York City, the author asked him if the Federal Reserve, Federal Deposit Insurance Corporation, the SEC or any other of the myriad of regulators in the United States or in other major countries understand (1) the differences between securitized asset classes and (2) how to differentiate between regulations that should apply to which classes. He unequivocally told the author, "No, they do not." He went on to explain that they did not understand that difference and there was a zero percent chance that they would regulate in a manner that reflects such differences. What he stated at that time rang true with respect to discussions the author had with staff members of the United States Congress; and his prediction of regulations (whether statutes, proposed rules or final rules) being crafted that fail to reflect an understanding of the various segments of debt capital markets that utilize securitization has truly come to pass. What we have seen with repeated regulatory changes post 2007 is that regulators have demonstrated a tendency implement blanket regulations and then have to be educated by interest groups and financial institutions who understand the complex differences of the various elements of debt capital markets.

Thus, as proposed regulations have been promulgated in a manner that has, in certain key areas, shown too little understanding of the complexities of asset classes and securitization tools, regulators have met with stiff resistance from industry groups who have been dismayed

126) Adam Ashcraft, Vice President, Head of Structured Credit, Fed. Res. Bank of NY, Remarks made on ABS Financial Reform Panel at Asset-Backed Securities Summit, New York, NY (Jun. 29, 2010).
at the failure of the regulators to understand the subject matter of their proposed regulations. These shortcomings have all come to light in the rules promulgation processes and rules substance discussed herein.

Ultimately, a key lesson that should be learnt from the experience of ABS regulators in the EU and the United States is that regulatory authorities need to be properly trained in the fields they regulate. This particular issue gets down to matters of who is hired to actually research and draft regulations, what type of ongoing training they should be receiving and also what they should be required to do before regulating in new fields unfamiliar to them. If Korea is to learn anything from the EU and the United States bumbling ABS regulatory processes since 2007, it is that banking, finance and securities regulators should be required to have basic understanding of the industries they regulate over. That requires a greater level of consultation with and learning from industry players who know much more about shadow banking products, like ABS, than regulators who have until recently had little experience beyond superficial securities law reporting requirements.

IV. Conclusion.

This particular article started over three years ago with research into the substance of new securitization regulations in Europe and the United States. Over time, the author watched for and read proposed regulations and commentaries on them. He noticed something that he suspected might happen but, in reality, shocked him: European and American regulators of ABS, while targeting some areas that are in need of regulatory improvement over the pre-2008 landscape, have failed to create such regulations in a coherent fashion. Nothing
illustrates this point more than the fact that we are now five years on from the onset of the sub-prime crisis in the United States that triggered the global financial crisis and we are yet to see reasonably crafted ABS regulations coming out of the United States on risk retention, diligence or other key issues. In Europe, we see regulations that are blanket in nature and remarkably inflexible. Both the delays and lack of carefully crafted regulations can be attributed to failures in premises, processes and personnel.

New ABS regulations are a fact of life in the United States, Europe and many other jurisdictions in the world. There are serious questions about how well such regulations have been crafted to address the real problems that led to the credit crisis and whether they have placed appropriate burdens on regulated entities. There are also issues that stem from how well regulators have coordinated across borders. Such issues need to be corrected in future rounds of regulation, whether in the EU, the United States or in the various G-20 members that are most likely to utilize ABS and that are capable of broad coordination.

Ultimately, the objective of new ABS regulations should be to help foster a climate that is suitable for strong debt markets to work properly. In order for financial institutions to utilize securitization in a proper intermediary function, we will need to see improved economic conditions that will give investors confidence to utilize securitization as a tool for providing enhanced liquidity in desired sectors, stronger legal protections for all parties involved in ABS markets, including access to data they need, and a regulatory framework that is stable. Right now, none of these factors is fully in place in the EU or the United States.

Nevertheless, the time is right for national regulators, such as those in Korea, and international debt capital market participants to endeavor to continue to use and strengthen ABS markets. As they do that or as they even attempt to launch ABS products for the first time in new
jurisdictions, the applicable regulators need to do a better job than American and European regulators have demonstrated with respect understanding the institutions and markets they are seeking to regulate. Additionally, they need to acknowledge that no regulations can make up for prudent underwriting and thorough due diligence. Also, no amount of regulation can force such activities to take place beyond a cursory review. However, carefully crafted rules that get securitizers and investors to better assess risks can and should be pursued. To that end, current key efforts at promoting risk retention and enhanced due diligence should continue to be pursued but only in a manner that attempts to solve institutional or market weaknesses while keeping in mind the need to (i) create adequate legal protections for all impacted market participants, (ii) foster strong economic foundations for impacted sectors of the economy and (iii) maintain a lowest degree of political risk possible for market participants. Such objective can only be effectively met if regulators do a better job than American and EU regulators have done of trying to understand the markets, institutions and products they regulate.
Appendix A

Table 1. *Undermining Balance Sheets of Financial Institutions*: Writedowns, Losses & Capital Raised by Top 15 Private Financial Institutions with US Subprime RMBS Exposure (as of Aug. 12, 2008)

| Firm (HQ Nation)       | Writedowns & Losses (billions of USD) | Capital Raised (billions of USD) |
|------------------------|----------------------------------------|----------------------------------|
| Citigroup (USA)        | 55.1                                   | 49.1                             |
| Merrill Lynch (USA)    | 51.8                                   | 29.9                             |
| UBS AG (Switz.)        | 44.2                                   | 28.3                             |
| HSBC (UK)              | 27.4                                   | 3.9                              |
| Wachovia (USA)         | 22.5                                   | 11.0                             |
| Bank of America (USA)  | 21.2                                   | 20.7                             |
| IKB Deutsche (Germany) | 15.3                                   | 12.6                             |
| RBS (UK)               | 14.9                                   | 24.3                             |
| Washington Mutual (USA)| 14.8                                   | 12.1                             |
| Morgan Stanley (USA)   | 14.4                                   | 5.6                              |
| JPMorgan Chase (USA)   | 14.3                                   | 7.9                              |
| Deutsche Bank (Germany)| 10.8                                   | 3.2                              |
| Credit Suisse (Switz.) | 10.5                                   | 2.7                              |
| Barclays (UK)          | 9.1                                    | 18.6                             |
| Lehman Brothers (USA)  | 8.2                                    | 13.1                             |

Source: Yalman Onaran, *Banks' Subprime Losses Top $500 Billion on Writedowns (Update1)*, Bloomberg (Aug. 12, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8sW0n1Cs1tY (last visited Feb. 17, 2013).
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미국과 EU의 세계금융위기와 자산유동화증권에 관한 규제 방안

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Georgette Chapman Phillips는 Cornell International Law Journal의 2009년 기사에서 부채시장이 기능하기 위해서는 적절한 법률상의 보호, 견고한 경제적 기반 그리고 낮은 정치적 리스크와 같은 요소가 뒷받침되어야 한다고 역설한 바 있다. Phillips는 권리를 충분히 보호하는 담보법과 같은 법률적인 보호가 필요하며, 안정적인 인플레이션 및 부동산 시장이 존재하여 경제가 안정화되어 있어야 하고. 정부는 사적 재산이나 계약상의 권리에 대하여 존중하여야 한다고 주장하였다. 이와 같은 법률적, 경제적, 정치적 기초의 중요성을 저자에게 안정적이고 유용한 증권시장을 재건하기 위하여 고심하는 선진국의 최근의 규제 동향을 분석하는 기초가 되었다.

미국과 EU는 최근의 경제적 위기에 이따른 금융시장의 재구체화의 선봉에 서 있다. 이들은 2007년 이래, 세계의 다른 나라들과 마찬가지로, ABS에 대한 규제를 새롭게 도안한 바 있다. 이러한 규제는 포괄적인 그러나 상당히 어려운, 금융시장에 대한 국내외적 재규제의 일부가 할 수 있다. 이들 나라의 규제는 부채 시장의 기능과 관련하여 일부 경제적인 효과가 있다 하더라도, 시장 참여자들이 의존할 수 있는 신뢰할 만한 기준을 제시하지 못하고 있고, 시장과 관련된 정치적 리스크를 중폭시키고 있다고 평가할 수 있다. 이러한 규제의 노력들이 리스크 보유 규제와 공시규제라는 증권화의 주된 영역에서 혼란스럽고 부적절하다는 점이 이미 명백하다. 이 두 영역에서 미국과 EU는 유사한 목표를 지향하지만, 국내적으로나 국제적으로 제대로 조화되지 못한 규제의 실을 걷고 있다고 생각된다. 이는 규제기관이 규제 대상이나 현인들에게서 충분히 이해하지 못한 재소간의 충격 속에서 혹은 기회주의의 발상에서 규제절차를 밟았는데 일부분 기인한다.

규제기관과 시장참여자가 ABS 시장의 재부흥하기 위해 노력하거나 그러한 시
장을 처음으로 출범시키고자 한다면, 규제 대상과 시장에 대한 제대로 된 이해가 선행되어야 한다. 무엇, 신중한 인수와 철저한 실사를 보완할 규제만 있을 수 없을 것이다. 규제를 아무리 늘리다 하더라도 투자자들이 그러한 합리적 행동을 하도록 강제할 수 없기 때문이다.

주제어: 증권화, 투명성, 리스크 보유, 국제 금융 위기, 미국, EU