Living on the Edge: Securitization Supervision and Characterization Problems

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1. INTRODUCTION

Mr Jason Kravitt, one of the leading experts in securitization in the world, argued that 'There is something about the practice of securitization that engenders intense emotions. One either loves securitization or hates it.'[1] This bold remark was made when the full extent of the 2007–2008 financial crisis was not yet known. Made today, it would be even bolder, for the number of securitization haters has soared, and the number of securitization lovers has dwindled with every development unveiling new cases of incompetence and plain greed.

Thus, asking whether all securitization bashing is justified would be a provocative question. True enough, the use made of this mechanism by bankers was all the more reckless. It fuelled a debt expansion and housing bubble that, when bursting, created the worst financial crisis since the Great Depression. Worst still, securitization decisively contributed to turn a real estate collapse into a money market freeze, crippling the economies' ability to borrow their way out.

Yet well-employed securitization can be an extremely useful mechanism to manage liquidity shortages (particularly in financial firms). Furthermore, securitization was only the trigger in a Russian roulette game played with a fully loaded gun, as the root causes of the current crisis were in the global trade and financial imbalances, which particularly affected the US economy. Likewise, the crisis' disastrous effects will likely serve as a warning light for the future, as prior crises served to bring junk bonds and other financial instruments to normality.

Finally, securitization's excesses were partly due to its being a technique under inadequate regulation. Criticism against Basel I and Basel II Frameworks on Banking Capital,[2] particularly on the securitization provisions are now commonplace and experts are placing much of the weight of the blame on this set of rules.

Yet while we accept the premise that securitization was improperly regulated; and that the Basel Framework suffered some deficiencies, we do not accept that securitization issues are limited to that. We contend that one of securitization's main problems is that, despite its economic importance, it lived largely on the edges of the regulatory web. Widely employed, yet barely understood by bankers, lawyers or regulators, 'securitization' is a victim of its own success, with its widespread use hindering its ability to define with precision a specific transaction type. That was the problem encountered by regulators, who often opted for piecemeal regulation to solve concrete problems, which pushed securitization even more to the shade; instead of reaching for a comprehensive approach, which could have brought structured finance to the (much needed) limelight.

In the present study we will make a brief introduction to securitization, its specific varieties, and its role in the context of the 2007–2008 financial crisis (2). Next, we analyse the difficulty of defining securitization and special purpose vehicles(SPVs) from the perspective of general financial rules, and finding a common concept in specific regulations (3). We will then outline the implications this has for supervision (4), to finally gather some general conclusions (5).

2. SECURITIZATION: DESCRIPTION, TYPES, AND ROLE IN THE 2007–2008 CRISIS. PRELIMINARY THOUGHTS ON REGULATION

2.1. The Standard Securitization Transaction

Securitization, or structured finance, is a complex process surrounded by an even more complex vocabulary, and deliberately involved in an aura of mystery. In order to separate intrinsic from intentional intricacies, we will describe a basic securitization transaction. It works as follows.

1 Kravitt, Jason, *Foreword: Some Thoughts on What Has Happened to the Capital Markets and Securitization and Where Securitization is Going* Draft, 7 Aug. 2008, 5. Available at <www.pli.edu/public/17984/foreword.pdf>.

2 Basel Committee on Banking Supervision 'International Convergence Of Capital Measurement And Capital Standards'. Basel. July 1988 (Basel I); and 'International Convergence of Capital Measurement and Capital Standards. A Revised Framework. Comprehensive Version' June 2006 (Basel II).

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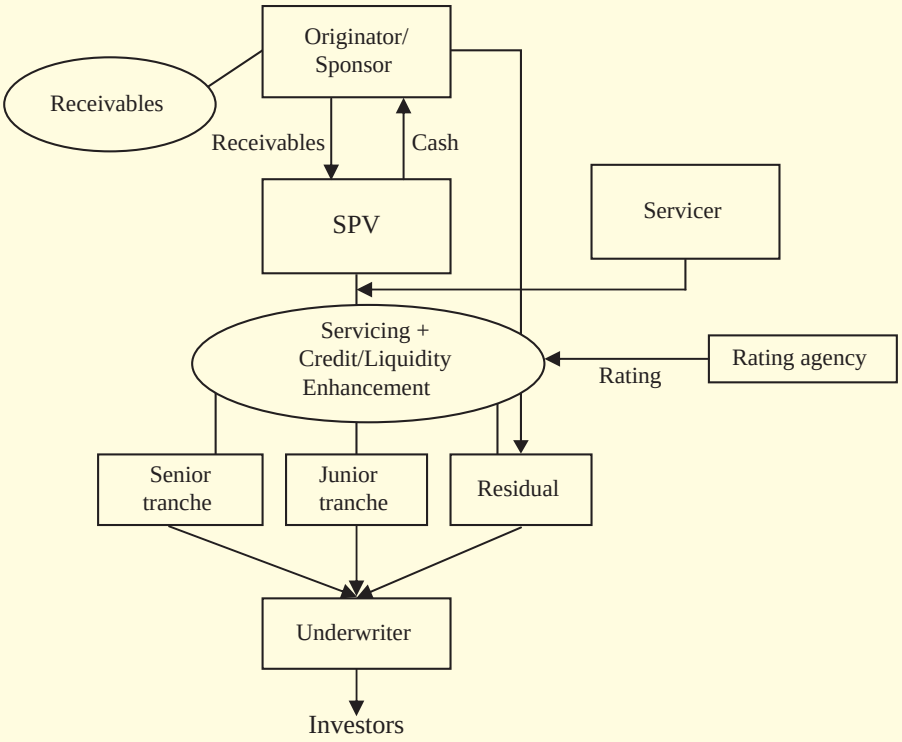
Figure 1



This securitization transaction begins with the 'originator' or 'sponsor', a large corporation (usually a financial undertaking) in need of liquidity. In order to do that, the firm must sell the assets in the market, exchanging them for cash. Those assets (generally receivables arising from credit arrangements) differ widely in payment terms, maturity, etc., hence the need to 'repackage' them in a pool that makes regular payments at the end of each stipulated period.

In addition, the assets need not only be repackaged, but also separated and isolated from the originator/sponsor; so that a potential investor is not exposed to the risk inherent to the originator's global activity (complex and difficult to evaluate) but to the risk inherent to the underlying loans (supposedly easier to estimate with statistical models).

The best way to do that is to resort to a so-called SPV. The SPV, a corporation, partnership, or trust, acquires the receivables from the originator, and sells securities to investor. The securities' periodical payments will rely on the flows from the underlying assets that have been securitized. The SPV thus isolates the underlying assets from the originator, and channels the offering to investors, and investors' cash towards the originator.

In order to ensure that the transaction runs smoothly, however, it will be necessary that someone continues to collect the cash from the debtors of the underlying receivables, and provide the necessary cash if there is a temporary or permanent shortage of funds to satisfy investors' payments. This task will be performed by the servicer, which often will be the originator itself.

Once the transaction 'architecture' is in place, it will be necessary to place the securities among investors willing to purchase them. This will be a task for the underwriters, who are well-acquainted with the intricacies of capital markets and securities offerings.

Finally, in order for the offering to gain acceptance among investors, they must be provided with a measure of the level of risk involved in the securities. In this sense, an adequate rating by a rating agency will be the basis for investors to assess the soundness of the transaction structure, the securities' creditworthiness, and the overall probability of default.

2.2. Specific Securitization Varieties

Classifications of securitization deals can be numerous, depending on the distinctive factor chosen to identify the transaction. For example, depending on the arrangement for payment to investors, and the type of SPV chosen, the deal can be a pass-through (where the SPV passes payments to the investors, on the same periods, and with the same fluctuations, as in the actual receivables) or a pay-through one (where payments are made on the stipulated dates regardless of the cash flows from the collection dates and defaults of the underlying assets).

An important distinction that must be made is that between 'static' and 'dynamic' transactions. In a static transaction, an asset pool is isolated, and that asset pool will be backing the payments to investors, and thus held till maturity. Yet this rigidity in the selection of the assets may be too risky for investors to bear (together with the possibility of default by underlying debtors, there is also the risk of anticipated cancellation of the underlying loans, in which case the cash would lose utility for periodical payments). Furthermore, the dates of payment and maturity of the assets may diverge, causing potential disruption. For those reasons, it is not uncommon to find structures with some stipulated

degree of substitution of the underlying assets in cases of default, anticipated cancellation, maturity, etc. These could be defined as 'revolving' structures.

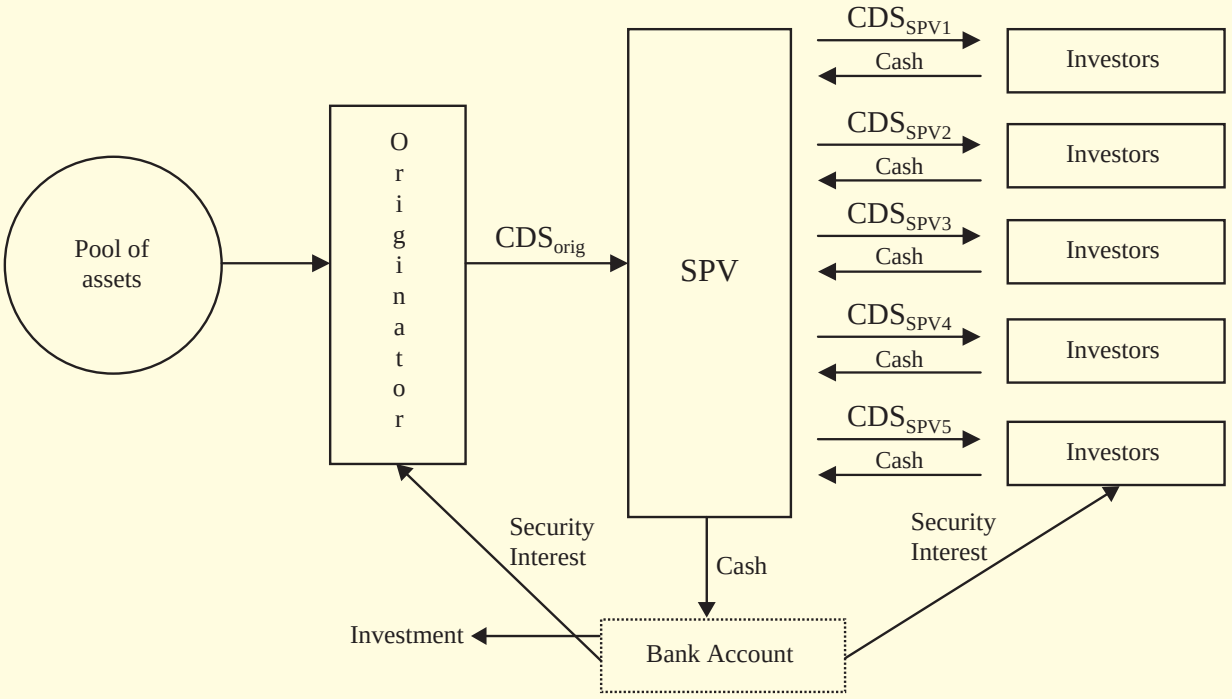
One step further, however, would be those structures where they are substituted not just on the basis of restricted causes, like those outlined above, but also in cases where a better offer is found in the market, giving rise to an active management of the pool. This would be a feature more frequent in those cases where the underlying assets are themselves securities (thereby allowing, by their more standardized nature, an adequate process of valuation), as in a securitization of corporate bonds, or asset-backed securities. This second case is known as 're-securitization', or 'securitization of securitized assets'.

Another securitization type of relevance for this study is the so-called 'synthetic securitization', characterized by the use of derivative contracts. It is important to note from the outset that a securitization transaction may use derivative contracts without becoming a 'synthetic securitization'. That is the case when those derivatives are employed to hedge investors against interest rate or currency risk. In those cases, the hedging agreement is an ancillary one. As opposed to that, in synthetic securitization the derivative contract lies at the core of the transaction, for it is employed to transfer the main risk involved in it: the risk associated with the underlying assets themselves.

This requires a type of agreement more modern than interest rate or currency contract: the so-called 'credit derivative'. Credit derivatives (Credit Default Swaps, or CDSs being the most popular)[3] are contracts that protect the creditor against the risk that its debtor will default. In the securitization context, they are employed as a substitute mechanism to the pure assignment of receivables used in the 'traditional' or 'plain vanilla' securitization.

Synthetic securitization in its most basic version requires a minimum of two derivatives contracts: one between the originator/sponsor and the SPV, another between the SPV and investors. The second contract will supposedly mirror the first. Under those contracts, investors will make a payment of a principal amount in cash to the SPV, which will hold it for the benefit of the originator/sponsor.[4] In exchange, the originator/sponsor makes periodical payments; which, channelled through the SPV, are finally transferred to investors. When a credit event (e.g., a default of a certain size in the pool) occurs, the SPV, will draw on the deposited cash, and make it available to the originator. In exchange, the originator will transfer the SPV, the defaulted assets, or a cash equivalent (physical or cash settlement). Despite its minimum version only requiring two contracts, it is common to divide the transaction in tranches, according to the risk involved, which would require as many separate contracts as tranches.

Figure 2



Source: Ian Bell & Petrina Dawson, 'Synthetic Securitization: Use of Derivative Technology for Credit Transfer', *Duke Journal of Comparative and International Law* 12 (2002): 561.

3 Credit derivative agreements are varied, but they usually imply a combination of CDS, credit spread swaps (CSS), or credit linked notes (CLN). Bell, Ian & Dawson, Petrina, 'Synthetic Securitization: Use of Derivative Technology for Credit Transfer', *Duke Journal of Comparative and International Law* 12 (2002): 551.

4 *Ibid*., 560.

2.3. Securitization and the 2007–2008 Financial Crisis

Once the different types of securitization have been identified, it is necessary to say a word or two about the reason that securitization has recently been the subject of attention by the mass media: the 2007–2008 financial crisis. In this sense, it will be useful to separate the role of securitization, which acted both as trigger and novel element of this crisis, from the role of purely economic forces involved in creating the conditions for its development.

At the very heart of the crisis were the global imbalances in trade and finance generated from 2000 onwards. A growing trade deficit in the United States made this country more dependent on debt. Under normal circumstances, this should have led, on the one hand, to an increase of interest rates, a slowdown of economic growth, and the curbing of consumption; and, on the other hand, to a currency rise in the economies with trade *superavit*, equivalent to the fall in the dollar, things that, all together, should have reined on the trade deficit.

Instead, the exchange rates did not fulfil their stabilizing role. China's active policy to keep the Yuan low could be blamed, on the one hand. Yet at the core of the problem was the rise in demand for dollar-denominated assets around the world. This demand came, on one side, from oil-rich countries, which, due to the rise in oil prices, had plenty of cash to invest. On the other hand, it came from Asian countries, which, after their own financial crises in the 1990s (caused in part by those States' inability to keep their exchange rate), were focused on building up reserves of foreign currency (so that, in case their currency depreciated, they could prop up its value by selling their reserves, and purchasing assets denominated in that currency). As can be imagined, the preferred currency in their war chest was the dollar.

Under normal circumstances, the increase in demand (i.e., the existing demand by US investors plus the one from foreign investors) for investment-grade American assets (generally of AAA or similar rating) should have increased their price, leading to a new equilibrium with supply. Yet in this case, the increase in demand led to… an increase in supply of AAA assets. And here is where securitization came to the stage and the problems began.

Securitization had so far been a mechanism for financial and other firms to enhance liquidity. Yet the increased demand of AAA assets created an opportunity to profit from that, and firms (mostly banks) began a massive vicious circle where they repackaged their credit assets and sold participations in them to investors, while using the cash obtained to generate new assets that would be securitized again. From the traditional 'originate-to-hold' banking model, the 'originate-to-distribute' model evolved.

The problem is that incentives are clearly upset from the first to the second model. A bank has a stronger incentive to closely monitor its borrowers when it is holding the loans (thereby bearing the risk of default) than in cases where these loans will be ultimately held by someone else. Thus, in the US a process was operated where traditional methods of client scrutiny were progressively substituted by an over-reliance in the clients' credit score.[5]

This lower level of scrutiny (and the lower level of documentation it entailed) might have been detected upon a close examination by sophisticated investors. Alas, this examination suffered too from an over-reliance on numerical indicators. Because if banks heavily trusted FICO scores, investors' reliance on the ratings provided by agencies like Moody's and Standard & Poors was closer to blind faith. This was reckless at least on two counts. First, because rating agencies were evaluating products whose risks were barely understood, let alone properly appraised.[6] Second, because those ratings were supposed to measure only a security's risk of default, without any consideration to other factors, like liquidity risk (i.e., the risk that an investor willing to sell some of those securities in the market does not find a purchaser).[7]

The problem was aggravated because asset-backed securities were repackaged again and again (re-securitization) giving rise to overly complex products that nobody could understand or value properly.[8] And, just to add more to the mess, originators and sponsors of securitization transactions retained a great amount of risk in their assets despite having securitized them; a risk that had been unduly placed off-balance sheet.[9] The bottom line is that nobody knew how much risk there was, and where was that risk concentrated, and so when the housing bubble burst in 2007, and borrowers began to default, inter-bank markets froze, since nobody wanted to lend to anybody. This systemic freeze led to the collapse of one entity after the other to the present day.

5 In the US companies like Fair Isaac elaborate clients' credit score according to their history of meeting payments, coming up with the so-called 'FICO score'. FICO scores have been one of the important measures to evaluate a client's creditworthiness. Traditionally, however, banks run their own tests to double-check whether the assessment made by the FICO scores was adequate, often requiring their potential clients to provide extensive documentation. According to some economic studies, securitization greatly altered this dynamic. Under an 'originate-to-distribute' model what matters for the bank is not so much whether a client is creditworthy, but whether his FICO score makes the loan eligible for being securitized. Therefore, banks began to cut short their scrutiny process in favour of the numerical rating. The results were striking, for mortgage credits slightly above the threshold that made them eligible for securitization showed higher rates of default than those slightly below that threshold, despite corresponding supposedly to more creditworthy debtors. See Benjamin J. Keys, et al., 'Did Securitization Lead to Lax Screening? Evidence from Subprime Loans 2001–2006', January (2008), 8–13 and 18–19.

6 In mid-October 2008 some correspondence between two analysts from rating agencies was exposed. In the recollection made by The Economist, one analyst said '*That deal is ridiculous. We should not be rating it*'. His correspondent replied: '*We rate every deal... it could be structured by cows and we would rate it*'. 'Credit-Rating Agencies. Negative Outlook', *The Economist*, 15 Nov. 1981.

7 See The Economist, 'Black Mark. An Accounting Standard Comes under the Microscope', *Paradise Lost. A Special Report on International Banking. The Economist*, 17 May 2008, 14.

8 '*CDOs (securitisations of securitisations, which are instruments based on pools of mortgage-backed securities) [...] caused big problems because they were very opaque and particularly susceptible to correlations and liquidity risk*'. The Economist 'Ruptured credit. Securitisation has its flaws, but many of them can be mitigated', in *Paradise Lost. A special report on international banking.* 10.

9 Citigroup, e.g., announced in repurchased between 2007 and 2008, all the assets from its off-balance sheet Structured Investment Vehicles, in order to protect its reputation. The risk of this purchase (and the consequent assumption of risks) was clearly not reflected in the balance sheet. See The Economist 'Ruptured credit. Securitisation has its flaws, but many of them can be mitigated', in *Paradise Lost. A special report on international banking.* 6.

In conclusion, the financial crisis had its origin in typical economic imbalances. Securitization was the means by which those imbalances were channelled into the flooding of financial markets with bad debt. And safeguard mechanisms, either in the market (e.g., FICO scores or rating agencies) or in regulatory provisions (e.g., banking regulation) failed to put a check on these excesses.

2.4. Securitization as a Transaction in the Shade and the Need for Specific Supervision

No sooner had the collapse occurred that the quest to assign the blame began. On the regulatory side, the righteous wrath of policy experts and opinion makers fell on the Basel Framework for Capital Measurement. This set of banking regulations lacked adequate rules for disclosure of off-balance sheet transactions, and suffered from an over-reliance on agencies' credit ratings. As a result, banks following these rules did neither properly reflect nor adequately appraise the risks in their balance sheets.

While we may agree on this extensively debated regulatory blunder, we want to focus on a not-so-much discussed aspect: the specific regulation of securitization transactions and SPVs. Yet in previous lines we acknowledged that securitization is quite a clockwork transaction, and SPVs a mostly passive device, then, why the need to discuss regulation? We find at least three reasons why this may be a useful exercise.

First, there are occasions, as in synthetic or dynamic transactions, where securitization and the SPV may not be characterized by such automatism, hence the usefulness to address regulatory problems in an adequate framework. Second, securitization has been a transaction mostly developed in the shade of financial markets, with financial regulations following a piecemeal approach that has covered only specific aspects of it. Thus, a comprehensive set of rules could contribute to some standardization, enhancing predictability. This coupled with general licensing requirements could improve transparency, and boost liquidity. In third place, a discussion of specific securitization – SPV regulation could unveil deficiencies in the regulatory and supervision system as a whole. Therefore, even if we conclude that no specific regulation is necessary, we consider that the discussion per se is useful, necessary; and, given the present state of affairs, peremptory.

3. PRUDENTIAL REGULATION AND CHARACTERIZATION PROBLEMS DO WE REALLY KNOW WHAT SECURITIZATION IS?

It is a common assumption that the ability to provide financial services must be made subject to license by a competent authority. Only by means of a licensing process can a State ensure that prudential regulation is abided by, and thus investors' interests are protected. Yet the trouble with securitization is that, despite having a potentially substantial impact on those interests, and financial markets at large, it does not sit comfortably with traditional categories of financial activity. Thus, as surprising as it may seem, such an important financial activity as securitization has gone largely unlicensed. Furthermore, even specific regulations covering 'securitization' and 'SPVs' differ as to what is meant by those terms.

3.1. Prudential Regulation, Access to Activity, and the Slippery Notion of Securitization

3.1.1. *Securitization and SPVs as Credit Institutions*

At first sight, any comparison between a solid and hulky credit institution, and a thin securitization vehicle would seem ridiculous. Yet if we make abstraction of the actual entities, and think about the activity performed by securitization SPVs, we could be amazed about its similarity to that undertaken by banks. Indeed, a securitization SPV takes money from the public (investors in the public offering) and transfers it to the originator. Then, if we skip the fact that, formally, the underlying assets from which investors are paid have been transferred to the SPV, we have that every time a payment is due, the originator collects the money (for it usually retains the servicing role) and pays it to the SPV (the SPV, in turn, transfers it to investors). Now, is that not something strikingly similar to what a bank does?

Indeed, this impression, made in a legal vacuum is confirmed by regulatory provisions on this matter. The notion of a 'credit institution' under European Community law, encompasses every *'undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account'*.[10] This includes the activity of factoring,[11] which closely resembles securitization, except for the obvious fact that one is performed by a bank and the other by an SPV. Were the SPV to be regarded as a bank, and the problem would be solved. Such was the argument put forward by some national regulators, who insisted on the need to treat SPVs as regular financial intermediaries.[12]

To counter that, it has been argued that the active role of the bank in a factoring transaction, with its servicing, administration and management, cannot be compared to the passive role of the SPV in a securitization.[13] Either for this reason, or just to plainly avoid unexpected trouble, the European regulator excludes SPVs/ Special Purpose Entities (SPEs) from the notion of 'credit institution'.[14] Seemingly, some national regulators expressly exclude SPVs from registration, but only as long as activities like loan

10 See Art. 4(1) of the Directive 2006/48/EC.

11 Annex I (List of Activities subject to Mutual Recognition) of the Directive includes within the definition of 'Lending' the factoring transaction, where the originator sells its receivables to a bank at a discount.

12 The *Banca d'Italia* (BdI), on the basis of Ministerial Decree of 6 Jul. 1994, which included factoring among financial transactions subject to regulation, argued that SPVs should be considered as regular financial intermediaries. The Banca d'Italia expressed this view through a resolution (*circolare*). See *Impresa*, 1999, 1401.

13 Danillo Galletti, 'Articolo 4', in Danillo Galletti, Gianluca Guerrieri, Andrea Carinci, *Legge 30 Aprile 1999, N. 130 Disposizioni sulla Cartolarizzazione dei Crediti*, 1064–1065.

14 Article 4 (*Definitions*) of the 2006/48/EC Directive provides, in its no. 44, that '"*securitisation special purpose entity (SSPE)" means a corporation trust or other entity, other than a credit institution, organised for carrying on a securitisation…*'.

servicing have been outsourced to third parties with a license.[15] Yet while the outcome is clear, it cannot be said to be convincing.

3.1.2. *SPVs as Insurance Undertakings*

The initial contrast with SPVs is even more pronounced when insurance companies are involved. Not only the very connotation of mighty and deep-pocketed entities is at odds with what an SPV is. The insurance activity would be at odds with securitization… at first glance. If we avoid thinking about traditional categories of insurance (life, health, cars…) we immediately see that one very popular branch of the insurance business has lately been credit risk insurance.

Yes, we could counter; but there is no insurance contract where the insured transfers to the insurance company the receivables subject to the credit risk; and that is exactly what occurs in securitization. That, provided we focus on 'traditional' securitization. As seen earlier, financial practice offers the possibility of 'synthetic' securitization, where originator and SPV; and SPV and investors, enter into credit derivative agreements (typically CDS).[16] Under such agreements, a principal amount in cash is paid by investors and deposited by the SPV in a bank account, while the originator makes periodical payments; and, if a default occurs, it draws from the deposit. Could that not be assimilated to the insurance activity? Just make the periodical payments be the premium, and the amount drawn be the compensation, and the securitization SPV could go as an insurance company.

The distinction between insurance and credit derivative contracts has already been the subject of thoughtful discussion. It has been argued that insurance contracts are characterized by a *remedial* nature, whereas that purpose is absent from derivative contracts.[17] Nevertheless, while this distinction may be true, it may also be all too subtle, and lost in the complexities of each specific deal, where a contract type conceived formally for one purpose is used for another. In this respect, what should matter for the purposes of regulation should not only be the nature of the contract, from a legal perspective; but the nature of the activity, from a business standpoint.

Indeed, we can take the example of French securitization rules, which are one of the few that expressly regulate synthetic securitization. Those rules contemplate the possibility for the SPV to transfer the risk associated to the assets by means of both financial contracts and insurance contracts,[18] without entering into the distinctions and subtleties outlined by legal scholarship. From a more simplistic perspective, the 2007–2008 financial crisis offered sufficient examples of the intermingling of both activities, in the form of insurance companies gone bust for getting too deeper into securitization activities (AIG, an insurance behemoth being the most notorious example). Subtle distinctions did not seem to matter much when profit was available.

3.1.3. *SPVs, Investment Firms and Collective Investment Undertakings*

Securitization SPVs must also stand the test of other categories, like that of investment firms, and collective investment undertakings. As to the former, the obvious difficulty comes from the fact that there has not been much effort to isolate a notion of 'investment firm'. European rules, for example, refer to firms providing investment services or performing investment activities;[19] but beyond that broad reference, an investment firm will very much be anything the law says an investment firm is, whatsoever. And it could not have been otherwise; for the number of potential activities that can be undertaken in financial markets is legion, and subject to a thriving and ever-changing practice.

Thus, it would be reasonable to assume that an investment firm will be an entity undertaking an activity in financial markets that is relevant enough for investors' interests and market stability as a whole as to attract regulatory attention. Yet if that is the current position, we should question why securitization SPVs are left out of that category.[20] The reason could well be that the relationship 'firm-client', implied in the scheme of financial regulation,[21] is absent in the securitization scenario, for the very notion of 'client' is substituted by that of 'investor'. Still, it is undeniable that SPVs act as intermediaries between the originating companies and investors. And, as to the relevance of their activity, the 2007–2008 financial crisis should provide us with sufficient evidence of it. Thus, we find no reasonable argument to exempt SPVs from the status of investment firms.

As to the consideration of SPVs as collective investment undertakings, the comparison is even less unavoidable. Both are vehicles formed by an underlying asset pool that sells its participations among investors, who have no say in the investment policy of the pool. Of course, some differences persist: underlying assets are receivables in one case, and securities in the other; SPVs are generally passive, whereas collective investment undertakings are actively managed; SPVs act as a vehicle for the originator, whereas

15 In the Netherlands, the SPV will be exempt from registration if it has outsourced the servicing of the loan receivables and the administration thereof to an entity holding a license under the Financial Services Act. See van 't Westeinde, Mariëtte 'Chapter 36. Netherlands', in *The International Comparative Legal Guide to: Securitization 2007* (Global Legal Group, 2007), 287.

16 To subscribe the contract, the SPV agrees with the trustee acting in representation of the investors' interests. Ian Bell & Petrina Dawson, 'Synthetic Securitization: Use of Derivative Technology for Credit Transfer', *Duke Journal of Comparative and International Law* 12 (2002): 559.

17 David Benton, Patrick Devine & Philip Jarvis, 'Credit Derivatives Are Not Insurance Products', *International Financial Law Review* 16 (1997): 29; José Manuel Cuenca Miranda, 'Los Derivados de Crédito: El Contrato de *Credit Default Swap*', *Revista de Derecho Bancario y Bursátil* 78 (2000): 23; Philip R. Wood, *Regulation of International Finance* (London: Sweet & Maxwell, 2007), para. 11-074, 318–319.

18 See Arts L214-49-1 (financial contracts) and L214-49-11 et seq. (insurance contracts) of the French Financial and Monetary Code.

19 See Recital (7) of the 2004/39/EC MiFiD Directive.

20 Annex I A of the 2004/39/EC MiFiD Directive makes a list of '*Investment services and activities*', and does not include any activity resembling what a securitization SPV does.

21 Article 4(1)(1) of the MiFiD Directive provides that: '"*Client*" *means any natural or legal person to whom an investment firm provides investment and/or ancillary services*'.

management companies act for the benefit of investors; they spread risk,[22] while SPVs concentrate it (by acquiring assets from a single originator). Yet those differences could be blurred depending on the type of securitization (and collective investment): re-securitization transactions involve asset-backed securities (not receivables) as underlying assets; some dynamic securitization structures may imply the substitution of the underlying assets, and even the active management of the portfolio, including the purchase of assets from multiple originators; unit trust managers will act in the best interest of the bank or investment firm acting as a sponsor of the unit trust, while it would not be hard to derive a duty on the side of SPV managers to care for investors' interests.

This impression is confirmed by examining some of the regulations in the matter. European Directives, for example, require that the investment pool of assets be formed by 'eligible investments', which must generally be securities.[23] This would in principle rule out securitization schemes other than re-securitization (where underlying assets are themselves asset-backed securities). Yet the scope of eligible investments has been expanded to include *'bonds and other forms of securitized debt'*.[24] This would also include securitization transactions over corporate bonds, but would leave out mortgage or credit card securitization, which have traditionally accounted for the bulk of the industry.

From the perspective of management, thus, collective investment differs from securitization in that it targets the public at large, including unsophisticated investors, who need to be protected from exotic bets, or untested and risky products; hence the requirements of risk spread and reliable eligible investments. Yet those differences blur as soon as receivables from a single originator, packaged and offered as securities, are repackaged with those from other originators, and used to back new asset-backed securities. As such, there would be a two-step process; with a first securitization, different in kind to collective investment; and a second (re-)securitization, where the asset pool and its management should be regulated under the rules for collective investment undertakings.

Indeed, it could be argued that the two-step process is too subtle a distinction; and could create too wide a loophole; and thus all SPVs alike should be regulated as UCITS. This has clearly been the view of the French regulator. Under French law, securitization and SPVs form part of the wider spectrum of collective investment.[25] Seemingly, the regulatory model adopted by Spanish law (with a securitization fund and a management company) suggests that the model followed is that of collective investment.[26] The problem of this approach is that, for cases of purely 'passive' securitization the appointment of a management company constitutes an unnecessary and redundant step. Still, it could be countered, better safe than sorry.

Other countries have adopted the opposite approach, by expressly exempting SPVs from license and registration requirements. The clearest case is that of the United States,[27] where collective investment is regulated under the 1940 Investment Company Act. US regulators have created an exemption from registration for *Issuers of Asset-Backed Securities* provided the payments made by those securities depend on the payment from the underlying assets; and the securities have been rated in one of the four highest categories by at least one Nationally Recognized Statistical Rating Organization (NRSRO), that is rating agency; or otherwise sold to qualified investors.[28] Yet express exclusions do leave open the debate on the nature of the SPVs' activity, the differences in substance with collective investment, and the absence of a need for license requirements.

3.2. Specific Regulations and the Resilient Absence of Uniformity

3.2.1. *Securitization Regulations, Securitization Definition and Its Troubles*

It is not surprising that, given the troubled relationship between securitization and SPVs on one side, and traditional categories of (regulated) financial activity, on the other, some States have opted for a middle-of-the-road solution, like enacting specific securitization rules. Those participate in the general principles of financial regulation, but resist any categorization. Some examples are Italy,[29] Spain,[30] United States,[31] India[32] or Portugal[33] (under French law securitization is a mode of collective investment; but could well be included in this group, for securitization is provided with a specific regime).[34]

22 Article 1(2) of Directive 85/661/EEC provides that: '*For the purposes of this Directive, and subject to Article 2, UCITS shall be undertakings: the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading*'.

23 See Art. 1(2) of Directive 85/661/EEC *supra*.

24 See new Art. 1(8) of Directive 85/661/EC, as amended by Directive 2001/108/EC with regard to investments of UCITS.

25 The Law 88-1201, which regulated securitization funds (*fons communs de creances*) in the context of collective investment undertakings. After being incorporated into the French Financial and Monetary Code, the *fons communs de titrisation* (trust SPVs) are regulated under S. 2 (*Les organismes de titrisation*) of Ch. IV (*Placements collectifs*) of Title 1 (*Les instruments financiers*) of Book II (*Les produits*), whereas s. 1 regulates 'traditional' collective investment undertakings, and includes general provisions common for all entities.

26 The 19/1992 Act, as well as the 926/1998 Royal Decree contemplate a model with a trust-like fund formed by the underlying assets, and a management company, as in unit trusts.

27 That would also be the case in Austria, where 'securitization companies' (*Verbriefungs-spezialgesellschaften*) are expressly exempt from registration requirements, since it is not considered that they undertake any banking activity (*Bankgeschäft*). See Tibor Varga & Felix Hörlsberger, 'Chapter 7. Austria' *The International Comparative Legal Guide to: Securitization 2007* (Global Legal Group, 2007), 43.

28 See Rule 3 (a) (7). The rule does not exclude the so-called Principal-Only (PO) or Interest-Only (IO) securities, which give their holder the right to receive the residual interest in the asset pool. That despite the original position by the SEC, that ordinary investors might not appreciate the risks involved, See Gerard Uzzi, 'A Conceptual Framework for Imposing Statutory Underwriter Duties on Rating Agencies Involved in the Structuring of Private Label Mortgage-Backed Securities', *St. Johns Law Review* 70 (1996): 788.

29 See 130/1999 Securitization Act.

30 See 19/1992 Act, and 926/1998 Royal Decree.

31 See AB Regulation.

32 See the 2002 Securitization and Reconstruction Act.

33 See Decree-Law 453/1999.

34 See Arts L 214-42-1 to L214-49-13 of the French Financial and Monetary Code.

One could expect that specific securitization rules would increase certainty and predictability as to the nature and substance of the activity itself and that is the case, if we limit our analysis to a domestic level. If we engage, however, in a comparative exercise, we will conclude that, in addition to not being clearly included in any of the existing categories of financial activity, securitization does neither entail a uniform concept, nor encompasses a defined set of activities.

Take, for example, the distinction between static and dynamic securitization. Under the first, there is a single and identified pool of assets backing the securities issued. Under the second, the pool assets will rotate, either because they are substituted when reaching maturity, or even because there is an active management of the pool. Such dynamic structures are considered to fall within the definition of 'securitization' envisaged in the regulations under Spanish, French, or Italian law,[35] or European rules on prospectus information.[36] Yet despite the majority of regulations being inclined to encompass revolving (or even actively managed) transactions within their reach, American law, on the other hand, excludes them from the scope of securitization regulations. It does so under the premise that, in dynamic transactions, the securities issued are not 'asset-backed', for the assets are not identified.[37]

We must clarify that American AB Regulation is not focused in the structure of the deal, but merely on information disclosure aspects. Therefore, by restricting themselves to passive transactions, the rules do not pretend to outlaw dynamic securitization. Rather, they merely state that the forms to be filled by the sponsors will not be those specific for asset-backed securities.

A seeming division of views exists with regard to synthetic securitization structures, that is transactions that use derivative technology for the purposes of risk transfer. In this regard, it is the 'positive' view (i.e., the view encompassing the structure within the definition of securitization) that is in the minority. American AB Regulation expressly excludes synthetic securitization from its scope.[38] Spanish, Italian or Portuguese laws are designed having 'traditional' securitization (i.e., assignment of receivables) in mind.[39] In that context, concluding on the use of over-the-counter (OTC) derivatives, necessary to accomplish this transaction, would probably stretch the language of the rules to the limits of the permissible.

The exception remains France. Its rules on securitization expressly contemplate the possibility of using derivatives not just for exchange or interest rate risk, but for transferring the underlying assets' risk (i.e., credit risk).[40] The requirements to accomplish a synthetic securitization are threefold: the risks must be included in the by-laws of the vehicle, together with an investment strategy;[41] the total net loss cannot be higher than the total assets held by the SPV;[42] and (in case of repos and insurance contracts) the agreement must be concluded with a credit institution or insurance company licensed in accordance with the laws of France, an EU, or Organization for Economic Cooperation and Development (OECD) country.[43]

A third aspect where the views may differ is on whether a securitization SPV is allowed to undertake any activities other than the core formalities necessary to securitize the assets (i.e., receive the assets from the originator, transfer the money to him, and offer and sell the securities). A reading of US AB Regulation would lead us to conclude that the SPV will only undertake a passive role, with no involvement in matters like the servicing of the assets.[44]

European countries somehow following the pattern of collective investment when regulating securitization, split the roles between the actual vehicle formed by the asset pool (passive) and the management company. The latter performs a more active role, not just in the administration of the pool, but also in the management of cash payments, where the depositor must often act at the behest of the management company.[45]

Still, those countries stop short of assigning purely 'servicing' functions, like receivables collection, to either the vehicle or the management company. Some leave this matter to the parties' agreements;[46] others imply that the originator will keep performing

35 See Art. 4(1) of Spanish Royal Decree 926/1998, Art. 214-49-5 para. 1 of French Financial and Monetary Code; or Art. 1(1) of Italian Law 130/1999.

36 See para. 2.3. of the Annex VIII (Minimum Disclosure Requirements) of the European Commission Regulation No. 809/2004 of 29 Apr. 2004 implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements, which refers to the information to be included '*In respect of an actively managed pool of assets backing the issue*'.

37 See SEC, *AB Regulation. Final Rule Request for Comment*, 32. '*In addition, the lack of a "discrete" requirement would make it difficult for an investor to make an informed investment decision when the composition of the pool is unknown or could change over time*'.

38 See SEC, *AB Regulation. Final Rule Request for Comment*, 35.

39 References to the 'receivables', and their assignment can be found in Art. 2(1)(a) and (b) of Spanish Royal Decree 926/1998, or Art. 1(1) of Italian Law 130/1999, or Art. 1(1) of Portuguese Decree-Law 453/99.

40 The very purpose of securitization entities envisaged in the law is, on the one hand, to be exposed to risks as a result of the acquisition of receivables, or the conclusion of financial instrument contracts (*contrats constituant des instruments financiers à terme*); and, on the other hand, to procure the financing of the risks by the issuance of securities or the conclusion of financial instruments, or insurance contracts. See Arts L214-42-1 and L214-49-11 et seq. of the French Financial and Monetary Code.

41 See Art. R. 214-92 of the decretal part of the French Financial and Monetary Code.

42 See Art. R. 214-99 of the decretal part of the French Financial and Monetary Code.

43 See Art. R. 214-100 and R. 214-111 of the decretal part of the French Financial and Monetary Code.

44 According to the SEC AB Regulation, an asset-backed security is '*a security that is 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 …*'. See s. 229.1101 (Item 1101) (c) (1).

45 See Art. L 214-46-1 of the French Financial and Monetary Code, and Art. 18 of Portuguese Decree-Law 453/99. In addition to that, in countries like Italy, where the securitization company holding the assets is an atypical financial intermediary (case of Italy) there has been some debate as to the limit on the activities that the entity could undertake beyond the actual securitization. Some scholars have argued that those companies should be allowed to perform some advisory roles beyond the merely passive one of holding the assets. See Danillo Galletti, in Danillo Galletti, Gianluca Guerrieri & Andrea Carinci, *Commentario alla Legge 30 Aprile 1999, n. 130. Disposizioni sulla Cartolarizzazione dei Crediti* In *Le Nuove Leggi Civili Commentate*, no. 5 Settembre-Ottobre 2000 (Milano: CEDAM, 2000), 1062.

46 The American AB Regulation, for example, which focuses on the information that must be disclosed on the servicer, but not on who must perform the actual servicing function. See SEC, *AB Regulation. Final Rule*, 117.

that role,[47] but Western regulations leave the SPV out of those tasks, as they hold that, crucial as they are for the success of the transaction, they cannot yet be included as 'securitization' activities.

The case is different for some regulations in other countries, like India. India's 2002 Securitization and Reconstruction Bill, under the umbrella of 'securitization', creates a whole new brand of operating companies (securitization/reconstruction companies). The task of those companies is not only to receive the assets and sell securities to investors, but also to administer the deposit accounts necessary to have a proper cash management[48] (crucial to achieve asset segregation from the originator); and, what is more important, to service the receivables, by enforcing them against debtors when necessary.[49]

With that context, it is legitimate to ask what is securitization and of what does it consist. Does it involve a merely passive holding of a self-liquidating of pooled assets, as suggested by the American rules? Or it does include structures where the asset pool is actively administered by a specifically appointed management company, as implied in most European regulations? Does it include the use of derivative and insurance contracts, as contemplated by French law? Or in those cases the 'derivative' aspect weighs too much as to override the 'securitization' element, as implicit in the laws of most other countries? Is it limited to the 'legal' administration of the assets, as most regulations seem to suggest? Or does it include the actual administration of the receivables (in the form of servicing activities) as Indian rules provide?

Further to that, we could even wonder whether the concept of securitization does depend upon the law or is beyond it. This apparently theoretical question is relevant to assess whether a certain regulation is simply trying to establish certain requirements for a particular type of transaction, or whether it tries to go beyond that, and outlaw every transaction outside the description contemplated in the regulation. And, were it so, a concept of securitization would still be needed to determine what exactly is being outlawed. The question can also be relevant if a statute employs the word 'securitization' (a statute other than that pretending to delimit the activity). Should the reference be appraised in accordance with existing rules, or with regard to commercial practice? In either case, should that analysis be limited to a national, or a transnational level?

A comparative analysis thus shows that the most basic definitional questions do not find a uniform answer across the legislative spectrum. And, in a system based on delimited categories and definitions, it is hard to supervise an activity if we cannot define it satisfactorily.

3.2.2. *Accounting Regulations and the Difficulties with Defining the 'SPV'*

As far as the prior analysis shows, securitization constitutes a slippery subject, hard to characterize by existing rules. Thus, following a logical order, we must now focus on the instrument employed by sponsors of securitization transactions to isolate the risks associated with the pooled assets: the SPV. These words, employed today as a term of art, describe an entity whose role is central (at least from a formal perspective) for the purposes of the deal. Thus, if no satisfactory answer on 'securitization' is provided by existing rules, a good proxy could be to settle on a certain notion of 'SPV', or similar.

The task, alas, is as frustrating as searching for a definition of securitization, or even more. The field of law dealing more closely with the notion of SPVs is that of accounting regulation. SPVs came to be on the spot as a result of their fraudulent use in accounting-related scandals, like Enron's.[50] Enron used these 'puppet entities' to keep risky assets and massive liabilities off its balance sheet: by thinly capitalizing them, a controlling stake could be given to a straw man, or a person in the orbit of Enron, and its CFO, Andrew Fastow.[51] The entities, thus, were formally 'controlled' by someone else, while Enron still retained the whole profits and risks of the transaction, cunningly disclosing the former, while concealing the latter.

With the outrage that ensued, regulators had to make sure that like scandals would not be repeated. Thus, accounting standards bodies (like the International Accounting Standards Board, or IASB, and the American Financial Accounting Standards Board, or FASB) set their views in promulgating specific rules for these 'puppet entities'.[52] This new approach, however, could not work without a proper definition of the phenomenon that was to be regulated. And with that accounting rules have so far struggled. The rules issued by the IASB, rather than precisely defining what SPEs are, describe the different situations where they can be used, and the characteristics that accompany them, but without any aspiration of being exhaustive. SPEs, thus, are created to achieve a narrow and well-defined purpose, with strict limits in the powers of their management that cannot be modified.[53] The rule, however, does not say how those factors must be appraised (whether all of them need to be present, or only some, how much importance does each of them enjoy, etc.).

47 That is the case of Spanish, French or Portuguese regulations. See Art. 2(2)(b) para. 2 of the Spanish Royal Decree 926/1998; Art. L 214-46 of the French Financial and Monetary Code; and Art. 5(2) of the Portuguese Decree-Law 453/99.

48 See s. 7(2) of the Indian Securitisation and Reconstruction Bill.

49 See s. 9 of the Securitisation and Reconstruction Bill.

50 See William Jr Powers, Chair *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* February (2002) (hereafter *Powers' Report*); Steven L. Schwarcz, 'Securitization Post-Enron', *Cardozo Law Review* 25 (2004): 1542–1543; Steven L. Schwarcz, 'Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures', *University of Cincinnati Law Review* 70 (2002): 1309–1318.

51 See *Powers' Report*, 47 et seq.; 68 et seq.; 79 et seq.; 99 et seq., etc.

52 See Standing Interpretations Committee (of the International Accounting Standards Board, or IASB) Interpretation SIC-12, *Consolidation – Special Purpose Entities* and the (American) Financial Accounting Standards Board (FASB) Interpretation No. 46, *Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51* January 2003. This interpretation was revised in the same year, turning into Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003) – an interpretation of ARB No. 51*. We must note that SIC-12 was promulgated by the IASB in June 1998, earlier than Enron's accounting scandals rose to the surface.

53 With the consequence that the entity operates in 'autopilot' mode. See Standing Interpretations Committee SIC-12, para. 1.

The rules promulgated by the American FASB choose a completely different approach. Interpretation 46(R) coined the term 'Variable Interest Entity' (VIE).[54] By so doing, the regulator put an emphasis on all the elements that absorb the variability (primarily losses) of the assets. That includes equity capital (traditionally employed as the single indicator of 'control' and consolidation) but also arrangements like guarantees or credit enhancement, which in case of SPVs take the hardest blow when losses materialize.[55] Therefore, an entity will be deemed a VIE if either (first) the total equity investment at risk in the entity does not permit the entity to finance its activities without subordinated financial support;[56] or (second) holders of equity lack any of the characteristics normally attached to a controlling financial interest;[57] or (third) voting rights do not correspond to gains and losses, or *substantially all of the entity's activities* involve or are conducted on behalf of an investor *with disproportionately few voting rights.*[58]

Together with the definition of VIE American accounting rules contemplated that of Qualifying Special Purpose Entity (QSPE).[59] In order to be a QSPE, the vehicle must have its activities significantly limited in the inception documents, the assets held must be passive in nature, and the vehicle must be unable to sell or dispose of those assets.[60] In essence, these rules are describing the vehicle of a 'passive' securitization,[61] leaving out vehicles in revolving or dynamic structures.

Existing rules did not properly characterize the securitization scenario. SPE and VIE rules were too wide; and they had to be, in order to include all relevant cases where 'dummy' entities are used. QSPE rules, on the other hand, were too narrow, and intended to provide preferential treatment to a specific case within securitization. New proposals have been released, which reform the wider definitions,[62] while suppressing the narrower.[63] New definitions focus on the limitation of activities of the vehicle,[64] and the impossibility to assess 'control' in a conventional way.[65] Yet they risk leaving too broad a definition, which would be equally useless.

4. IMPLICATIONS FOR SUPERVISION

The first thing to establish for a sound system of regulation and supervision is to know *what* is being supervised, *whom* should be supervising, and *how* should it supervise. It is most disturbing that, in securitization, none of this is entirely clear.

The most serious source of uncertainty relates to the competent authority to supervise. Depending how we characterize securitization, it should be subject to supervision by the authorities supervising credit institutions, insurance undertakings, or securities firms and securities markets. For now, in countries with specific securitization regulations the task falls to the securities markets supervisor,[66] or is shared between the latter and the central bank.[67] Yet for those cases where the vehicle may be exposed to insurance risks, supervision is entrusted (e.g., in France) to the insurance undertakings supervisor;[68] while supervision of synthetic securitization by means of derivatives falls to the securities markets supervisor.[69] It is disturbing that the law does not provide clear-cut rules to differentiate both cases.[70]

54 See Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003) – an interpretation of ARB No. 51* paras 5 et seq.

55 See Interpretation No. 46(R) Appendix B (*Variable Interests*) para. B2.

56 The threshold is placed on 10% of the value of the assets. This does not exclude the possibility of demonstrating by means of qualitative or quantitative analysis that the entity can finance its activities without subordinated financial support. See Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003) – An interpretation of ARB No. 51* paras 9(a)–(c).

57 That is, either they are unable to make economic decisions relevant for the entity by means of exercising their vote, or they are not obliged to suffer the entity's losses (guarantees) or to receive residual returns (caps on the returns). See Interpretation No. 46(R), *Consolidation of Variable Interest Entities (revised December 2003) – An Interpretation of ARB No. 51* para. 5(b).

58 *Ibid.,* para. 5(c).

59 This term was not coined in the rules on consolidation, but the rules on asset transfer. See Financial Accounting Standard Board Financial Accounting Standard (FAS) 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (a replacement of FASB Statement No. 125) September 2000 paras 35 et seq. and 171 et seq. One of the requirements to account for an asset transfer is that the transferee has the unrestricted ability to sell or pledge the assets himself. In securitization cases, SPVs (who would be deemed the transferee) see their ability to operate with the assets greatly restricted. Thus, American accounting rules provided a sort of legal fiction by which investors would be deemed the actual transferees. For that it was necessary that the vehicle did not count for the purposes of asset control; hence the requirements included in the rules.

60 See FAS 140, paras 35(b)–(d).

61 This with the intention of giving preferential treatment. When a QSPE is involved, not only the transfer counts as a sale for accounting purposes but the QSPE is automatically excluded from consolidation in the originator's balance sheet (whether or not it complies with general requirements contemplated in Interpretation 46(R)). See Interpretation No. 46(R) para. 4(c).

62 The American FASB has not proposed any amendment to the existing rules, while the IASB launched a new version of consolidation rules, with extensive reference to 'Structured Entities', the new term that replaces the former 'Special Purpose Entities'. See International Accounting Standards Board (IASB). *Exposure Draft (ED) 10. Consolidated Financial Statements. Comments to be received by 20 March 2009,* December 2008. See also International Accounting Standards Board (IASB). *Basis for Conclusions on Exposure Draft (ED) 10. Consolidated Financial Statements. Comments to be received by 20 March 2009*, December 2008 and International Accounting Standards Board (IASB). *Draft Illustrative Examples. ED 10 Consolidated Financial Statements. Comments to be received by 20 March 2009,* December 2008.

63 The privileged treatment of QSPEs was put in question in the aftermath of the crisis, with the result that recent proposals for the modification of US accounting rules contemplate its suppression. See FASB Financial Accounting Series. *Exposure Draft (Revised) Proposed Statement of Financial Accounting Standards. Accounting for Transfers of Financial Assets. An amendment of FASB Statement No. 140*, No. 1610-100, 15 Sep. 2008, para. 2(a). According to the explanatory part, the definition of QSPE had been overstretched, and employed in cases where the conditions were not met in substance. *Ibid*., para. A18.

64 IASB, *Exposure Draft (ED) 10. Consolidated Financial Statements cit.*, para. 30.

65 IASB, *Basis for Conclusions on Exposure Draft (ED) 10*, para. B 106.

66 See, e.g., Art. 6(3) of Spanish Law 19/1992; Art. L214-49-1 para. 2, and Art. L214-49-7, para. 2 of the French Financial and Monetary Code.

67 See Art. 3(3) of Italian Law 130/1999, and Arts 106 et seq. of Italian General Banking Law.

68 See Art. L214-49-13; and, more generally, sub-section 2 of section 2, Ch. IV, Book II of the French Financial and Monetary Code.

69 See Art. L214-49-1 para. 2 of the French Financial and Monetary Code.

70 Article R214-111 does not provide clear distinctions that distinguish credit derivatives from insurance contracts, leaving the matter quite open. Furthermore, other articles in the French Financial and Monetary Code (notably Art. L214-42-1, paras 1 and 2, or Art. L214-44) refer to securitization by means of financial instruments (derivatives) *or* insurance contracts, implying that both can be used for the same purpose.

Furthermore, even disregarding the trouble to select the competent authority to supervise the vehicle or its management company, the problems persist if we focus on the supervision of originating companies, where they are banks. Banking supervisors enforcing regulations based on the Basel Framework would need to rely on a definition of SPV, to determine whether the transaction should be kept off-balance sheet. For that purpose, resort must be had to accounting rules, which, with a multiplicity of concepts (Special Purpose Entity, VIE, Qualified Special Purpose Entity, Structured Entity…) can create confusion. That confusion could be enhanced if the vehicle is an SPV (or SPE, VIE, QSPE, *Società Europea* (SE), etc.) under accounting rules and the Basel Framework, but the transaction accomplished does not qualify as securitization under national regulations (e.g., because it is a synthetic structure, which is not admitted under domestic rules). In that case, the relationship between banking supervisors and securities markets/insurance supervisors is unclear.

The right path to proceed would seem to be a division of competences based on the interests at stake. Enforcement of codes of conduct for investor protection purposes seems a task for supervisors of securities firms and markets: they should make sure that information is adequately disclosed; and that sponsors are sufficiently checked, for example by ensuring that SPV managers and management companies are independent and act in the interest of investors. Banking and insurance supervisors should, on the other hand, make sure that risk is adequately accounted for, and that there is not a too high concentration of it threatening market stability. Lastly, banking supervisors should be aware of the compliance with adequate originating practices, and make sure that credit institutions comply with quality standards for credit underwriting.

And still, the answer may yet not be that simple. In cases where the underwritten credit is of poor quality, this will be an issue for supervision at the origination level. Yet bad loans, when securitized, will certainly raise issues concerning investor protection (e.g., statements in the offering documents as to the quality of underlying assets may be deemed false; mechanisms to put a check on the originator may be insufficient, etc.) thereby prompting the supervisor of securities firms and markets to intervene. Finally, an excessive accumulation of positions on bad loans will increase the probability of the originating bank having to absorb the assets as a matter of reputation; which will be proof that the risks were not properly accounted for in the first place, something that will be for the banking supervisor to decide. This may even threaten the stability of institutional investors who have subscribed derivative or insurance contracts, which will be a matter shared between the insurance and the banking supervisor.

The dire picture outlined above becomes more gruesome if we extrapolate it to the cross-border context. There the problems described will be aggravated by the inconsistencies between domestic rules, the uncertainty as to the applicable law, and the possible turf wars between national supervisory authorities.

5. CONCLUSIONS: WHAT SECURITIZATION TELLS US ABOUT THE EXISTING REGULATORY FRAMEWORK

A Comparative analysis of existing regulation; of general rules on financial intermediaries, as well as specific provisions on securitization shows quite startling results. Across the international regulatory spectrum no consensus has emerged as to what securitization really is or consists of. Equally important, there is no clear guidance as to what type of regulated financial activity securitization resembles the most. This creates obvious problems for assigning the responsibility of surveillance. If that is the context, it is hard to bring securitization back from the edges of the regulatory web into the realm of legal certainty.

The analysis, however, is also important for what it teaches about the existing regulatory framework of financial intermediation. Securitization does not fit properly because it is a by-product of modern financial innovation, estranged from the inner conceptions that gave rise to the current regulatory system. Yet this alienation is very present in modern financial practice, where complex transactions often mingle products like loans, insurance and derivatives; and firms engage in providing such complex services, while mixing them with extensive advice on all kinds of products and transactions (the 2007–2008 financial crisis is a coarse example of this multi-functionality of financial firms, with the consequent difficulty to isolate risks). This leads to a deeper reflection on the need to change the foundations of existing financial regulation.

When the current framework was envisaged, regulators did not create immutable categories, belonging to the World of Ideas of Plato, or the Ihering's Heaven of Concepts, where everything exists in its essence. Rather, they were good observers of the economic and financial reality of their time, and captured it, while making sure that existing activities evolved within the boundaries of prudence and reasonableness. Thus, traditional regulations were divided into rules on credit institutions, investment firms, insurance companies and collective investment undertakings because that covered the scope of financial activity at that time, and firms would not venture beyond their own turf.

Consequently, financial regulation's trouble to tackle securitization's problems is but the tip of a great iceberg; for the question resounding across policy shops should not be in what category does securitization fit, but whether such categories make sense at all. A famous quote from George Bernard Shaw says that '*Crude classifications and false generalizations are the curse of organized life*'. While it is hard to think of a more 'organized life' than that described in financial regulations, it is now the responsibility of legislatures and policy-makers to make classifications more refined, and generalizations more harmonious.