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RISK in the GLOBAL REAL ESTATE MARKET

International Risk Regulation,
Mechanism Design,
Foreclosures,
Title Systems,
and REITs

Michael C. I. Nwogugu

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Mechanism Design, Foreclosures,
Title Systems, and REITs*

MICHAEL C. IANWOCUGH



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*This book is dedicated to my paternal grandparents,
Mr. and Mrs. Gabriel O. Nwogugu,
and my maternal grandparents,
Bishop and Mrs. L. M. Uzodike*

Preface

The purpose of this book is to present a long overdue and multi-faceted critique of the main elements of global real estate markets and generally accepted risk management approaches within the context of constitutional economics, and to introduce new mortgage-alternatives products that solve some of the existing problems. Constitutional economics is almost entirely neglected in modern academic real estate analysis, fiscal policy, and monetary policy, even though it has substantial macroeconomic implications.

The global financial crisis has exposed many weaknesses in financial markets' (especially real estate and fixed income markets) monetary policy and regulation in many countries. More than 110 countries created new constitutions or substantially amended their constitutions between 1990 and 2010, with many of the new constitutions based on U.S.- and U.K.-style constitutions. It is now clear that the major distinguishing factors between countries that were affected by the global financial crisis of 2007–2011 and those that were relatively insulated included the size of their national mortgage markets, the existence of special constitutional courts, prevalence of special mortgage statutes (such as deficiency judgment statutes) and types of mortgage products, lack of culture of compliance, efficiency of legal processes (e.g., foreclosures), and underwriting quality. However, despite greater international coordination and new laws that were enacted during the past three years, global risk regulation remains highly ineffective as manifested by the recent failure of government stimulus programs and government-sponsored risk-reduction programs in many developed and third-world countries.

This book is unique because:

- It explains how constitutions affect risk regulation, fiscal policies, monetary policy, and the economics of real estate transactions.
- It introduces new theories of “takings”—in most common law and commonwealth countries, takings significantly affects land policy, urban development policy, property values, and tax revenues.
- It explains why mortgages, foreclosures, title systems, asset securitization, and REITs are unconstitutional.

- It explains how constitutions and risk regulations affect economic models and real estate transactions.
- It explains the effects of preemption and federalism on risk regulation, risk management, and real estate transactions.
- It introduces economic psychology theories that relate to risk and constitutional economics.
- It explains the institutional context within which real estate and risk management function.

WHO THIS BOOK IS FOR

The scope of this book is international, and the issues raised are especially relevant to countries that are developing their constitutions and/or real estate markets and capital markets.

This book is written for management consultants; investment professionals, research analysts, and portfolio managers; corporate governance professionals; central bankers; urban development professionals; economists and government regulators; real estate and banking professionals; lawyers; and senior-undergrad (fourth-year undergraduate), as well as PhD and master's degree students.

WHAT THIS BOOK COVERS

Chapter 1, Regulation and Constitutional Torts, explains the nature of constitutional torts within the context of the commonalities among constitutions of different countries. It is noteworthy that most commonwealth countries “borrowed” their constitutions from England, and during the past 20 years, more than 70 countries have either enacted new constitutions that are based on the U.S. Constitution or have amended their constitutions to be similar to the U.S. Constitution. The chapter also introduces federalism and preemption and associated regulatory arbitrage, which are subsequently shown to have significant economic and behavioral effects on parties to mortgages, foreclosures, titles systems, and asset securitization transactions, particularly in countries that have federal systems of government. The chapter explains the traditional tests for constitutionality (which are similar across most common law countries). The chapter introduces the *theory of substantial inducement* as an alternative to the state action requirement in constitutional law. “Quasi-constitutions” and social capital are also explained as important elements of regulation of transactions and enforcement of statutes.

Mechanism Design is a growing area of economics, which, unfortunately, has not been applied in a practical manner to many modern socio-economic problems. Moreover, most of the research on mechanism design has been theoretical work, and not practical applications. Chapter 2, *A Critique of Mechanism Design*, surveys the literature and critiques of existing academic thought on mechanism design. Some of the criticism and issues discussed are relevant to the design of mortgage markets, alternatives to foreclosures, and mortgage-alternative products.

While traditional mortgages are very similar across most countries, the regulation and organization of mortgage markets has almost completely omitted the psychological effects and social problems caused by mortgages and foreclosures, which have become serious public health problems in many countries. Chapter 3, on public health, surveys recent empirical and theoretical research based on data/samples from various countries that conclusively show that mortgages and foreclosures cause long-term mental health problems for individuals and households (and employees of lenders); and that governments have not addressed these issues at all or sufficiently in terms of public health interventions and/or changes in mortgage/foreclosure regulations and the design of mortgage products. The consequences of these mental health problems are manifested in higher crime rates, divorces, personal bankruptcies, and individual productivity losses, all of which have adverse multiplier psychological effects on other individuals and groups. It is very likely that these mental health problems will continue because the same causal factors and choice patterns are very likely to continue in the future.

During 2003 to 2010 the global mortgage and housing markets experienced substantial structural changes and shocks. Chapter 4, on psychological factors inherent in housing demand and mortgage demand, analyzes key events during this period, and shows that some of the socioeconomic trends pertaining to mortgages and housing were associated with both psychological effects and causes. This chapter also introduces the testable hypothesis of psychological biases and effects that can explain changes in housing demand and mortgage demand. The implication is that all house-price forecasting models are inaccurate because they don't incorporate these trends or psychological biases/effects.

Chapter 5, *Behavioral Biases in Property Taxation and Property Appraisal*, introduces new theories and biases inherent in the property appraisal process and the property taxation process, which may affect mortgage market dynamics and demand for real estate. Again, the resulting implication is that property-price forecasting models are inaccurate because they don't incorporate these psychological biases/effects.

Foreclosures are quite common in most countries and the actual procedures are patterned after the British- and U.S.-type foreclosures. The

detrimental effects of foreclosures have been extensively documented in many academic and practitioner journals and books—but there has been no detailed analysis of the constitutionality of foreclosures. Chapter 6 fills that gap, and shows why foreclosures are unconstitutional. New theories of takings are introduced. The chapter also shows how foreclosures reduce the effectiveness of central banks' monetary policies.

Preemption remains a major element of constitutional analysis—in most countries, federal laws (and or constitutions) often conflict with state statutes, which causes substantial macroeconomic and microeconomic problems for governments, societies, and households. In some countries (such as the United States), bankruptcy codes conflict with mortgage statutes. Although the U.S. Supreme Court has established some standards for preemption, these standards don't address many elements of modern commerce and complexity. Chapter 7, on the constitutionality of the bankruptcy codes' preemption of mortgage statutes, explains the economic ramifications of such preemption and the conditions under which it increases social welfare.

Chapter 8, Mortgages and Deeds of Trust, explains why elements of traditional mortgages (such as right of redemption, anti-deficiency statutes, anti-prepayment penalty statutes, and so on) are unconstitutional. This chapter also introduces new theories of takings and explains how mortgages drastically reduce the effectiveness of central banks' monetary policies and governments' quasi-fiscal policies, and also distorts (reduces low-cost matching) the marriage market and the job markets.

The subprime mortgage markets in most countries have similar characteristics in terms of the timing and magnitude of bubbles and shocks. Chapter 9, on subprime mortgages, explains why subprime mortgages are unconstitutional (equal protection, speech, and so on) and highly detrimental to social welfare.

Property Title systems are the backbone of property transactions, and are critical for perfection of security interests and verification. Unfortunately, the two main types of property title systems (the Torrens system and the recording system) are unconstitutional. Chapter 10 on title systems explains the economic ramifications of the unconstitutionality of title systems and introduces new theories of takings.

REITs have been introduced in many countries despite the many inherent problems in the REIT structure. Ernst & Young (2010), the European Public REIT Association (2010), and Allens Arthur Robinson (2009) provided a comparison of characteristics of REITs in various countries—which confirm that REITs in most countries are very similar to U.S. REITs. Nwogugu (2007, 2008a, 2008b) explained the corporate governance and securities law problems caused by the REIT format. Chapter 11 on REITs explains how REITs are unconstitutional.

Until the U.S. asset-backed securities (ABS) markets collapsed in 2008, asset securitization was a major source of financing for many companies in many countries. Although the literature on ABS and securitization is extensive, very few articles have addressed the legality and constitutionality of asset securitization. Nwogugu (2008c, 2008d, 2009) showed that asset securitization is unconstitutional and violates usury statutes, fraud statutes, antitrust laws, and civil RICO laws (U.S.). Chapter 12 on asset securitization extends Nwogugu (2009), and explains how securitization is not only unconstitutional, but also substantially reduces the effectiveness of central banks' monetary policies.

Chapters 13 through 15 on the CIS Region, the CEE (Central and Eastern Europe) Region, and China: (1) introduce the elements of a proposed new mortgage-alternatives market for China and CIS/CEE countries; (2) explain why asset liability management (ALM) is wrong and is an obstacle to lending in both developed and developing countries; and (3) introduce new mortgage-alternative products for the China and CIS/CEE markets that address many of the problems inherent in traditional mortgages, alternative mortgages, title systems, and foreclosures. While ALM has remained a staple of modern banking, modified duration and convexity are wrong, and perceived interest rate risk is often overestimated and can be a framing effect. Perceived interest rate risk ranks below the median among other risks that lenders face (such as liquidity risk, documentation/legal risk, etc.) in terms of severity.

There is a companion web site for this book that lists the supporting court cases and some other related articles. The web address is www.wiley.com/go/nwogugu.

Michael C. I. Nwogugu
July 2011

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