

Observations on the Securitization of Non-Performing Loans in Russia

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Introduction/Abstract

Asset securitization is a burgeoning trend in Russia as companies burdened by poor credit ratings seek access to capital at lower costs than they would be allowed in traditional equity or debt markets. In other countries, non-performing loan portfolios are assets that are frequently securitized. But securitization of these bad loans has not occurred in Russia at the levels one might expect. This has been due to both a relatively small amount of loans that under-perform as well as legal and regulatory impediments that have discouraged investors and lenders alike. However, expansion of consumer credit in Russia and the circumstances under which it is occurring indicate that the level of non-performing loans is due to rapidly increase and as the rationale for maintaining the impediments that stand in the way of securitizing these loans is being re-examined, those impediments are being scaled back to make way for market participants to engage in such securitizations. Thus, this article anticipates a significant rise in the level of non-performing, which will be logically paired with an increased interest of Russian lenders in securitizing these assets.

Landscape

Asset securitization

Securitization is the creation of securities that are “primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.”¹

¹ U.S. Securities and Exchange Commission. <http://sec.gov/rules/final/33-8518.htm#I>.

Asset securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into tradable securities that may be offered and sold in the capital markets and can target a broader investor base with different risk characteristics.² In a basic securitization structure, an entity, often a financial institution and commonly known as an originator or lender originates or otherwise acquires a pool of financial assets, such as mortgage loans, either directly or through an affiliate. It then sells the financial assets, again either directly or through an affiliate, to a specially created entity that issues securities “backed” or supported by those financial assets. These securities are thus aptly referred to as asset-backed securities (ABS).³ Payment on the asset-backed securities depends primarily on the cash flows generated by the assets in the underlying pool and other rights designed to assure timely payment, such as liquidity facilities, guarantees or other features generally known as credit enhancements. One of the main goals in structuring asset-backed securities is to insulate the investors of such securities from the corporate credit risk of the originator.⁴

In principle, any asset or entitlement that provides predictable cash flows can be securitized, so long as those cash flows can be legally transferred via a true sale. Even future expected cash flows, such as tax revenues or utilities payments may be securitized.⁵ However, the most commonly securitized types of assets are mortgage receivables (both residential and commercial), credit card receivables, auto loans, and consumer loans.

² Peiser and Wang, “Non-performing Loan Resolution in China,” Real Estate Issues (2002). Available at http://findarticles.com/p/articles/mi_qa3681/is_200210/ai_n9139379.

³ These entities are typically referred to as “special purpose entities” or “special purpose vehicles” (SPVs). U.S. Securities and Exchange Commission. <http://sec.gov/rules/final/33-8518.htm#I>

⁵ International Financial Corporation, “Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs” (March 2005).

Securitization of Non-performing loans

Of the asset classes mentioned above, several originate as loans from lenders (almost always banks) to debtors. Naturally, some loans issued will be repaid late or will not be repaid at all. These loans are considered non-performing. The definition of a non-performing loan (NPL) differs in that parties may disagree as to when a loan becomes “non-performing” (i.e. whether after 60, 90 or 120 days delinquency).⁶ However, for the purposes of this paper, these distinctions are not significant and the term NPL is used to refer to a loan or portfolio of loans that the lending institution is unlikely to recover or believes is unlikely to be recovered efficiently.

Just like any other asset class, NPLs may be securitized by selling the expected stream of cash flows, whatever that may be, to investors. Even with the securitization of NPLs, recovery methods – such as debt collection, liquidation of property, corporate restructuring, and negotiated settlements – still must be employed to produce the cash flows that service the interest and principal owed to security holders. However, the originators of the NPLs are able to recover a portion of the cash recovery value up front, and will often outsource NPL recovery tasks to third party specialists.⁷

⁶ In fact, some analysts distinguish a buffer period between performing and non-performing loans by referring to those loans – say those between 30 days and 90 days delinquent – as “under-performing” loans. Russia, however, has no official legal definition of “non-performing loan.” Loans are classified as “substandard” if delinquent for between 6 and 30 days for collateralized loans and no more than 5 days for uncollateralized loans, “doubtful” if delinquent for between 31 and 60 days for collateralized loans and between 6 and 30 days for uncollateralized loans, and classified as a “loss” if delinquent for over 180 days, regardless of collateralization. World Bank Development Economics Research: Russia. <http://econ.worldbank.org>.

⁷ Xu, Min, “Resolution of Non-Performing Loans in China”, The Leonard N. Stern School of Business, Glucksman Institute for Research in Securities Markets (April 1, 2005). Available at http://w4.stern.nyu.edu/glucksman/docs/Xu_2005.pdf.

NPL securitization is unique in the opportunities it provides for both originator and investor. From the bank's standpoint, securitizing its NPLs removes an illiquid and high-risk asset from its balance sheet and replaces that asset with cash. Doing so has the obvious advantage of increasing the bank's operating capital position by allowing it to use the cash to issue more (and hopefully wiser) revenue-producing loans.

Since the first securitization of NPLs by Resolution Trust Corporation in the United States, this disposition method has played a growing importance in many countries' NPL disposal programs.⁸ In fact, over the past 20 years, the NPL market has changed from a small, fragmented market into one that is global and robust. This has been fueled in part by intensifying competition among investors to acquire NPLs in numerous and diverse markets. As a result, NPL transactions are being completed more and more quickly and transaction activity is at a 20-year high as banks continue to sell NPLs to clean up their balance sheets and meet more stringent global capital standards.⁹

Structures

In a typical securitization, the originator will sell or assign the assets to be securitized to a special purpose vehicle (SPV). The SPV is an entity created for the specific purpose of securitizing the assets in question and is usually incorporated and structured so that it is unlikely (and usually unable) to ever file for bankruptcy.¹⁰ To finance the purchase of the assets, the SPV

⁸ Id.

⁹ Ernst & Young, Global Nonperforming Loan Report 2006.

¹⁰ International Financial Corporation, "Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs" (March 2005). In fact, the SPV should have "limited legal capacity" meaning that it may not engage in any transactions other than those necessary to the securitization. Effectively, "the SPV will not be allowed to issue any additional debt or to enter into mergers or other transactions. All parties to contracts with the Issuer

issues securities (usually debt collateralized by the assets) in the capital markets. Thus the securities issued are backed by the underlying assets purchased by the SPV, which are typically the principal source of cash produced to service the securities.¹¹

It is imperative that once the sale and transfer of the assets to the SPV has been effected, it cannot be challenged, voided or otherwise reversed for any reason, even if the originator becomes insolvent. This concept is referred to as *true sale*. Without a true sale to the SPV, the originator's creditors, in the event of the originator's bankruptcy, could have legal claims to the assets underlying the securities that the SPV sold to investors. This possibility of course would undermine the integrity of the securities. Whether a transaction constitutes a true sale under the applicable law (notably, whether it would be recognized as such by the governing court should the originator become insolvent) must be established through a legal analysis of the transaction.

Notwithstanding the necessity from the perspective of the securities investor to legally shield the securitized assets from the originator, another important potential benefit of a true sale – which is often the primary reason an originator seeks to securitize at all – is that the originator may have access to cheaper funding than it otherwise would through traditional financing methods. In other words, if the securitized assets, after being separated from the originator, have a credit quality higher than that of the originator as a whole, the true sale may allow the originator to obtain funding at better terms than would be the case otherwise through a traditional

agree that they will not petition for the winding-up or insolvency of the SPV, and the SPV undertakes not to enter into voluntary liquidation. In addition, the parties will acknowledge that the extent of any demands they may have is limited to the available assets of the Issuer, and subject to the order of priority (the “payment waterfall” or “agreed payment procedure”) agreed in the transaction documents. Where the Issuer is a company, it is often owned by a charitable trust, which ensures independent control of the Issuer. Often the Issuer's assets will be pledged to the respective note holders.” Id.

¹¹ International Financial Corporation, “Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs” (March 2005).

loan or bond issue, as these forms of debt would likely have to repaid at higher rates that reflect the originator's credit rating as a whole.

Another popular method used in structuring asset securitization is to create a trust to distribute the securities. Under a typical trust structure, the originator transfers the underlying assets to a trust, the beneficiaries of which are the investors. The trust also obtains the rights to income from the assets and during the term of the securitization income received from the assets is collected by the originator and deposited – and often invested in "eligible securities" – in accounts controlled by the trustee, who is typically a third-party specialist, and disbursed by the trustee to the security holders in payment of the securities. The trustee may or may not be obligated or permitted to use the assets under its control to engage in profitable activities for the investors.

By isolating the underlying assets from the originator's other assets in the form of a trust, this structure achieves benefits similar to those of a true sale to an SPV. However, a major limitation to the efficacy of the trust structure is that the transfer of senior beneficiary interests to investors constitutes a transfer of rights, but does not guarantee a legal "true sale" of the assets. This means that the security holders under a trust structure are not the only parties with potential legally recognized ownership interests in the securitized assets. This deficiency is particularly important because unless the trust has acquired the assets through a true sale or other similarly perfecting transaction, a bankruptcy court could decide to prevent the originator from paying the trust.

Markets for Russian Securitized Products

In the past several years, Russia has seen its first successful large securitization transactions of both future cash flows and existing receivables, and banks in Russia maintain significant interest in continuing to perform these deals, especially in sectors such as natural resources, credit cards, and auto loans.¹² Banks realize that these deals can serve to significantly reduce the costs of interest rates on money borrowed. Russian law requires banks to maintain a ten percent regulatory capital ratio, so if a bank has \$100 million invested, a \$10 million “cushion” must be maintained.¹³ Therefore, one way or another, Russian banks need to refinance these loans. The conventional commercial loan and private sector bond market in Russia is also growing but, because the issuers are located inside Russia where, as in other emerging market countries, because of perceived risk and credit enhancement requirements, corporate and sovereign issuers typically have relatively low credit ratings, they pay considerably more interest on a loan than is usual in the international capital markets.¹⁴

¹² In fact, a significant amount of the almost \$5 billion spike in world-wide emerging markets securitization issuance in 2004 came from Russia's Gazprom export future flow transaction, Gazprom International S.A. (notes rated 'BBB'), which contributed over \$1.3 billion. “The transaction benefited from Gazprom's long history in the reliable delivery of gas to Western European customers combined with significant incentives for continuing to do so. These factors allowed us to gain comfort with an overall probability of full and timely payment of debt service on the rated notes that is consistent with the assigned rating, despite the potential limitations on the security of the assets under Russian law.” Standard & Poor's, “Structured Finance Commentary: EEMEA Gains a Foothold in the Global Securitization Market”, 13 (December 2005). See also Securitization in Russia: Some Legal Issues (September 2006). Available at <http://www.mayerbrownrowe.com/publications/article.asp?id=2966&nid=6>; Ossa, Felipe, “Russia's Great Leap Forward in 2006, Asset Securitization Report” (January 2007). Available at <http://www.securitization.net/international/article.asp?id=355&aid=6741>. Recent deals have included Gazprom International S.A., Russia International Card Finance S.A., Alfa Diversified PaymentRights Finance Company S.A., Russian Auto Loans Finance (RALF), Eurasia Structured Finance No.1, S.A., Russian Consumer Finance No. 1 S.A., and most recently a pledge by OPIC to provide \$200 million in financing for a mortgage credit facility that could potentially support more than \$1 billion in securitizations. See OPIC Press Release (April 18, 2007). Available at <http://www.opic.gov/news/pressreleases/2007/pr041807.asp>.

¹³ Hilger, Lauren, “Russia's Securitization Market on the Rise”, Securities Industry News (March 14, 2007). Available at <http://www.securitiesindustry.com/article.cfm?pg=bnews&articleid=19882&print=yes>.

¹⁴ See Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com (May 2004). Available at <http://www.gtnews.com/article/5470.cfm>. The average long-term rating on Russian banks is a 'B-',

However, the relatively high credit quality of some of their assets creates tremendous incentives to securitize them, for in a securitization transaction, originators will often structure the transaction such that the most senior class of notes can achieve a high rating (often a 'AAA' rating for sovereign issuers) and thus result in a much lower cost of interest to the bank.¹⁵

Rackham and Rose offer this perspective: “For example, the rate is often 5% or more above the interbank rate. If a securitized bond is allocated an AAA rating, interest could be charged at as low as only 0.5% over the interbank rate.”¹⁶

Russian banks are not only interested in doing these deals, but they are prepared to complete them and have in place the necessary framework to do so. The large Russian banks have the “regulatory consents (essentially, hard currency approvals) as well as the necessary data collection and management systems on their debt portfolios to provide the level of tailored information demanded by rating agencies.”¹⁷

Political and social factors that seem to be ever present in Russia have long been of concern to potential investors. The risk associated with political controls more closely resembling those of communist-era Russia than of an open market society and the slow pace of the Russian government to privatize and regulate particularly the banking industry, rather than

which is well below the 'BBB' lower limit of investment grade bonds as determined by S&P. See Standard & Poor's, “Structured Finance Commentary: EEMEA Gains a Foothold in the Global Securitization Market”, 10 (Dec. 2005). However, recent efforts have benefited Russia's sovereign debt which, since July 2006, has maintained an investment-grade rating. See Bartlam and Artmann, “Securitisation Sensation: Increased Lending, New Laws and More Sophistication and Understanding in the Marketplace Mean the Russian Securitisation Market is in the Ascendancy”, Orrick Structured Finance Report (September 2006).

¹⁵ Standard & Poor's, “Structured Finance Commentary: EEMEA Gains a Foothold in the Global Securitization Market”, 13 (Dec. 2005).

¹⁶ Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com, (May 2004). available at <http://www.gtnews.com/article/5470.cfm>.

¹⁷ Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com (May 2004). available at <http://www.gtnews.com/article/5470.cfm>.

control outright, are prevalent among these concerns. These concerns were exacerbated in 1998, when several macroeconomic effects led to a financial crisis in Russia and a virtual collapse of its banking system.¹⁸ Global Political Risk Consultant Stephan Rabimov portrays Russia's transition from communism to capitalism and the resulting deficiencies in its legal and economic framework that led to the crisis:

Russia's economy transitioned from a central planned economy to a capitalist, market driven economy almost over night without the benefit of having necessary and fundamental policies in place. Financial markets require a host of supporting rules and regulations of private business as well as accounting standards, from tax law to regulatory development of financial service firms, which Russia did not have prior to making the transition. Thus, successful transfer of enterprises from state to private ownership had strong implications for the general perception of equity investment in emerging economies. Russia presents an intriguing case study as its collapsing central authority was soon transformed into a perverse and almost criminal mindset of capitalist and corrupted market-oriented reforms. The Russian transition failed to recognize that property rights were unclear and often not recognized. The great number of supporting actions, such as the development of contract and commercial law, privatization of state-owned assets, and explicit recognition of the commercial rights and immunities of individual, enterprises and corporations were non-existing, therefore non-enforceable.

¹⁸ Alexander, Hoelscher and Fuchs, "Banking System Restructuring in Russia", Investment Climate and Russia's Economic Strategy, Moscow (April 5, 2000). Available at <https://www.imf.org/external/pubs/ft/seminar/2000/invest/pdf/alexander.pdf>.

This was reinforced by the scarcity of people with the knowledge and skills necessary to create the needed legal systems.¹⁹

Rabimov's argument that Russia's failure to privatize and set up a regulatory framework to effectively govern property rights was a fundamental reason the 1998 crisis occurred still has valid implications to today's potential investors, who feel that regulation as well as transparency of ownership in the Russian banking system is still not where it should be. Foreign investors see administrative barriers (not to mention corruption) as major obstacles to investing in Russia.²⁰ For instance, most of the one thousand or so of the licensed and registered Russian banks are small and under-capitalized and the sector is dominated by two state-owned banks, which together account for a large minority of banking assets. Foreign investment in the sector is limited to a small percentage of assets and the Russian government even controls a 25 percent stake in the largest insurer.²¹

However, Russia's banking sector is consolidating and profits, particularly those of the smaller banks, have continued to rise on increased banking activity.²² These increases can be primarily attributed to rapid and significant growth in lending activities, most notably increases

¹⁹ "Playing a Few Hands at Russian Roulette: Anatomy of the Russian Currency Crisis" (November 26, 2004). Available at SSRN: <http://ssrn.com/abstract=637743>.

²⁰ According to the survey "Russia: Investment Destination," corruption and administrative barriers top the list of obstacles for foreign investors in the Russian economy. "The Economy and Investment Climate in Russia", The American Chamber of Commerce in Russia (2006). Available at [http://www.ey.com/Global/download.nsf/Russia_E/Investment_Climate_in_Russia_2006/\\$file/Investment_Climate_eng_2006.pdf](http://www.ey.com/Global/download.nsf/Russia_E/Investment_Climate_in_Russia_2006/$file/Investment_Climate_eng_2006.pdf).

²¹ See Kane, Holmes and O'Grady, "2007 Index of Economic Freedom: Russia". Available at <http://www.heritage.org/research/features/index/country.cfm?id=Russia>. See also Rabimov, "Playing a Few Hands at Russian Roulette: Anatomy of the Russian Currency Crisis" (November 26, 2004). Available at SSRN: <http://ssrn.com/abstract=637743>.

²² See The Economic Intelligence Unit Country Report: Russia, 34 (December 2006); 2005 Annual Banking Supervision Report, Central Bank of the Russian Federation (2006). Available at http://www.cbr.ru/eng/today/annual_report/ar_2005_en.pdf.

in consumer lending.²³ Further, according to proposals put forward by the finance ministry, the state will reduce its presence in the banking system – in fact it has already announced deals to do just that – and within the next five years exit the sector completely.²⁴ This privatization should serve to fuel further competition among banks and, when coupled with smart banking regulations, will likely cause banks to implement best practices to further increase their lending activities. Such regulations are already being put into place. Due to Russia's negotiations in its attempt to join the World Trade Organization, the Russian government has approved several amendments to the regulations governing the banking sector. These amendments provide equal rights to both domestic and foreign investors to invest in Russian banks, while at the same time tightening acquisition regulations on ownership to improve control to make ownership more transparent and ultimately reduce corruption and money-laundering.²⁵

One factor contributing to significant growth in loan activity (or at least buzz among market participants) is Russian President Vladimir Putin's announced goal that one third of Russians own their own homes by 2010 and his efforts thus far to launch "an affordable housing market."²⁶ But these statements, while presenting a hopeful picture, mean little as the present

²³ "According to data from the Russian Central Bank (RCB), total bank lending (in both roubles and foreign currency) rose by 44% year on year by end-August, with a rapid expansion in both corporate and personal (mainly consumer) lending. Personal loans accounted for nearly one-quarter of total bank lending, having expanded by 87% over the twelve months to end-September." The Economic Intelligence Unit Country Report: Russia, 34 (December 2006). As of September 2006, mortgage lending was up six hundred percent from 2003 levels. See Bartlam and Artmann, "Securitisation Sensation: Increased Lending, New Laws and More Sophistication and Understanding in the Marketplace Mean the Russian Securitisation Market is in the Ascendency", The Lawyer (September 18, 2006). Available at <http://www.thelawyer.com/cgi-bin/item.cgi?id=121949>.

²⁴ See The Economic Intelligence Unit Country Report: Russia, 24 (December 2006); "Russia finance: Sberbank's Cash Windfall", Economic Intelligence Unit (February 26, 2007). The Russian government recently announced it is selling almost its entire stake in Sberbank, Russia's largest bank. Although questionable from a political standpoint, the sale seems to presage a trend toward privatization, if only on its face. See *Id.*

²⁵ The Economic Intelligence Unit Country Report: Russia, 24-25 (December 2006).

²⁶ Petrov, Nikolai, "Monolithic New Duma is Just an Illusion", Moscow Times (Jan. 14, 2004). See also Bartlam and Artmann, "Securitisation Sensation: Increased Lending, New Laws and More Sophistication and

Russian administration will bear no responsibility to act upon them - the decision will fall to Mr. Putin's immediate successor or the one after.²⁷ If Putin's targets are reached, then the effects for the lending market are likely to be tremendous. Consumer lending would skyrocket even further than it already has, drastically increasing bank's loan portfolios.

Regardless of whether Putin's goals are reached, however, the demand for loans from consumers and small business is likely to continue to rise, growing much more quickly than the bases of capital available for banks to lend. And with domestic finance from traditional capital markets in Russia limited, Russian lenders will increasingly continue to seek out alternative sources of capital to fuel the demand for these loans. Already successfully completed securitization transactions have attracted widespread attention and this form of financing will continue to rise with the demand for additional capital.

Securitization of Non-performing loans in Russia

Inexorably, increased lending activity in the form of consumer and small business loans will lead to more loans that do not perform, particularly in Russia where systems to analyze the credit risk of consumers are still being developed. Prior to legislation that came into effect in early 2005 and allows for credit reporting,²⁸ each bank was maintaining its own data, rather than a central database of consumer credit information.²⁹ The president of a prominent Russian rating agency reported to the World Bank:

Understanding in the Marketplace Mean the Russian Securitisation Market is in the Ascendency”, *The Lawyer* (Sep. 18, 2006). Available at <http://www.thelawyer.com/cgi-bin/item.cgi?id=121949>.

²⁷ “Russia finance: Sberbank’s Cash Windfall”, Economic Intelligence Unit (February 22, 2007).

²⁸ Russian Federal Law No. 218-FZ, dated 30 December 2004, *On Credit Histories*.

²⁹ See Gardner, “Home Credit Still Struggles in Russia: Interview with Ladislav Chvatal”, *Czech Business Weekly* (January 15, 2007). Available at <http://www.cbw.cz/phprs/2007011519.html>. See also 2005 Annual

“Russian banks have traditionally focused on large corporate clients. Once a bank is comfortable with the risk posed by such a client, lending is profitable. However, the number of such clients is limited. As banks get deeper into the economy, they need to focus on ever smaller institutions. Currently, there is a wave of interest and investment in retail customers. The technology is quite different. Rather than analyzing each credit separately, the class of clients is assessed by a scoring model and losses are expected across the whole portfolio. This technique reduces individual transaction costs, but it requires the technology to set up the models, monitor the performance of the portfolio and deal with delinquent borrowers. As these techniques become more widely used, banks will be able to provide finance to wider ranges of borrowers.”³⁰

Credit bureaus, which are just getting started in Russia, are important developments that will allow for much more efficiency in banks' lending decisions. Also, with reliable consumer information banks will be able to more efficiently collect payment on loans that are nonperforming. “If you don't have a good database you can't know whether your next step is to go to [the borrower's] home, to provide him different repayment options, or to accept that he will pay after another 15 days.”³¹ Further, regarding NPL securitization:

“The value of traditional securitized products, such as credit card and auto loans, can be estimated by statistically extrapolating the historical loss data to forecast the

Banking Supervision Report, Central Bank of the Russian Federation, 81 (2006). Of course, collection of such consumer credit information will likely take years to produce reliable and useful sources of credit history for lenders to rely on.

³⁰ Report of Richard Hainsworth, General Director of the RusRating Agency at the Symposium of the World Bank (Sochi, 2005). Available at http://www.rusrating.ru/en/research/regional_banks.

³¹ Gardner, “Home Credit Still Struggles in Russia”, Czech Business Weekly (December 1, 2007). Available at <http://www.cbw.cz/phprs/2007011519.html>.

expected probability of default and severity of loss for each loan pool. The cash flows of the NPLs can be extremely difficult to estimate, due to a lack of transparency on historical loss data and the short credit history for consumer loans still in their infancy, such as mortgage and auto loans. This substantially increases the difficulty of valuation for investors. Encouragingly, originators are gaining proficiency in identifying and collating the historical cash flow data, which will become a vital part of the disclosure in securitization documents. The establishment of consumer credit information services will also ease the securitization of non-performing consumer loans.”³²

Even despite a lack of reliable consumer credit information, since 2000, Russian consumer credit has increased more rapidly than that of nearly any other country as has the level of Russian consumption expenditures.³³ At the same time, interest rates on loans to consumers are extremely high compared to those in other emerging market countries.³⁴

What seems to be surprising, however, is a decreasing ratio of NPLs to total loans over the same period.³⁵ But however important these ratios are to the health of the Russian banking

³² Xu, Min, “Resolution of Non-Performing Loans in China”, The Leonard N. Stern School of Business, Glucksman Institute for Research in Securities Markets (April 1, 2005). Available at http://w4.stern.nyu.edu/glucksman/docs/Xu_2005.pdf. Although describing non-performing loan issues in China, the principle rings true in Russia, where similar circumstances are now present.

³³ See The International Monetary Fund's Global Financial Stability Report, Ch. 2 (September 2006).

³⁴ See Id. at 52.

³⁵ See The International Monetary Fund's Global Financial Stability Report, Statistical Appendix (April 2007). Ironically, among other sources, the Annual Report of the Russian Central Bank paints a more dire picture for the industry: “Overdue debt on loans to households increased rapidly in 2005 and its share in total loans expanded from 1.4% as of January 1, 2005, to 1.9% as of January 1, 2006. The share of overdue debt on ruble credit to households expanded from 1.3% as of January 1, 2005, to 2.0% as of January 1, 2006.” 2005 Annual Banking Supervision Report, Central Bank of the Russian Federation, 30 (2006). See also The Economic Intelligence Unit Country Report: Russia at 35 (December 2006) (“The rapid increase in consumer lending has raised the risk of non-payment... 2.7% of loans were overdue in August [2006], compared with 1.9% in the same period of 2005. Although not yet alarming, the rapid growth in both personal lending – which is mainly consumer credit – and the equally rapid rise in overdue repayments is not sustainable.”). Further, some experts believe that around 10-15 percent of all Russian consumer loans are nonperforming, but that banks make up for it with higher interest rates. PricewaterhouseCoopers, “Russia – Banking Sector Overview” (2006).

industry from a macroeconomic perspective, they fail to underscore the very real case that the number and amount of nonperforming loans is increasing, whether or not those figures are compared to the number and amount of all loans. Ernst & Young's 2006 Nonperforming Loan Report explains:

Although “NPL ratios remain very low since Russian families have historically prided themselves in having a strong repayment culture... as a metric, an NPL ratio can hide the level of problem loans during periods of rapid credit growth. Additionally, Russian banks sooner rather than later might feel the pain of NPLs if economic expansion stalls and competition for credit-worthy borrowers tightens.”³⁶

This is to say that using percentages to compare non-performing loans to total loans can lead to faulty conclusions, particularly when, as in Russia, consumer lending is rapidly increasing and the best NPL data will always be “backward looking and may not fully reflect the lending... [during] rapid credit expansion.”³⁷ Of course, this is not to say that Russia's banks cannot carry the burden of even higher rates of NPLs. The most recent IMF Global Financial Stability Report presents Russia has having one of the highest ratios of bank provisions to NPLs (higher even than that of banks in the United States), indicating that Russian banks are

³⁶ Ernst & Young, Global Nonperforming Loan Report 2006, 69.

³⁷ The International Monetary Fund's Global Financial Stability Report, 56 (September 2006). Standard & Poor's predicts that the “relatively high quality of assets in Russia — particularly auto loans, mortgages, and consumer loans — is not sustainable if the current credit expansion continues. For example, the rapid growth in household debt in 1999-2002 eventually manifested itself in explosive dynamic delinquencies in 2002-2003. In Russia, for example, aggressive expansion of Home Credit and Finance Bank LLC had resulted in growth of the gross NPL ratio to 24.1% in the first half of 2005 from 12.0% in the same period a year earlier. While this may well be an isolated incident, it underlines our concern over the long-term asset quality of emerging market retail lending banks.” Structured Finance Commentary: EEMEA Gains a Foothold in the Global Securitization Market, 13 (Dec. 2005).

and should remain well positioned to handle their NPLs. The volume of Russian NPLs will increase at least as long as consumer lending increases in Russia. Russian banks, while able to survive such bad loans, rather should increasingly want to remove these NPLs from their balance sheets if possible. Through securitization, this can be accomplished in a manner that greatly reduces, if not eliminates, the risk associated with such loans while at the same time freeing up capital needed for the banks' further lending initiatives.

BARRIERS AND OPPORTUNITIES IN RUSSIA

While there have been several successful deals, a lot of talk about securitization in Russia and the market participants are becoming more comfortable, the legal and economic barriers still pose significant difficulties. Valid concerns on the part of market participants arise from legal uncertainty and the lack of precedent in dealing with securitizations.³⁸ Steps have been taken to modernize Russia's laws to embrace securitization, but considerable administrative legislative efforts are still required to shore up investor confidence.

Economic Factors

Non-Transparent Ownership

Russian banks generally have not fully disclosed their ownership structures. Several reasons for this exist: a hold-over from past political fears, tax implications of a large shareholding in an institution, etc.³⁹ However, the Central Bank of Russia has begun exerting

³⁸ Standard & Poor's, "Structured Finance Commentary: EEMEA Gains a Foothold in the Global Securitization Market", 13 (Dec. 2005).

³⁹ Report of Richard Hainsworth, General Director of the RusRating Agency at the Symposium of the World Bank (Sochi, 2005). Available at http://www.rusrating.ru/en/research/regional_banks.

tighter regulations regarding transparency of ownership by requiring banks to disclose and has made transparency of bank ownership structure a primary task for the Bank of Russia in upgrading banking regulation and supervision.⁴⁰ Nevertheless, these disclosures made to the Central Bank are still not yet being made available to the general public and non-transparency in ownership hinders investment.⁴¹ Russia needs to continue to aggressively encourage full disclosure of bank ownership structures.

Foreign Exchange Control

Russia has traditionally been well known for its hard-line approach to currency control. This was particularly true until June 2004 when a new *Law on Currency Regulation*⁴² came into effect and introduced a movement toward more liberal currency control system. The new law had the effect of abolishing the requirement for transaction-specific authorizations from the Central Bank for currency transactions and replaced them with compulsory use of special-type accounts and mandatory “reserving”. But now, prompted by President Putin's intent to abolish remaining onerous restrictions to speed up the process of making the ruble a fully convertible currency, the Russian government and its Central Bank have done away with even these requirements. The law also eased restrictions on foreign currency purchases and the opening of foreign accounts by Russian residents.⁴³

⁴⁰ 2005 Annual Banking Supervision Report, Central Bank of the Russian Federation, 50 (2006).

⁴¹ Report of Richard Hainsworth, General Director of the RusRating Agency at the Symposium of the World Bank (Sochi, 2005). Available at http://www.rusrating.ru/en/research/regional_banks.

⁴² Russian Federal Law No. 173-FZ, dated 10 December 2003, *On Currency Regulation and Currency Control*.

⁴³ See Baker & McKenzie, “Legal Alert: Liberalization of Russian Currency Control” (2006). Available at <http://www.nfa.ru/nfa2/english>. See also “Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs”, International Financial Corporation's Technical Working Group on Securitization, 34 (March 2005).

As the IFC notes, however, “the new law entitles the currency control authorities, at any time, to impose reserve requirements on numerous currency operations which may be concluded under securitization transactions.”⁴⁴ Such restrictions will likely not hinder or frustrate securitizations, but potential extra costs may make them more expensive to complete, and hence reduce investor interest.⁴⁵

Legal Factors

While banks in Russia are becoming more and more sophisticated and aspiring to complete securitization deals, the legal framework has not been so quick to follow. Some of the fundamental mechanisms inherent in securitizations – true sales, SPVs, bankruptcy remoteness, and various tax concepts – have yet to be interpreted by Russian courts and thus present uncertainty in how Russian law might be applied. The several successful deals already executed prove that this does not preclude securitizations from taking place, but the legal uncertainty equates to risk which has likely deterred potential investors and slowed the pace of securitization in Russia.⁴⁶ However, things do seem to be moving in the right direction with the passage of securitization-specific legislation, the Mortgage-Backed Securities Law⁴⁷ (the “MBS Law), which defines a type of bond that can be used in domestic mortgage securitization, introduces the concept of an SPV, and provides for limited true-sale concepts.⁴⁸ Also promising was the late

⁴⁴ Id.

⁴⁵ See Id.

⁴⁶ See generally Bartlam and Artmann, “Securitisation Sensation: Increased Lending, New Laws and More Sophistication and Understanding in the Marketplace Mean the Russian Securitisation Market is in the Ascendancy”, Orrick Structured Finance Report (September 2006).

⁴⁷ Russian Federal Law No. 152-FZ, dated 11 November 2003, *On Mortgage-Backed Securities*.

⁴⁸ See Id.

2006 announcement by the Russian Federal Financial Markets Services⁴⁹ of the proposal of new draft laws (the “Draft Laws”) that would amend several pieces of current legislation to facilitate securitization of various asset types.⁵⁰

True Sale

Receivables, under Russian law, can be transferred under assignment or by factoring.⁵¹ In an assignment, the contractual rights to a stream of cash flows generated by the underlying assets are transferred to, ultimately, the investors in the securities. Factoring, on the other hand, is the process of selling the receivables for cash in what is essentially a purchase and sale agreement. While the Draft Laws contemplate changes to legislation regarding factoring, they are silent on the regulation of assignments. Both methods are discussed herein, however.

Assignments

Assignment by way of an agreement has been the most prevalent way to transfer receivables for securitization in Russia. However, in Russia, the agreement to an assignment is distinguished from the legal transaction underlying such transfer.⁵²

Rights Eligible for Assignment

⁴⁹ “The Federal Financial Markets Service (FFSM) is the federal executive body, which controls and supervises activity in the financial markets, including the activity of exchanges, and issues the relevant regulations. It also regulates the investment of pension savings. The key objectives of FFSM are to maintain stability in the financial markets, make the markets more efficient and attractive to investors, increase market transparency and reduce investment risks. It achieves these objectives by regulating the activities of financial market participants and by setting out the conditions for securities issuance and trading.” Russian Federal Financial Markets Service website. Available at <http://www.fcsm.ru/eng/>.

⁵⁰ See Federal Financial Markets Service of Russia, “Passage of Legislation on Securitization to Create New Possibilities for Financial Market Participants.” Available at http://www.fcsm.ru/eng/catalog.asp?ob_no=9149. See also Dragunov, Vladimir, “Proposed Changes to Securitization Legislation in Russia,” GTnews.com (March 2007). Available at <http://www.gtnews.com/article/6657.cfm>.

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⁵² See Dragunov and Turetsky, “The International and Comparative Legal Guide to Securitisation: Russia”, 271 (2006).

Whether a transfer of rights is legal and binding will determine whether a true sale has been made and whether a Russian debtor must recognize the sale. “The transfer of assets at a discount (for the purpose of covering funding costs) or with a deferred element (to cover over-collateralization levels) risks challenge under Russian bankruptcy law if the amounts involved are significant. This is because a liquidator of the originator has the power to set aside transactions made at an undervalue.”⁵³ As Russian case law and legislation has not been fully developed in this area, doubts generally surround the area of rights transfers by assignment. “The net adverse result of such lack of clarity is that, if the assignment/transfer is not correctly effected, there is a risk that it may be challenged by the debtor/liquidator of the originator. The transfer could then be reduced to being merely the SPV's unsecured contractual claim over the originator's right to a third party receivable.”⁵⁴ Essentially, this means that investors of securitized assets could find they have no rights to the underlying assets and that their investments are worthless. “Russian courts have traditionally maintained the conservative position that a creditor's rights under a contract can only be transferred in full (not in part), and only together with a transfer of all its corresponding obligations under the contract.”⁵⁵ Under this view, the transferee essentially replaces the original contracting party rather than simply acquiring some or all of the rights assigned to it. This approach had some support among Russian legal scholars, however it does not allow for the structure of a typical securitization transaction. More recently the Russian Supreme Court has clarified, in a number of decisions,

⁵³ Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com, May 2004, available at <http://www.gtnews.com/article/5470.cfm>

⁵⁴ Id.

⁵⁵ Melnikas and Stepanenko, “Assignment of Receivables as Viewed by Russian Courts: A Significant Obstacle to Securitization”. Available at <http://www.iflr1000.com/includes/print.asp?CountryID=57&sIndex=2>.

that a creditor can transfer rights either fully or partially, if it has proved that it has fulfilled its duties and remains a creditor under the relevant contract.⁵⁶

Furthermore, the Supreme Court has supported a partial assignment of rights without the transfer of corresponding obligations under continuing contracts (for example, gas or electricity supply contracts) provided the rights being assigned: (i) are uncontested; (ii) arose before the assignment; and (iii) are not conditional upon any counter-performance by the assignor. However, in affirming the assignability of payment rights under these conditions, the Supreme Court did not succeed in significantly widening the scope of rights capable of being assigned under Russian law. In fact, the Supreme Court's rulings limited the assignability of rights only to situations in which it is proven beyond doubt that each of the conditions above is met.⁵⁷

Assignment of Future Flows

It is even more uncertain whether it is possible to transfer future cash flows by way of assignment. “This is because, on a conservative view, the contract of assignment at the date it is signed must describe in writing in sufficient detail all rights to be transferred (including quantum) in the manner prescribed by mandatory Russian law.”⁵⁸ “Some arguments are being made in support of the possibility of assignment of such rights, while the prevailing view (which is supported by courts and some scholars) still is that rights under future contracts cannot be

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Id.

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Id.

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Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com, May 2004, available at <http://www.gtnews.com/article/5470.cfm>

assigned, mainly because the scope of the rights being assigned cannot be fully identified as of the moment of transfer. In particular, some courts have taken the view that a right being assigned should be identified by reference to a specific contract from which such right arose.”⁵⁹ There is a slight distinction among legal scholars, however, between rights under future contracts and future rights under existing contracts. Most scholars concur that future rights under existing contracts are assignable, but that the assignability of rights under future contracts is disputable.⁶⁰ This is mainly due to the lack of ability to identify future rights being assigned at the time of transfer. “In particular, some courts have taken the view that a right being assigned should be identified by reference to a specific contract from which such right arose.”⁶¹ Russian court practice has also shown that alternative methods of assignment of future receivables are being used successfully in the absence of a consensus among the courts and authorities and at least one court has established a precedent by permitting a rights assignment under a future contract with the qualification that that the assignment agreement may only be valid after the completion of the underlying future contract.⁶² However, even if a Russian court did not view a future receivables assignment as vesting of title to the receivables in the purchaser, it may still view such a transaction as a preliminary agreement, or “agreement to agree,” which under Russian law would

⁵⁹ Melnikas and Stepanenko, “Assignment of Receivables as Viewed by Russian Courts: A Significant Obstacle to Securitization”. Available at <http://www.iflr1000.com/includes/print.asp?CountryID=57&sIndex=2>.

⁶⁰ Id. In fact, the “direct reference to the pledge of future property rights in Russian law has provided comfort for at least one successful cross-border securitization of such future rights, the securitization of diversified payment rights by Alfa Bank in March 2006.” Bartlam and Artmann, “Securitisation Sensation: Increased Lending, New Laws and More Sophistication and Understanding in the Marketplace Mean the Russian Securitisation Market is in the Ascendancy”, Orrick Structured Finance Report (September 2006).

⁶¹ Melnikas and Stepanenko, “Assignment of Receivables as Viewed by Russian Courts: A Significant Obstacle to Securitization”. Available at <http://www.iflr1000.com/includes/print.asp?CountryID=57&sIndex=2>.

⁶² Id.

grant the purchaser the right to force the seller to execute a new agreement to assign the future receivables.⁶³

The lack of mention of assignment rights in the Draft Laws does little to pave the way for transfers by way of assignment and it thus may fall out of favor, replaced by factoring as the preferred method to complete several types of securitizations.

Factoring

Russian law recognizes factoring as a unique way to transfer several types of receivables. “Factoring is defined as a “financing against an assignment of a monetary claim” whereby a licensed factor provides financing to the client against an assignment of a monetary claim arising from the client delivering goods, rendering services or performing works to a third party.”⁶⁴ Factoring has had separate legal treatment and is generally a more securitisation-friendly transfer mechanism when compared to a general assignment.⁶⁵ Factoring now has the potential to become the primary method of completing some kinds of securitizations as the Draft Laws clarify and provide for these types of transfers explicitly. However, factoring is not a generally accepted method to transfer loans, mortgages, and consumer credit receivables and the Draft

⁶³ See Dragunov and Turetsky, *The International and Comparative Legal Guide to Securitisation: Russia* at 272 (2006).

⁶⁴ Id.

⁶⁵ Id.

Laws make no mention of expanding the scope of factoring to include such loans and receivables and so will remain a limited method of securitization for several asset classes.⁶⁶

Prior to the Draft Laws, SPVs to which the rights were transferred, were required to hold a factoring license to receive assets under a factoring agreement, unless it was a bank or other credit institution. Matters were further complicated by the fact that there was no implementing legislation or authoritative literature or commentary describing and explaining the use of factoring in Russia, and no information on the procedure for obtaining a factoring license.

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The Draft Laws change this by contemplating optional public registration of the factoring agreement and assigning the responsibility of determining the procedure for registering to the Russian government. The Laws also clarify that a future receivable is transferred as of the moment it originated, unless stipulated differently in the factoring agreement. They also provide for the ability for other (unspecified as of yet) laws to be applied to the transfer of receivables as of the date of the factoring agreement.⁶⁸

Special Purpose Vehicles

The MBS Law, by providing for a “*mortgage agent*”, a legal entity that may be used only in mortgage securitizations, was the first time the concept of an SPV structured specifically for securitization in Russia was introduced. “The mortgage agent must be incorporated in the form of a joint-stock company and has a limited capacity and strict staffing/management

⁶⁶ Dragunov, Vladimir, “Proposed Changes to Securitization Legislation in Russia”, GTNews (March 5, 2007). Available at <http://www.gtnews.com/article/6657.cfm>.

⁶⁷ Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com, May 2004, available at <http://www.gtnews.com/article/5470.cfm>

⁶⁸ Dragunov, Vladimir, “Proposed Changes to Securitization Legislation in Russia”, GTNews (March 5, 2007). Available at <http://www.gtnews.com/article/6657.cfm>.

requirements.”⁶⁹ The Draft Laws expand on this concept and contemplate a new entity called the special finance company⁷⁰ (“SFC”) that is incorporated and set up for the specific purpose of purchasing receivables and issuing bonds backed by those receivables.⁷¹ Prior to the Draft Laws, a Russian SPV was unlikely to receive a high enough credit rating to issue a securitized bond. Presumably, the Draft Laws, if effected, would open up the possibility to the SFC of achieving such a rating by, among other things, setting several restrictions on recourse against the SFC's assets by creditors of the originator.⁷² Also, prior to implementation of the Draft Laws, a Russian SPV would not be exempt from taxes on its profits, despite the fact that any gain it realized on the sale of securities was passed through the SPV to the originator.⁷³ The Draft Laws propose amendments to the Tax Code to exempt any income received by the SFC associated with securitizations from the Russian profits tax. Instead, the Draft Laws establish methods for calculating the VAT on receivables such that, when the receivables are sold at par, there would be no tax consequences.⁷⁴ Even more hopeful is a that “a VAT exemption on any sale of receivables to the SFC is... under consideration as well.”⁷⁵

In many developed countries, an SPV can take the form of a charitable trust – typically a grantor trust, as it does not generate tax at the trust level – for several reasons. Under a trust structure, none of the participants in the deal must consolidate the SPV on their

⁶⁹ Dragunov and Turetsky, *The International and Comparative Legal Guide to Securitisation: Russia*, 270 (2006).

⁷⁰ In Russian: *spezializirovannoe finansovoe obshchestvo* (SFO).

⁷¹ Dragunov, Vladimir, “Proposed Changes to Securitization Legislation in Russia”, GTnews (March 5, 2007). Available at <http://www.gtnews.com/article/6657.cfm>.

⁷² For more details on the mechanics of the proposed legislation, see Id.

⁷³ Rackham and Rose, “Russian Securitizations: Just Around the Corner?”, GTNews.com, May 2004, available at <http://www.gtnews.com/article/5470.cfm>.

⁷⁴ Dragunov, Vladimir, “Proposed Changes to Securitization Legislation in Russia”, GTnews (March 5, 2007). Available at <http://www.gtnews.com/article/6657.cfm>.

⁷⁵ Id.

balance sheets, nor can they be deemed responsible for its obligations.⁷⁶ The concept of a trust, however, is not recognized by Russian courts or legislation.⁷⁷ Thus, the uncertainty of tax and accounting treatment under Russian law for trusts further complicates asset transfers in securitization transactions.⁷⁸

SOLUTIONS AND WORK-AROUNDS

However, even with significant barriers in the form of a lack of a determinable and unified picture of the legality of securitization structures, and even disregarding the imminent passage of the Draft Laws into fully applicable legislation, Russian lenders have found successful ways to securitize assets. Enlisting the aide of law firms and other securities specialists, originators have been paired with investors in securitization transactions using various solutions to help minimize legal and financial risk. Utilizing a trust structure is one of these methods, with one reason being that Russian courts may take a cue from the rest of the developed world's concept of trusts and offer an economically favorable analysis of such a transaction. Other methods to work around the current economic, political, and legal barriers include:

⁷⁶ International Financial Corporation, *Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs* at 26 (March 2005); Rackham and Rose, "Russian Securitizations: Just Around the Corner?", *GTNews.com*, May 2004, available at <http://www.gtnews.com/article/5470.cfm>.

⁷⁷ See *Id.*; International Financial Corporation, *Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs* at 26 (March 2005).

⁷⁸ For details on a similar situation in China, where a lack of precedent and legislation regarding trust and accounting treatment led to ambiguity and hindered securitization, see Xu, Min, "Resolution of Non-Performing Loans in China", *The Leonard N. Stern School of Business, Glucksman Institute for Research in Securities Markets* (April 1, 2005). Available at http://w4.stern.nyu.edu/glucksman/docs/Xu_2005.pdf.

- Creating escrow accounts and/or special tranches to absorb losses from commingling assets⁷⁹ (By ensuring that proceeds from securitized receivables are immediately allocated to the receivables and distributed to the issuer, commingling risk can be mitigated. If the lender is not able to allocate proceeds to its accounts receivable quickly enough, a pledge of the account at which proceeds from the assets arrive could be used to mitigate the commingling risk. Distributions in tranches to specific classes of asset holders may also be used to further designate that payment flows belong to specific parties, an issue which may deter Russian courts from including them in an originator's bankruptcy sale.⁸⁰);
- Foreign exchange and interest rate hedging (Issuers should hedge any risks that could be caused by fluctuation in currency exchange or interest rates as these can result in imbalances between the issuer's inflows and outflows of cash, frustrating the ability to service the securities. This is a concept, widely accepted among finance professionals dealing in markets with these types of risk, which up until recently was labeled as gambling by Russian courts. However, a new federal law⁸¹ grants judicial protection to derivatives.);

⁷⁹ “Commingling risk – i.e. the risk that cash proceeds from securitized receivables are commingled with other assets of [a lender who services the loans], and subsequently become part of the [lender's] bankruptcy estate—is one of the key risks to be addressed in most securitization transactions.” International Financial Corporation, *Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs* at 32 (March 2005).

⁸⁰ International Financial Corporation, *Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs* at 31-32 (March 2005). The IFC argues that it is thus necessary to adopt a “necessary statutory provision such that the subordination of securities tranches is enforceable on the Issuer's bankruptcy.” Id.

⁸¹ Russian Federal Law No. 5-FZ, dated 9 February 2007, *On Amendments to Article 1062 of the Second Part of the Civil Code of the Russian Federation*. See the FFSM release at http://www.fcsm.ru/eng/catalog.asp?ob_no=9143.

- Arranging for mezzanine tranches to be purchased by organizations such as the International Finance Corporation to overcome the sovereign ceiling on ratings⁸² (On assets with the potential to achieve a rating higher than Russian sovereign ratings, it made sense to sell tranches of those assets to an organization that could then issue them under a credit rating higher than the originator could achieve.);
- Storage of personal obligor⁸³ details with a third party (possibly a credit bureau) to overcome data protection and banking secrecy issues (“The assignment of receivables to the purchaser would normally involve a transfer of relevant data on the obligors. If such data are qualified as confidential, their transfer may lead to an infringement of the obligors' rights. In the first place, data protection rules are of the utmost importance for the assignment of consumer loans by banks which are bound to observe strict confidentiality. Non-banks, however, may also face obstacles in transferring obligor-related data to the Purchaser. Problems could arise due to a lack of consistent and systematic legislative guidance on the handling of confidential data.”⁸⁴ By storing this information with a third party who is permitted to receive the data, information about the loans or receivables may be verified without compromising private data.).

These work-arounds to some of the issues created by the legal and regulatory barriers to securitization present in Russia have encouraged market participants to continue securitization

⁸² Bartlam and Artmann, “Securitisation Sensation: Increased Lending, New Laws and More Sophistication and Understanding in the Marketplace Mean the Russian Securitisation Market is in the Ascendancy”, Orrick Structured Finance Report (September 2006).

⁸³ The obligor is the person or entity that has an obligation to pay all principal and interest payments on a debt. In the case of a home mortgage, it would be the person who borrowed money to purchase the home.

⁸⁴ International Financial Corporation, Securitisation in Russia: Ways to Expand Markets and Reduce Borrowing Costs at 33 (March 2005).

deals. Further, the amendments contemplated in the Draft Laws are a responsible measure to prevent potential problems that a mere reactive response may simply exacerbate. Taking into account the numerous work-arounds and the Draft Laws, which are likely to be passed soon, the regulatory and legal climate for securitizations in Russia is looking better than ever. And, while there is still much room for progress, the large recently completed successful transactions indicate that market participants will continue to push to exchange securities for efficient capital that aids in the expansion of the banking system's ability to provide loans to more consumers and ultimately drive the economy.

CONCLUSION

There is no shortage of suitable assets and cash flows in Russia and the country has already begun a rapid increase in consumer credit levels. Securitization has already emerged as a successful financing tool and the civil law nature of Russia's legal system, contrary to that of a common law system, likely means that some of the structures like those contemplated in the Draft Laws will pave the way for the immediate availability of securitization techniques by market participants if and when the Draft Laws become law.

Economic factors surrounding the increase in consumer credit levels, such as the concurrent increased level of spending in Russian households, the high interest rates at which household loans are offered, and the lack of strong consumer credit data, all point to a continuing rapid increase in the levels of NPLs. This will cause strain on Russian banks' balance sheets, incentivizing the banks to securitize their NPL portfolios in order to obtain the inexpensive capital that securitization can afford and to reallocate the risk of the NPLs. At the same time,

banks will increasingly want to refinance their existing loans for another reason: to continue to lend more intelligently. As the quality of consumer credit data gets better on the increased development of credit bureaus, the accuracy of credit reports on potential borrowers will increase as well, causing banks to become more comfortable lending to consumers. This increasing comfort level, coupled with the continued rise of demand for loans will increase competition among banks, who will then need to look for ever cheaper ways to obtain capital. Securitizing nonperforming loan portfolios is a logical way to react and adapt to the economic climate in Russia, both currently and in the future, and will likely make substantial headway as a financing technique in the near future.