

REGULATING SECURITISATION IN THE AFTERMATH OF THE GLOBAL FINANCIAL CRISIS: LESSONS FROM EUROPE

Abstract: The conventional narrative woven around securitisation in the aftermath of the 2008 Global Financial Crisis (the ‘GFC’) was based on a fundamentally flawed understanding of the real role and purpose of this important financing technique. In particular, it failed sufficiently to distinguish between transactions that were entered into as a funding technique to support real economy lending by banks and non-banks, and/or as a means of transferring risk for regulatory capital purposes, and more complex structures that were developed later and which were not used to finance the origination of hard assets or the real economy, or for regulatory capital purposes, but rather to profit from arbitrage opportunities arising in the market. The European regulator fell under the spell of this conventional narrative, and in the decade immediately following the crisis developed an ever changing and highly punitive regulatory framework for all securitisation transactions that resulted in the virtual disappearance of the European securitisation market. A new regulatory framework was introduced in 2019 and, although it is yet to be fully implemented, and has already been amended to support the economy from the severe economic effects of the Covid-19 pandemic, it does go some way towards addressing the shortcomings of its predecessor. However, it remains to be seen whether the new regime will revive the market as intended; the early indications are not overly positive, and it seems likely further changes will be required.

INTRODUCTION

As indicated by the title, this article focuses on the European experience of the GFC. In particular, the misunderstood role of securitisation in that crisis, and how that influenced the regulatory treatment of securitisation during the following decade. In short, we argue that the conventional narrative woven around securitisation in the aftermath of the GFC obscured the financing technique’s real role and mission and led to the creation of a European regulatory framework that not only failed to address the legitimate concerns surrounding securitisation but imposed unnecessarily punitive restrictions on all forms of securitisation that have been damaging for the wider real European economy. That regulatory treatment ultimately led to the virtual disappearance of large parts of the European securitisation market, a catastrophe the regulator has recently recognised the need to alleviate.

In order to frame our consideration of the key issues, it is appropriate briefly to review the origins of securitisation and the reasons why it developed into an important financing technique in the USA and, more importantly, for the purpose of our analysis, also in Europe.

Tracing the Origins of Securitisation

A good place to start is to provide an appropriate definition for this financing technique. This may sound unnecessary, but arguably one, if not the, main reason why the European Commission (the ‘EC’) failed in its mission to appropriately regulate securitisation post the GFC was precisely because it failed to appreciate the core features of a securitisation transaction and the rationale for entering into such transactions.

Securitisation is, essentially, a method of asset-backed financing whereby debt finance, typically in the form of debt securities, is raised, primarily against a specific portfolio of assets, in a manner which seeks to insulate the investor in the debt securities from risks other than the risk of the specific portfolio of assets not performing in the manner anticipated. Consequently,

securitisation has been defined as ‘the process of turning assets into securities’,¹ or as a ‘method of achieving a structured finance transaction’, whereby debt is raised against, and based (solely) upon, an underlying pool of assets.² The words ‘process’ and ‘method’ are key in these definitions, since securitisation is a financing technique aimed at raising debt finance via the issuance of structured debt finance instruments. The essence of this financing technique is the issuance of debt securities, the repayment of which is inextricably linked to the relevant portfolio of assets that comprise the core subject matter, the commercial driver if you will, of the debt financing. In the aftermath of the GFC the European regulator failed to appreciate the significance of these core features and focused almost entirely on the products the securitisation market had created, almost without reference to how they were created.

The first European securitisation transactions can be traced back to 18th century Prussia when Pfandbriefe bonds were first issued in the aftermath of the Seven Years’ War.³ However, the financing technique we know as securitisation today was developed in the United States in the 1970’s as a means of financing the purchase of residential property. The expression ‘securitisation’ was coined because it describes the conversion of an asset, typically a loan, into a marketable debt security. The techniques developed in the United States were expanded from the mid-1980’s to assets other than residential mortgages. Assets that were commonly securitised included credit cards, car loans and leases, aircraft leases, commercial property loans, infrastructure related receivables, (including roads, railways, power stations, bridges etc.), general corporate loans and trade receivables.

This financing technique soon spread to Europe, initially to the UK in the mid-1980’s when residential mortgage securitisation was developed, and then, as in the United States, it expanded to a wide range of assets. Its perceived importance as a financing technique throughout continental Europe was highlighted by the fact that from the late 1980’s, a number of European jurisdictions including Italy, Spain, France, Portugal and Greece, implemented legislation aimed specifically to facilitate securitisation.

The European securitisation market quickly spread to an almost limitless range of underlying assets, but the early structures had a number of common factors. The debt securities issued were inextricably linked to, and collateralised by, the credit of an underlying pool of assets; those debt securities were typically issued in different tranches, each tranche enjoying a different priority and the debt securities were typically overcollateralised in the sense that the value of the underlying portfolio of assets was frequently greater than the value of the securities issued, thereby providing a level of credit enhancement to the holders of the securities in the event of credit losses in the underlying portfolio.

Securitisation techniques were soon used to develop what one commentator has referred to as ‘an alphabet soup of other structures’⁴ which, rather than being collateralised directly by an underlying portfolio of assets, were collateralised by debt instruments, typically debt securities, which were themselves directly or indirectly collateralised by an ever-increasing mix of underlying assets.⁵ Further developments saw synthetic structures which were not based

¹ *A Dictionary of Finance and Banking* (5th edn OUP 2014).

² Sarah Paterson, Rafal Zakrzewski, ‘Composite and Specialised Financing Transactions’ in Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson, & Zakrzewski on the Law of International Finance* (2nd edn, OUP 2017) 747.

³ For a brief history of the Pfandbrief, see Dieter Bellinger, ‘The History of the Pfandbrief, its Legal Framework and its Issuers’ in Philip Moore (ed) *The Pfandbrief: A European Perspective* (Association of German Mortgage Banks and Euromoney Books 2000) 28ff.

⁴ Marke Raines, ‘UK Regulation of Term Securitisation Following a Hard Brexit’ (2018) 13(4) *Capital Markets Law Journal* 534, 535.

⁵ See Suleman Baig and Moorad Choudhry, *The Mechanics of Securitization: A Practical Guide to Structuring and Closing Asset-Backed Security Transactions* (Wiley Finance 2013) 4; Frank J. Fabozzi, Henry A. Davis, and Moorad Choudhry, *Introduction to Structured Finance* (Wiley Finance 2006) 119ff.

on the original classic ‘true sale’ structure of the underlying portfolio of assets, but were based on a credit derivative (or some other type of credit protection mechanism) which was structured to mimic the financial performance of a reference portfolio of assets. These transactions were typically structurally less burdensome and costly than ‘true sale’ structures and did not always require a special purpose vehicle (‘SPV’) to be established (or maintained). Some of these synthetic structures were entered into for regulatory balance sheet management purposes, for example, to relieve large exposures or concentration of risk, whereas the objective in others, typically referred to as synthetic arbitrage securitisations, was to profit from the arbitrage opportunity occurring in the market.⁶

In light of the above, it is fair to describe securitisation as a spectrum, comprising various products and labels. And of course, the various labels exist because each of these products is unique in terms of structure and —crucially— in terms of the objectives it serves.

Reference to the objectives served by the various securitisation products brings us to the next important point, namely the reasons why securitisation expanded so rapidly in Europe from the mid-1980’s until the start of the GFC. The technique became so popular amongst European market participants primarily because it served (or, more accurately, classic ‘true sale’ and certain synthetic products served))⁷ one particular objective astonishingly well, namely, relief from regulatory capital requirements.⁸

The Role of Regulation in the Development of the European Securitisation Market

In order fully to appreciate the historic development of the European securitisation market, it is necessary to understand the regulatory developments that were taking place in the banking sector at the time securitisation was first introduced in Europe. The earliest European transactions coincide almost exactly with the development and implementation of what was known at the time as ‘the Basel Capital Convergence Agreement’,⁹ which set out the original text of the so-called Basel Capital Accord (or Basel I, as it later came to be known), aimed at applying, for the first time, common minimum capital standards to the international banking sector.¹⁰ It is difficult to overstate the importance of this regulatory development both for the global banking industry as a whole and more specifically the development of the European securitisation market.

⁶ For a more detailed analysis of arbitrage structures see Stefan Krauss and Frank Cervený, ‘Why Synthetic Securitisations are Important for the European Capital Markets Union’ (2015) 2-3. Synthetic securitisation structures are analysed more below.

⁷ The objectives served by more complex securitisation products, such as certain variants of the collateralised debt obligation (the ‘CDO’) were indeed very different from those of residential mortgage-backed securities (‘RMBS’) or asset-backed securities (‘ABS’).

⁸ Apart from regulatory capital relief, securitisation was a huge success in Europe because it also achieved disintermediation, allowing corporates to raise funds by using their receivables as collateral to issue securitisation products, whilst giving them access (through the purchase of such products) to previously inaccessible underlying credit. Their importance notwithstanding, these drivers are less relevant for the needs of the present paper and will not be analysed further.

⁹ Basel Committee on Banking Supervision, ‘International Convergence of Capital Measurement and Capital Standards’ (July 1988) <<http://www.bis.org/publ/bcbs04a.pdf>> accessed 16 March 2021.

¹⁰ Basel I was introduced in 1988 and was transposed into European law the very next year, via Directive 89/647/EEC of 18 December 1989 On a Solvency Ratio for Credit Institutions [1989] OJ L386/14, ie the Solvency Ratio Directive.

Following the publication of Basel I in 1988, removal of assets from the regulatory balance sheet of banks became increasingly important.¹¹ Put simply, by transferring assets¹² to off-balance sheet SPVs, regulated banks could achieve complete regulatory relief from the capital carrying cost of the relevant portfolio of assets.¹³ The use of securitisation as a more efficient means of achieving regulatory capital relief was quickly recognised by European regulated banks, which had hitherto increasingly focused on loan asset sales as a way to manage lending limits, and large exposures. Securitisation significantly increased the efficiency of that market by enabling banks to pool portfolios of assets and thereby maximise the potential regulatory relief available.¹⁴

The development of loan transfers and securitisation as an efficient tool to manage some of the implications arising from Basel I was also recognised by various European bank regulators. As early as December 1987 the Bank of England, which at the time was the lead regulator for the UK banking sector, issued a consultative paper¹⁵ setting out its proposed supervisory response to the proposed new Basel framework which had been published earlier that year. That consultation process was followed by a notice issued by the Bank of England in February 1989¹⁶ setting out the conditions required to be satisfied in order for a bank to remove assets from its balance sheet for capital adequacy purposes. As its title suggests, that notice covered both the transfer of single loans and what were referred to at the time as ‘Packaging Schemes’, the process of packaging loans together and selling them as a block to an entity unconnected to the bank.

It was in the conditions applicable to Packaging Schemes that the regulator first recognised the use of ‘Securitisation Schemes’ as an effective way to transfer assets for regulatory (primarily regulatory capital) purposes. The supervisory policy in respect of securitisations, first published by the Bank of England in 1989, was refined and expanded on numerous occasions by the Bank of England and its regulatory successor in the UK, the Financial Services Authority (the ‘FSA’) in the period leading up to the GFC.¹⁷ Those changes largely reflected the different types of securitisation being used by banks for regulatory purposes and included both ‘true sale’ and synthetic transactions.¹⁸

Therefore, at the very time the first securitisation transactions were being structured in Europe, the need for banks to identify ways in which they could address the requirements of Basel I and optimise their balance sheets was already a pressing issue. It was initially because

¹¹ This issue was also recognised by European bank regulators, including the Bank of England which was, at the time the lead regulator of the UK banking sector. See Bank of England Notice ‘Loan Transfers and Securitisation’ BSD/1989/1 (February 1989).

¹² As already explained, by that time (late 1980s) these assets already included not just residential mortgage loans, but also credit card payments, auto loans, and leasing receivables.

¹³ Regulated credit institutions were particularly incentivised to remove high-quality, low yielding assets from their balance sheets, mostly because of the flat risk weight Basel I imposed on all corporate assets (except for residential mortgage loans), see Fabozzi (n 5) 295; Iris H-Y Chiu, Joanna Wilson, *Banking Law and Regulation* (OUP 2019) 336.

¹⁴ For an interesting account of the development of the asset sales market in the UK and how that developed into the securitisation market, see G.A. Penn, A. M. Shea, and A. Arora, *The Law and Practice of International Banking: Banking Law Volume 2* (Sweet & Maxwell 1987) 165-171.

¹⁵ Bank of England, ‘Loan Transfers and Securitisation’ 8/87 (December 1987).

¹⁶ Bank of England Notice (n 11).

¹⁷ The first Bank of England Notice was supplemented and amended by further notices which focused on specific aspects of the developing European securitisation market, for example, a notice published in April 1992 (BSD/1992/3) set out additional requirements in relation to the securitisation of revolving credits thereby giving the green light to the securitisation of credit card receivables. The last of those notices (before the GFC) was published in February 2007, see FSA, ‘Prudential Sourcebook for Banks, Building Societies and Investment Firms’ (2007) Section 9 (Securitisation).

¹⁸ FSA Notice (n 17) Section 9.5 and Section 6.

of this need that the technique's development would become inextricably linked with regulation.

For a number of reasons related to the approach taken by Basel I,¹⁹ securitisation was particularly effective in achieving balance sheet optimisation and the associated regulatory relief. This effectiveness, which, as already indicated, was also recognised by various European bank regulators at the time, was the main driver behind the rapid development of the European ('true sale' and synthetic) securitisation market and the great success the technique enjoyed for a prolonged period of time.²⁰

It is somewhat ironic that one of the main drivers of the success of securitisation, namely its regulatory efficiency and treatment, would ultimately become the catalyst for its demise.

The Development of 'Perverse' Structures

In many ways, securitisation became a victim of its own success: The effectiveness of the technique as a means of managing a number of the implications of Basel I resulted in it being used by an increasing number of European regulated banks, and its attractiveness to a broad range of investors also soon led investment bankers to conclude that certain types of securitisation afforded significant arbitrage opportunities and the profits that could be generated were enormous.

Although classic, 'true sale' and synthetic balance sheet securitisation transactions continued to thrive in Europe, it is undeniable that market participants increasingly looked to securitise 'for the sake of securitising'. Enter the CDO with its various distinctions.

To elaborate, CDOs were first developed in Europe in the late 1980's²¹ and, as was the case with other types of securitisation, the early transactions, which remained the most common, were based on the cash flows of a specific portfolio of underlying assets and therefore shared many features common to the classic 'true sale' structures. Their objective was also similarly aimed at removing assets from the regulatory balance sheet. Arbitrage CDOs on the other hand were quite different, in that they sought to capture the arbitrage opportunity or profit by capturing the spread between the yields paid to securitisation investors and the yield realised on the assets used as collateral for CDO issuance.²²

Capturing spread became so profitable, that it effectively created an insatiable demand for assets that could be used to collateralise such transactions. Once hard assets such as mortgage loans, credit card receivables etc. were no longer sufficient to fuel investor demand (and arbitrage opportunities), investment bankers turned to the other asset classes that existed in abundance at the time, namely the very securitised products they had already created. We refer of course to the asset backed securities that had been issued as part of a securitisation transaction. This use of asset backed securities as collateral marked the birth of the structured

¹⁹ One of the most important ones being the difference in regulatory treatment under Basel I between assets held in the banking book (like loans), and assets held in the trading book (like securities), in the sense that capital requirements were significantly higher for banking book assets, compared to trading book assets, see Simon Gleeson, *Gleeson on the International Regulation of Banking* (3rd edn, OUP 2018) 239-241. This became an issue after the 1996 Market Risk Amendment of Basel I (Basel Committee on Banking Supervision, 'Amendment to the Capital Accord to Incorporate Market Risks' (January 1996) <<https://www.bis.org/publ/bcbs24.pdf?noframes=1>> accessed 16 March 2021). The ultimate result was that by 'converting' their loans into securities (via securitisation) banks could reduce their capital requirements.

²⁰ By way of example, securitisation issuance in Europe for 2001 was equal to €152.6 bn, whereas in 2008 issuance had increased to €818.7 bn, see AFME, 'Securitisation Data Report: European Structured Finance Q4: 2015' 7 <<https://www.afme.eu/Portals/0/globalassets/downloads/data/securitisation/2015/AFME-STN-Securitisation-Data-Report-Q4-2015-v2.pdf?ver=2019-09-11-144337-337>> accessed 16 March 2021.

²¹ According to Fabozzi (n 5) 199, the CDO was first introduced in 1988.

²² *ibid* 120.

finance-backed CDO.²³ The final stage in this frenzy was securitisations that didn't require the removal of assets from the balance sheet of banks; enter the arbitrage synthetic CDO, which, like other synthetic structures previously mentioned (and unlike cash flow CDOs), was not collateralised by the cash flows generated by real assets but rather from a derivative instrument (typically a credit default swap) which was structured to mimic the performance of a reference portfolio of assets.²⁴

As already indicated, the development of arbitrage synthetic CDOs did not signify the disappearance of simpler securitisation products that aimed at balance sheet optimisation and regulatory relief;²⁵ it did mean however that the proceeds from securitisation were increasingly no longer channelled into the real economy.

Henceforth an increasing number of securitisation transactions were structured 'for the sake of securitising' in the sense that increasingly poorly underwritten assets were originated to use as collateral, particularly in the US subprime mortgage sector, and proceeds obtained from selling securities to investors were increasingly used to buy other securitisation products which were used as the collateral for new securitisations, and ultimately to make gains via the arbitrage opportunities presented by the market. This 'perverse' use of the technique created a bubble that remained hidden so long as securitisation was 'riding high'. Based on such weak underlying credit foundations however, it was inevitable that sooner or later, the success of securitisation would come to an end, although few would have predicted it would be so abrupt.

Securitisation's Reputation is Stigmatised

In a period of less than 3 years, a technique that had been lauded as a means for reducing risks for the entire banking system and providing attractive funding for the real economy²⁶ became an 'inherently dangerous and opaque toxic venom' that threatened the stability of credit institutions worldwide and the global financial system as a whole.²⁷ Securitisation became, almost overnight, the poster child of 'bad financial innovation',²⁸ and was stigmatised by the press,²⁹ academics,³⁰ and eventually by EU, UK, and US officials who expressed publicly their disbelief in the ability of financial innovation to be either useful or profitable,³¹ and pointed to the inherent vulnerability of the securitised credit model regarding financial stability shocks.³²

²³ *ibid* 119.

²⁴ *ibid* 120.

²⁵ Importantly, these structures also included cash flow CDOs and certain types of synthetic CDOs.

²⁶ FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (London 2009) 15.

²⁷ See Raines (n 4) 560 for further references.

²⁸ Niamh Moloney, 'The Legacy Effects of the Financial Crisis on Regulatory Design in the EU' in Eilís Ferran and others (authors), *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2012) 135-136.

²⁹ See for instance Martin Wolf, 'Securitisation: life after death' *Financial Times* (2 October 2017), <<https://www.ft.com/content/8dd50650-70fc-11dc-98fc-0000779fd2ac>> accessed 16 March 2021. See also Orkun Akseli, 'Securitisation, the Financial Crisis and the Need for Effective Risk Retention' (2013) 14 *European Business Organization Law Review* 1, 2 for further references.

³⁰ Kurt Eggert, 'The Great Collapse: How Securitization Caused the Subprime Meltdown' (2009) 41(4) *Connecticut Law Review* 1257; Roman Tomasic, Folarin Akinbami, 'Towards a New Corporate Governance After the Global Financial Crisis' (2011) 22(8) *International Company and Commercial Law Review* 237, 240.

³¹ Michel Barnier, 'Forging a New Deal Between Finance and Society: Restoring Trust in the Financial Sector' (Brussels, 26 April 2010) <https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_10_178> accessed 16 March 2021.

³² FSA Turner Review (n 26) 18, 41.

The once vibrant securitisation market ground to a virtual standstill,³³ from which, at least the European segment, some twelve years later, has yet to fully recover.³⁴

As its reputation was being very publicly tarnished, securitisation also caught the attention of the European regulator which almost immediately viewed the technique as the personification of inexcusable excesses and put it at the epicentre of its crackdown on financial innovation. Although securitisation provisions had already been included in Basel II,³⁵ these were deemed too lenient and insufficient even before they had been properly applied.³⁶

The proverbial elephant in the room is of course the GFC that started in 2007. It is now well established that the crisis was a turning point for securitisation. As subprime mortgage borrowers started defaulting on their loan payments, triggering the now infamous US subprime mortgage crisis, the securitisation market froze and confidence in everything securitisation-related was lost in dramatic fashion. As the US subprime mortgage crisis morphed into a global liquidity and solvency crisis,³⁷ securitisation investors, including banks and other financial institutions, suffered enormous credit and market losses.³⁸ The bubble created by the use of arbitrage CDOs as a means of capturing spread and ‘hiding’ US subprime credit risk was clearly a causal factor to those losses.

Whilst it cannot be denied that securitisation contributed to and amplified the severity of the GFC, the real role it played is much more nuanced than suggested at the time. This is an issue to which we will return later; however, for the present it is important to keep in mind the conventional narrative that was woven at the time, namely that securitisation was **the** major culprit for the crisis, because it was inherently complex and motivated by perverse incentives. This heavy stigma has been carried by the technique ever since.³⁹

The Survival of Securitisation

The stigmatisation notwithstanding, securitisation did not disappear completely, either in Europe, or especially in the US. Although it remains much smaller compared to pre-GFC levels, especially in Europe, and since the GFC has been heavily supported by central banks

³³ Baig (n 5) 28.

³⁴ AFME, ‘Securitisation Data Report: European Structured Finance Q2: 2019’ <<https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Data%20Report%20Q%202019-3.pdf>> accessed 16 March 2021.

³⁵ Basel Committee on Banking Supervision, ‘International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version’ (June 2006) <<http://www.bis.org/publ/bcbs128.htm>> accessed 16 March 2021.

³⁶ Indeed, it is interesting to note that when the crisis erupted, Basel II had not yet been fully implemented. Therefore, the effects of this regulatory piece on the events of 2007-09 is difficult to discern, see Chiu (n 13) 370; Francesco Cannata, Mario Quagliariello, ‘The Role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty?’ (2009) 3(09) *Carefin Working Paper* 14ff; and Andrew Cornford, ‘Revising Basel II: The Impact of the Financial Crisis’ (2009) 34-35(2-3) *Finance et Bien Commun* 60, 64.

³⁷ Niamh Moloney, Eilís Ferran, and Jennifer Payne, ‘Introduction’ in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015) 4; The High Level Group on Financial Supervision in the EU, ‘Report’ (Brussels, 25 February 2009) (hereinafter the de Larosière Report) 7-8.

³⁸ Raines (n 4) 539 561-562; Andrew Dennis, ‘Securitisation can be a Sturdy Ally for Investors’ *Financial Times* (15 August 2017) <<https://www.ft.com/content/0089dd70-7cef-11e7-9108-edda0bcbc928>> accessed 16 March 2021. See FSA Turner Review (n 26) 29ff for the effects of the GFC on the UK market.

³⁹ ECB and BoE, ‘The Impaired EU Securitisation Market: Causes, Roadblocks and how to Deal with them’ (2014) 2.

and their quantitative and collateral easing programmes,⁴⁰ the European securitisation market still exists.

Furthermore, after spending nearly a decade punishing the technique, the European regulator has recently indicated a willingness to re-embrace securitisation (or, rather, certain types of securitisation). So important is the technique now considered to be, that it is considered a cornerstone of the EU's ambitious Capital Markets Union ('CMU').⁴¹ The regulator now acknowledges that securitisation is 'a crucial element of well-functioning financial markets, an important channel for diversifying funding sources and allocating risk more efficiently within the EU financial system...and can help to free up banks' balance sheets to allow for further lending to the economy'.⁴² The new framework for European securitisation came into force in January 2019 pursuant to two Regulations⁴³ which are considered by the EU to be a key milestone in the EU's Capital Markets Union reform. Those Regulations, which are still in the process of being implemented by more detailed secondary legislation, and have also recently been updated and amended to take into account the economic repercussions of the ongoing Covid-19 pandemic,⁴⁴ are the clearest illustration of this re-embrace.

The distance from the events of the GFC, and the fact that the European regulatory authorities are clearly now keen to kick start the European securitisation market, or at least parts of it, make it both timely and appropriate to revisit the technique and consider it in a different light, ie through the lens of our current understanding of the events running up to the GFC, and the role securitisation played.

The same holds true for the post-GFC regulatory treatment of securitisation in Europe, a topic that remains both relevant and controversial. Specifically, it is now, over a decade and multiple waves of regulation later, pertinent to analyse the European regulator's response to the crisis and examine whether, and to what extent, the post-GFC regulatory framework addressed the concerns that were raised in the context of securitisation in the aftermath of the GFC. It is also appropriate to consider whether the concerns that were raised were justified, and whether the regulatory response has been appropriate and proportionate.

Following our analysis of the concerns raised in relation to securitisation in the aftermath of the GFC (**Part I**), we will examine the various and many regulatory changes made by the European regulator during the decade immediately following the crisis, which we consider it appropriate to label 'the punitive regulatory period' (**Part II**), and finally we will turn to the current regulatory phase during which the regulator has seemingly re-embraced securitisation (**Part III**). These matters are now of even greater importance in light of the severe economic damage caused to the European economy by the ongoing Covid-19 pandemic, in reaction to

⁴⁰ For the relevant analysis see Benjamin Braun, 'Central Banking and the Infrastructural Power of Finance: The Case of ECB Support for Repo and Securitization Markets' (2018) 0(0) *Socio-Economic Review* 1.

⁴¹ Gerard Kastelein, 'Securitization in the Capital Markets Union: One Step Forward, Two Steps Back' in Danny Busch, Guido Ferrarini, and Emiliios Avgouleas (eds), *Capital Markets Union in Europe* (OUP 2018) 464.

⁴² European Commission Consultation Document 'An EU Framework for Simple, Transparent and Standardised Securitisation' (18 February 2015) 2.

⁴³ Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms [2017] OJ L347/1 (hereinafter Regulation 2017/2401); Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 [2017] OJ L347/35 (hereinafter Regulation 2017/2402 or the Securitisation Regulation).

⁴⁴ For the update of the new securitisation framework see European Commission, 'Coronavirus Response: Making Capital Markets Work for Europe's Recovery' (24 July 2020) (hereinafter the European Commission Coronavirus Response).

which the regulator has acted swiftly by introducing much-needed (albeit fragmented) amendments to the securitisation framework⁴⁵. They are also of great importance for the UK that is already, post Brexit, forging its own path, having introduced the Securitisation (Amendment) (EU Exit) Regulations 2019 that came into force in December 2020 and amend the European securitisation framework.⁴⁶

PART I. CONCERNS RAISED ABOUT SECURITISATION IN THE AFTERMATH OF THE GFC – MYTH AND REALITY

Weaving the Conventional Narrative

As already indicated, justifiably or not, securitisation as a global financing technique came out of the GFC badly wounded, not just in terms of the quantum of losses suffered by investors in debt instruments issued as part of a securitisation, but also —crucially— in terms of perception. The fact that securitisation was seen most negatively in Europe is ironic since European securitisation generally performed exceptionally well both during and in the aftermath of the GFC. Credit, as opposed to market, losses were relatively low, certainly when compared with the US securitisation market, and also compared favourably with losses suffered in the European corporate debt securities market.⁴⁷

Perhaps the strongest evidence of the negative perception was seen in the volume and related value of securitisation issuance which in Europe fell from a peak of €481 bn in 2006 to €24.8 bn in 2009.⁴⁸

For the purpose of the present analysis it suffices to state that the negative perception linked securitisation to the ferocious search for yield among market participants in the years leading up to the crisis, and to a massive influx of cheap debt which spread throughout the global financial system and incentivised banks and other regulated credit institutions to deploy that cheap credit via ‘highly complex’, ‘innovative’, ‘opaque’, ‘toxic’ structured finance products.⁴⁹

Risky and complex variants of the securitisation model were utilised by credit institutions to originate poor credit quality assets, in particular US subprime mortgage loans, the risk of which was hidden in opaque CDOs and transferred across the global financial system. It was this ‘hiding’ and transfer of risk that ultimately led to the resulting instability in the global financial markets; it also contributed to the creation of a US housing market bubble that, once it burst, led to a liquidity drought and then to a solvency crisis that affected markets and economies all over the world.

In other words, the main concerns raised about securitisation in the immediate aftermath of the GFC centred around the perverse incentives that the technique was thought to have

⁴⁵ Referred to as the ‘Capital Markets Recovery Package’, these were adopted by the Council on 15 February 2021 and are considered in greater detail later in this article.

⁴⁶ For an analysis of the new Regulations and the ways they amend the European securitisation framework see Merryn Craske, Neil Macleod, and Mariana Padinha Ribeiro, ‘UK: Securitisation After Brexit - Considerations For Securitisations Involving UK Entities’ (25 February 2020) <<https://www.mondaq.com/uk/Finance-and-Banking/896694/Securitisation-After-Brexit--Considerations-For-Securitisations-Involving-UK-Entities>> accessed 16 March 2021. See also Andrew E Bryan, ‘Brexit and Securitisation: The Rubber Hits the Road’ (2021) 36(3) *Butterworths Journal of International Banking and Financial Law* 198.

⁴⁷ Raines (n 4) 539.

⁴⁸ *ibid.*

⁴⁹ Moloney Oxford Handbook (n 37) 4; Sarah Paterson, Rafal Zakrzewski, ‘Introductory and Ground Level Matters’ in Sarah Paterson, Rafal Zakrzewski (eds), *McKnight, Paterson, & Zakrzewski on the Law of International Finance* (2nd edn, OUP 2017) 47-48.

fuelled amongst market participants, especially banks and other credit institutions that utilised the originate-to-distribute ('OTD') model of securitisation to advance loans to people who could not afford them. It was argued that banks and other credit institutions were able to do this because, once the subprime loan had been advanced it was then immediately 're-packaged' and refinanced via complex securitisations that investors willingly bought, without fully understanding the risks associated with their investment. Critically, that included an inability, in the case of investments in CDOs, to understand the extent to which their investment gave them exposure to the US subprime market⁵⁰.

The initial focus on these two issues, namely perverse incentives and complexity, as key contributors to the GFC can be seen from the earliest official responses to the crisis in Europe. The de Larosière Report proposals for example recommended that issuers of securitised products retain an amount of risk for the life of the transaction,⁵¹ a measure clearly aimed at tackling the 'perverse' behaviour of originators when advancing loans with the sole intent of transferring them (and all associated risks) to investors in the global finance markets. On the issue of complexity the Turner Review argued that (because of its complexity) securitisation was inherently vulnerable to causing financial instability shocks to the entire financial system.⁵²

Perverse incentives and the inherent complexity of the technique were increasingly emphasised by officials and by critics of securitisation in the press and academia, who were soon hardwiring these concerns into the conventional narrative surrounding the crisis which effectively shaped public perception of the technique. In the circumstances, it is not surprising that narrative proved to be very influential in the post-GFC regulation of securitisation, an issue we consider in detail below.

The distance we now have from the events of 2007-09 enables us to examine these concerns and conduct in a more sober way.

In our opinion, neither accusation truly holds up: The concerns raised about the OTD model's perversion were unduly excessive and oversimplistic. They also contradict the way in which financial institutions understood and treated the risk embedded in the assets that were securitised, particularly subprime mortgage loans and the related securitisation products upon which they were based. In addition, they fail to recognise what was truly perverse, ie the use of securitisation as 'an end in itself', not as a means of transferring risk or providing funding to the real economy, but rather to make profit through arbitrage. So far as complexity is concerned, the proposition that 'securitisation is (inherently) complex' is rather non-sensical, since it fails to grasp the essence of securitisation, conflating the technique with the structured finance products (the debt securities) created via the technology of securitisation.

The proposition that securitisation was the main culprit for the GFC is far too simplistic. There is no doubt securitisation played a role, but that role was far more nuanced than the conventional narrative suggests.

Perverse Incentives

The perverse incentives argument, as pointed out in the de Larosière Report, can best be described as a type of information asymmetry between parties in a financial transaction. This information asymmetry can either be pre-contractual (adverse selection) or post-contractual (moral hazard).

In an adverse selection scenario one of the parties to the contract, eg a seller, has ex ante superior material information about the value of the asset it intends to sell and is able to conceal

⁵⁰ This was because the subprime mortgage loans had been repackaged with other assets via one or more CDO style 're-securitisations'.

⁵¹ de Larosière Report (n 37) 25.

⁵² FSA Turner Review (n 26) 42.

it. This party will ultimately benefit by selling assets of inferior quality because the buyer is unable either to acquire or understand the information that the seller possesses.⁵³ In a moral hazard scenario one of the parties is able to acquire additional benefits by acting in a risky fashion after the conclusion of the transaction, because its counterparty cannot monitor it effectively. If the risky behaviour is successful, all the benefits go to the risk-taker, but if it results in losses, it is its counterparty that bears them.⁵⁴

In the case of the OTD model of securitisation, the conventional narrative claimed that both forms of information asymmetry were present.

On the one hand, securitisation was (supposedly) tainted by adverse selection because banks and credit institutions which originated the underlying assets were better informed about the quality of those assets, as compared to market participants who invested in the related debt securities. This pre-contractual information asymmetry allowed the bank and credit institution originators to shift their risk to other segments of the market, by selling to the investors risky products (ie securities collateralised by ‘toxic’ subprime mortgage loans) for a price that did not accurately reflect the risks associated with those mortgage loans, because the investors had little understanding of the low quality and therefore high risk of the assets to which they were ultimately exposed.⁵⁵ Once the housing market (including subprime) bubble burst and the related securitisation products lost a significant part of their value, investors, many of which had systemic importance, experienced failure that threatened the viability of the financial system as a whole.⁵⁶

It was also argued that securitisation created a moral hazard problem in the contractual relationship between banks and other credit institution lenders and their borrowers, especially those who had taken out mortgage loans. According to this view, banks and other credit institution lenders did not have an incentive to carefully monitor the ability of borrowers to repay their loans, since they were able to ‘slice’, ‘repackage’ and transfer their risk to an unknown base of investors. Instead, banks and other credit institutions were incentivised to adopt ‘unscrupulous lending practices’,⁵⁷ that is, originate vast amounts of mortgage loans for borrowers who would never be able to repay them. Ultimately, this, together with other factors,⁵⁸ contributed to a housing market bubble that inevitably burst once subprime borrowers started defaulting on their obligations.

According to the conventional narrative, the perverse incentives of banks and other credit institutions stemmed from the superior information regarding their loans that these institutions possessed vis-à-vis investors and borrowers alike, as well as from their ability to shift the underlying risk of such assets. However, it is now clear that the reality was much more nuanced: the information the banks and other credit institutions possessed was not always superior and the risks associated with relevant portfolios of subprime mortgage loans and related debt securities was often retained, at least in part, by the originating lender.

With regard to information, it has been argued that in the case of complex securitisation products, the market did not suffer from a ‘classic’ asymmetric information problem, be it one of moral hazard or adverse selection. Instead, what was experienced was a different type of

⁵³ Brian J.M. Quinn, ‘The Failure of Private Ordering and the Financial Crisis of 2008’ (2009) 5 *New York University Journal of Law & Business* 549, 567.

⁵⁴ *ibid* 582.

⁵⁵ James Crotty, ‘Structural Causes of the Global Financial Crisis: A Critical Assessment of the “New Financial Architecture”’ (2009) 33 *Cambridge Journal of Economics* 533, 572-573; Baig (n 5) 26.

⁵⁶ Steven L. Schwarcz, ‘Secured Transactions and Financial Stability: Regulatory Challenges’ (2018) 81 *1 Law and Contemporary Problems* 45, 46.

⁵⁷ Steven L. Schwarcz, ‘The Conundrum of Covered Bonds’ (2011) 66 *The Business Lawyer* 561, 576-577.

⁵⁸ See European Parliament Research Service, ‘Understanding Securitisation: Background – Benefits – Risks’ (October 2015) Section 4.1.

informational market failure, one that Professor Schwarcz calls ‘mutual misinformation’.⁵⁹ As he explains, this informational market failure resulted in no party possessing superior information; rather, all the parties —banks, rating agencies and investors— miscalculated the risks associated with the assets included in the pool and therefore the risks relating to the securities issued.⁶⁰

We are not suggesting banks and other credit institution originators and investors were not able to understand the risks embedded in a particular securitisation transaction; it would have been relatively easy for them to do that. The real problem was that after a certain point in time, the credit assessment of mortgages was no longer deemed to be important, because banks were no longer interested in conducting it; fundamentally, the profit they were generating through arbitrage was just too good for them to bother. The problem with this behaviour is obvious. The fact remains however that bank and credit institution originators did not leverage their superior information to ‘trick’ investors into buying their products.

Furthermore, the amount of risk retained by these bank and credit institution originators up to the moment that the US housing market bubble burst, suggests they were either unwilling or unable to transfer it all to investors. Either way, it is difficult to reconcile this with the emphasis placed on perverse incentives by the de Larosière Report.

In addition to retaining a significant amount of risk by credit enhancing securitisation transactions via overcollateralisation, bank and credit institution originators also held substantial quantities of securitisation products. These products were retained for a number of reasons, including warehousing considerations,⁶¹ as well as to be used as collateral for short-term borrowing in wholesale markets.⁶² Particularly first-loss tranches of securitisations (ie those bearing the highest risk and thereby offering the highest reward/returns) were retained by banks in their capacity as originators and sponsors as a means of supporting (effectively credit enhancing) their securitisation deals.⁶³ Most importantly however, banks ended up keeping first-loss tranches because of the profits they could generate,⁶⁴ in other words they kept them in their capacity as investors.

This brings us to a very important, yet often neglected, point: On the eve of the GFC credit institutions (Lehman Brothers being a prime example) invested heavily in securitisation products, and especially in the riskiest tranches.

What is perhaps surprising, certainly with the benefit of hindsight, is that this type of risk retention by regulated credit institutions did not prevent them from achieving regulatory relief.⁶⁵ As mentioned above, the structure of Basel I allowed banks to minimise their capital requirements by transferring assets from their banking books to their trading books. Therefore, by selling loans to an SPV and effectively buying them back (or at least the risk relating thereto) in the form of tradable debt securities, credit institutions were able to achieve the desired regulatory relief.

Even in cases where the securitisation products were removed from the regulatory balance sheets of banks altogether, because, for example, they were sold to structured investment vehicles (‘SIVs’) that were not subject to regulatory capital requirements, banks remained

⁵⁹ Steven L. Schwarcz, ‘Securitization Ten Years after the Financial Crisis: An Overview’ (2018) 37(2) Boston University Review of Banking & Financial Law 757, 762.

⁶⁰ See Schwarcz Secured Transactions (n 56) 48-49 for further analysis about how mutual misinformation led to the overvaluation of mortgage loans.

⁶¹ Securitisations were effectively ‘stockpiled’ in the credit institutions’ books because of the (sometimes significant) time lapse between the origination of a loan and the sale of securities by the SPV to investors, see Crotty (n 55) 568.

⁶² Chiu (n 13) 7-8, 13-14.

⁶³ Fabozzi (n 5) 295.

⁶⁴ Crotty (n 55) 569.

⁶⁵ Fabozzi (n 5) 295.

exposed to the relevant risk, either directly via credit lines they entered into with the SIV or indirectly via reputational links.⁶⁶ As the crisis intensified, these links forced many credit institutions to take the assets back on their balance sheets.⁶⁷

The result of all these practices, when taken together, was that the incentives between the originators/sponsors and investors engaging in securitisation transactions were, in reality, very much aligned, whereas the disconnection between lenders and borrowers was to a large extent tackled,⁶⁸ clearly indicating that the perverse incentives concern supposedly stemming from the OTD model was much less significant than originally suggested.⁶⁹

Finally, albeit not directly related either to the possession of information or risk retention, it should be noted that the proposition that ‘credit institutions were incentivised to originate as many subprime loans as possible, since such loans would then be used as cannon fodder for the issuance of highly rated and thus lucrative debt securities’ is also not without compelling counter-arguments: In reality, the originators of such loans had good reason to be vigilant about the quality of assets they originated and included in the securitisation pools, and consequently the ability of their borrowers to repay their loans. One good reason is because, as we have already stated, securitisations are invariably credit enhanced via overcollateralisation and the excess collateral ultimately repaid to the originator once securitisation investors have been repaid.⁷⁰

The above observations notwithstanding, there was something truly perverse about the way securitisation technology was being used in the period immediately prior to the GFC, but this had little to do with the OTD model. Originating loans only to sell them to the market was not problematic per se, even if it allowed banks to lower their regulatory capital requirements. The real problem arose once the provision of loans and the generation of assets more generally (for reasons we explained in the introduction) stopped being an end and it became a means.

The true end game to this perverse practice was securitisation itself, or rather the arbitrage opportunity provided by the spread between the return paid to investors and the return realised on the underlying collateralised assets. That spread was increasingly captured via arbitrage CDOs. It was the opportunity to capture this spread that increasingly incentivised banks to lower their lending standards, increase the loan-to-value (‘LTV’) ratios and make mortgages available to borrowers who were never likely to be able to repay them.

The scale of this perverse practice is further highlighted by the fact that, once mortgage loans and other ‘real’ assets were no longer sufficient to feed the level of securitisation issuance sought by investment banks, those institutions turned to derivative structures which enabled them to continue issuing without the need to originate ‘real’ assets.

Thus, in the years immediately preceding the GFC, synthetic CDOs that used credit derivatives to mimic the credit profile and performance of a ‘reference’ residential mortgage portfolio and structured finance-backed CDOs that used MBS and ABS as their collateral increasingly became the new norm. The proceeds from such securitisation transactions were no longer used to finance the real economy, instead they were financing other securitisations. The end result of this perverse practice was that, when the securitisation market collapsed, the value of the market and credit losses suffered by investors was greater than the entire US mortgage market.

⁶⁶ Roger McCormick, Chris Stears, *Legal and Conduct Risk in the Financial Markets* (3rd edn, OUP 2018) 83.

⁶⁷ FSA Turner Review (n 26) 20.

⁶⁸ Schwarcz Secured Transactions (n 56) 48-49.

⁶⁹ *ibid* 48.

⁷⁰ We recognise this counterincentive did not prove to be sufficiently compelling to prevent banks from engaging in irresponsible lending practices. It might have been the case that the ‘lure’ of residual value was consciously disregarded in view of the much higher rewards that could be obtained from lending to subprime borrowers.

In light of all the above, we contend, with the benefit of hindsight, that the conventional narrative's concern regarding perverse incentives fueled by securitisation is both overstated and misdirected. Although it cannot be denied that securitisation technology was indeed abused, and that these abuses were a causal factor to the GFC, this had less to do with the OTD model, and more with the insatiable greed for profit through arbitrage.

In any event, it is fair to say that the depiction of banks and other credit institutions as masterminds which were able to trick borrowers and investors by getting rid of all the risk and keeping all the benefits for themselves might have been useful to appeal to public indignation at the time but is not entirely supported by facts.

Complexity

Turning next to the issue of complexity, the conventional narrative was indeed correct in stating that unsustainably high volumes of highly leveraged, non-transparent structured products such as the varieties of the CDO described above were being issued in the securitisation market immediately prior to US subprime market collapsing. It is also true that many of these products included features that added additional layers of complexity created solely to satisfy rating agency requirements, since it was credit ratings which ultimately enabled the music to keep on playing.

By cooperating with the leading credit rating agencies (the '**CRAs**') banks and credit institutions were able to 'game the system'. By taking advantage of the issuer-pays-model adopted by the CRAs, banks were able to obtain all the information they needed from the CRAs to enable them to structure their products in order to obtain the desired ratings.⁷¹ And after a certain point the credit ratings provided by CRAs were the key commercial driver (some would argue the only commercial driver) which securitisation investors (including credit institutions) focussed on in assessing the quality of the products they were buying. Conducting further due diligence was deemed unnecessary, especially when such products could be used to generate profit simply via arbitrage.

Although these findings are undeniably correct, it is appropriate to reconsider them today, more than a decade after the GFC, to examine some of their finer details. Our point is the following: the fact that complex structured products were developed using securitisation's technology, did not mean that all securitisation transactions and the securities issued became complex, therefore the proposition that 'securitisation is/became complex' is incorrect. It fails to recognise securitisation as a technique which should be distinguished from the specific debt securities it enabled to be issued.

Far from being a mere exercise in semantics, this distinction is important, because the conventional narrative did not focus on specific securitisation structures; instead, in the immediate aftermath of the GFC, securitisation became a one-size-fits-all label, synonymous with financial toxicity and a poster child for 'bad financial innovation'.⁷² By conflating securitisation and its products, this narrative obscured the reality of the essence of securitisation, which is after all a mere technique, a technology.

The conclusion is clear: The inherently dynamic nature of the securitised credit model meant that, since its original conception securitisation has been constantly evolving. The original 'true sale' structure that involved a single asset class (mortgage loans) has been used to develop a vast number of varieties, and the modern securitisation market comprises of a

⁷¹ Chiu (n 13) 360, 371-372.

⁷² Moloney Legacy (n 28) 135-136.

‘myriad asset classes and structures’,⁷³ a true alphabet soup of structured finance,⁷⁴ but this masks the reality that, put simply, securitisation is not a product, it is a spectrum.

Once again, the reason we place such emphasis on the distinction between securitisation and its products is not to contest the fact that certain CDOs and other similar structures were indeed non-transparent and thus difficult for market participants to decipher. We also accept these structures played an important role both before the GFC, by distorting the original motivation behind securitisation, as well as once the crisis had erupted, by making it difficult to quantify exposure to a particular asset class, for example, US subprime mortgages. However, it is far too simplistic to suggest all CDOs (let alone all securitisations) are inherently complex and therefore problematic. Such a statement tells only part of the story, even in the context of CDOs and shows a fundamental misunderstanding of the financial instrument and the wider securitisation market. This fundamental misunderstanding would prove to have disastrous consequences for the future of securitisation in the aftermath of the GFC, especially in Europe.

The Relative Success of the European Securitisation Market during the GFC

It is now well documented that European securitisation and structured finance products in general showed great resilience both during and in the aftermath of the GFC, and performed significantly better than their US peers, as well as other (European) financial products, such as corporate debt securities.⁷⁵

This makes perfect sense if one considers that the subprime mortgage crisis, in which the GFC had its roots, was a predominantly US phenomenon.⁷⁶ It is of course the case that credit institutions in European countries like the UK, where securitised credit played an important role in the mortgage market, did engage in similar practices to a certain extent, providing loans to borrowers who, in a different economic climate, would not have had access to such credit.⁷⁷ But poor credit quality of assets and especially mortgages in securitisation pools, the root cause of the subprime mortgage crisis in the US, was not the main problem for institutions like Northern Rock and HBOS.

To the extent that European credit institutions suffered securitisation-related losses, these were primarily the result of the global nature of the international debt finance markets, the exposure of European institutions to US (sub-prime mortgage backed) securities, and the fear that US subprime mortgages had via securitisation structures like the CDO contaminated numerous types of securitisation products. This fear among investors triggered a sell-off starting in mid-2007 that led to sharp decreases in market prices of all types of securitisation products, regardless of their country of origin or underlying credit quality, and eventually to significant market (as opposed to credit) losses suffered by European financial institutions.⁷⁸

Despite these market losses however, European securitisation products did not suffer significant credit losses.⁷⁹ By way of illustration, the cumulative default rate of such products for the period mid-2007 to mid-2014 was 1.58%. By comparison, the equivalent rate for US structured finance products for the same period was 19.3%.⁸⁰

⁷³ Raines (n 4) 534.

⁷⁴ FSA Turner Review (n 26) 14.

⁷⁵ Steven L. Schwarcz, ‘Securitization and Post-Crisis Financial Regulation’ (2016) 101 Cornell Law Review Online 115, 134-135; Kastelein (n 41) 467-468; Raines (n 4) 539; ECB and BoE The Impaired EU Securitisation Market (n 39) 3, 5; Dennis (n 38).

⁷⁶ Akseli (n 29) 5.

⁷⁷ FSA Turner Review (n 26) 29ff. For the growth of securitised credit in the UK see id 14 (Exhibit 1.5).

⁷⁸ Raines (n 4) 535.

⁷⁹ ECB and BoE The Impaired EU Securitisation Market (n 39) 3; Raines (n 4) 535, 539.

⁸⁰ Standard & Poor’s Ratings Services, ‘Seven Years on, the Cumulative Default Rate for European Structured Finance is Only 1.6%’ (26 August 2014) (hereinafter S&P 2014) 2-3.

As we have already indicated, more complex securitisation transactions were increasingly developed in the European securitisation market and continued to be issued alongside ‘plain vanilla’ structures, the latter of which maintained a very positive track record.⁸¹ For instance, since 2007 the default rate of EU AAA-rated RMBS never exceeded 0.1%, whereas the rate for EU BBB-rated RMBS peaked at 0.2%. In contradistinction, the default rates for U.S. AAA- and BBB- RMBS was between 3% and 16%⁸² and between 46% and 62%⁸³ respectively.⁸⁴

Turning to synthetic securitisation, the distinction made above between synthetic structures that were entered into for regulatory balance sheet management purposes (labeled accordingly ‘balance sheet synthetics’), and structures motivated by arbitrage opportunities (‘arbitrage synthetics’) is crucial; unlike arbitrage deals that experienced significant defaults, it is now acknowledged that European balance sheet synthetics performed very well before, during, and after the GFC.⁸⁵ In certain cases their performance was better than classic ‘true sale’ structures, across all asset classes, tranches, and ratings.⁸⁶ Indicatively, as of 2014, the average default rate for investment-grade balance sheet synthetics was 2%, whereas the default rate for comparable, ‘true sale’ ABS was 3.4% for the same year⁸⁷ and senior tranches of balance sheet synthetics that included small and medium-sized enterprises (‘SME’) loans in their pools had, as of the end of 2018, a lifetime default rate that was equal to zero.⁸⁸

This performance of SME synthetics is of particular importance for Europe given the importance of SMEs for the European economy,⁸⁹ and the effectiveness of balance sheet synthetic securitisation in transferring corporate credit risk and channelling funds to corporations and especially SMEs.⁹⁰ The specific characteristics of SME lending (such as the increased amount of operational handling required, and the often non-traditional collateral that is provided) make SME loans hard to sell and securitise via ‘true sale’ structures. On the contrary, the flexibility that synthetic securitisation offers regarding underlying loans makes it particularly suitable to handle SME lending.⁹¹ In view this data, the treatment of synthetic securitisation by the European regulator in the aftermath of the crisis (examined below) is puzzling, at best.

Conclusion

⁸¹ Miguel Segoviano and others, ‘Reviving securitisation’ in Banque de France (author), *Financing the Economy: New Avenues for Growth* (2015) Financial Stability Review 54; ECB and BoE *The Impaired EU Securitisation Market* (n 39) 5.

⁸² The default rate for prime U.S. AAA-rated RMBS was 3%, whereas the rate for the subprime AAA RMBS was 16%.

⁸³ The default rate for prime U.S. BBB-rated RMBS was 46%, whereas the rate for the subprime BBB RMBS was 62%.

⁸⁴ European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012’ COM (2015) 472 final (hereinafter STS Proposal) Explanatory Memorandum 3.

⁸⁵ EBA, ‘Report on STS Framework for Synthetic Securitisation Under Article 45 of Regulation (EU) 2017/2402’ (6 May 2020) (hereinafter EBA Report on Synthetic 2020) 12.

⁸⁶ See for instance EBA, ‘The EBA Report on Synthetic Securitisation’ (December 2015) (hereinafter EBA Report on Synthetic 2015) 17-18, Figure 7 and Figure 8.

⁸⁷ Orçun Kaya, ‘Synthetic Securitisation: Making a Silent Comeback’ (21 February 2017) Deutsche Bank Research – EU Monitor – Global Financial Markets 6.

⁸⁸ EBA Report on Synthetic 2020 (n 85) 26, Figure 16.

⁸⁹ According to Krauss (n 6) 1, as of 2015 more than 99% of all enterprises located in the European Union fell under the definition of SME.

⁹⁰ EBA Report on Synthetic 2020 (n 85) 78.

⁹¹ Kaya (n 87) 4-5; PGGM, ‘Simple Synthetic Securitisation: Why and How we Invest in Synthetic Balance Sheet Securitisations’ (November 2015) 2.

To conclude the first part of our analysis, the concerns raised about the securitisation market in Europe in the aftermath of the GFC were overly simplistic and did not reflect the reality of the market, rather they focussed on a sub-section of the market that, in turn, focussed primarily on arbitrage opportunities. The issue of perverse incentives stemming from the OTD model of securitisation was misunderstood and overstated by the conventional narrative and the accusations regarding complexity are also wide of the mark, to the extent that they conflate the (neutral) financing technique and its products and fail to see the other side of the coin, ie the reasons why securitisation was originally developed and became such a success.

Nevertheless, during a time of extreme public indignation and desperate search for a scapegoat, ‘greedy investment bankers’ and the financial products they devised became a soft target. Few people had heard of securitisation before the crisis, whereas it became a heady narrative in the aftermath. During that period few people, including the regulators, sought to distinguish the fundamentally different products that were conveniently grouped under the one label. The catastrophic results of the crisis and the fear that subprime products might contaminate the global securitisation market led to the markets effectively closing down for a time and affected the perception of securitisation on a global scale.⁹² In the public discourse that followed, the technique and all its products, howsoever structured, simple and complex, European and US, were bundled together and dismissed as ‘financial shamanism’ with no social value. In such a climate, it was hard for the regulator not to follow suit. Indeed, the stigmatisation of securitisation would result in a regulatory framework that would end up being highly skeptical, if not overtly punitive, towards the technique.⁹³

PART II. ADDRESSING THE CONCERNS OF THE GFC: THE INITIAL, PUNITIVE PHASE OF REGULATION

Ignoring Calls for Moderation

Notwithstanding the extremely negative perception of securitisation during the height of the GFC, other than for a very short period of time, the financing technique did not disappear completely. Furthermore, at the height of the crisis, when the technique was being characterised most negatively, a number of important international voices continued to recognise the importance of securitisation and cautioned that a more considered approach needed to be adopted. Indicatively, as early as April 2008, the International Monetary Fund (the ‘IMF’) forcefully argued that:

[I]t is important to note that securitization, per se, was not the problem—it was a combination of lax underwriting standards in the U.S. mortgage market, the concomitant extension of securitization into increasingly complex and difficult-to-understand structures, collateralized by increasingly lower quality assets, and a favorable financial environment in which risks were insufficiently appreciated.⁹⁴

⁹² Raines (n 4) 536; Standard & Poor’s Ratings Services, ‘Ten Years After The Financial Crisis, Global Securitization Lending Transformed By Regulation And Economic Growth’ (21 July 2017) (hereinafter S&P 2017) 4.

⁹³ S&P 2017 (n 92) 4.

⁹⁴ IMF, ‘Containing Systemic Risks and Restoring Financial Soundness’ (2008) Global Financial Stability Report xiii-xiv.

Echoes of a more sober and rational approach can also be found in parts of the de Larosière Report that cautioned against an overzealous regulatory response towards securitisation that would impede financial innovation and hamper economic growth.⁹⁵ The Turner Review also acknowledged the need for a simpler and safer securitised credit model.⁹⁶

However, despite these calls for moderation the regulator in Europe decided to follow a different path. Unsurprisingly, stability of the financial system was identified as the number one priority of financial regulation,⁹⁷ and the previous regulatory framework, ie Basel II and the CRD⁹⁸ (implementing Basel II in Europe) was considered to be in need of fundamental review and revision.⁹⁹ Accordingly, the regulator embarked on a new phase of regulation, one aimed at disciplining and punishing securitisation, since it was based on the premise that this financing technique is inherently dangerous for market participants and the financial system as a whole.¹⁰⁰

Since it was based on the fundamental premise that securitisation was primarily responsible for the GFC, it is not surprising that the initial regulatory response focused on those aspects of securitisation that were considered most responsible.¹⁰¹ Consequently, the regulatory framework that emerged consisted of a patchwork of rules that built upon the previous regime and was tailored to address the most serious concerns raised in the aftermath of the GFC, in particular, tackling securitisation's perverse incentives, and curbing complexity.

The First Wave of Regulation: CRD II¹⁰² & CRD III,¹⁰³ Solvency II,¹⁰⁴ and AIFMD¹⁰⁵

⁹⁵ de Larosière Report (n 37) 13-14.

⁹⁶ FSA Turner Review (n 26) 43.

⁹⁷ John Armour and others, *Principles of Financial Regulation* (OUP 2016) 64-66; Eilís Ferran, 'Crisis-driven Regulatory Reform: where in the World is the EU going?' in Eilís Ferran and others (authors), *The Regulatory Aftermath of the Global Financial Crisis* (CUP 2012) 9; Moloney Legacy (n 28) 116.

⁹⁸ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177/1; Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L177/201. Directive 2006/48/EC and Directive 2006/49/EC are collectively referred to as the 'CRD'.

⁹⁹ de Larosière Report (n 37) 16. It is important to note that this call for fundamental review was not fully reflected on the new securitisation framework.

¹⁰⁰ Raines (n 4) 535.

¹⁰¹ The initial European rules concerning securitisation that emerged post-GFC were based on the recommendations of Basel 2.5 (Basel Committee on Banking Supervision, 'Revisions to the Basel II Market Risk Framework' (February 2011) <<http://www.bis.org/bcbs/publ/d424.pdf>> accessed 16 March 2021). The problem was that Basel 2.5 was predominantly a response to the US subprime mortgage crisis, see EBF and others, 'Rebuilding Europe's Securitisation Markets: Further Work on Capital Calibration is Needed' (24 April 2017) 4.

¹⁰² Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management [2009] OJ L302/97 (hereinafter CRD II).

¹⁰³ Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] OJ L329/3 (hereinafter CRD III).

¹⁰⁴ Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) [2009] OJ L335/1 (hereinafter Solvency II).

¹⁰⁵ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L174/1 (hereinafter AIFMD).

In the immediate aftermath of the GFC, the EC quickly formulated a number of amendments to the CRD framework concerning securitisation positions of credit institutions.¹⁰⁶ Similar regulatory rules were introduced for insurance and reinsurance undertakings, and EU regulated alternative investment fund managers ('AIFMs').

The result was a patchwork of rules aimed primarily at addressing what had been identified by the conventional narrative as the main causes of concern for securitisation, ie perverse incentives and complexity. Consequently, the response focused on removing the perceived misalignment between originators/sponsors, investors, and borrowers by addressing the problem of information asymmetry in the OTD model, through a number of market-based regulatory rules.¹⁰⁷ In parallel, it consciously attempted to discourage complexity by, inter alia, punishing re-securitisation.

In the context of perverse incentives, the new European regime introduced, mainly via CRD II, a number of market-based rules¹⁰⁸ that amended the original CRD (specifically Directive 2006/48/EC)¹⁰⁹ and sought to tackle information asymmetry by bridging the gap between the various parties and aligning their interests.

Pursuant to a new Article 122a of the CRD, credit institutions were prevented from investing in securitisation positions, unless the originator, sponsor, or original lender retained, on an ongoing basis, 'skin-in-the-game', of no less than 5% net economic interest of the underlying assets.¹¹⁰ This risk retention rule, which was originally drafted at a much higher 15% level, and was not included in Basel 2.5, aimed at aligning the interests of the originator and the investors, by preventing the former from shifting all its risk to the market. The requirement for credit institutions to put their balance sheet (ie their 'skin') behind their lending would soon become a hardwired 'dogma'¹¹¹ that would be required in all subsequent European regulatory frameworks, with certain voices pressing for the threshold to be increased to 20%.¹¹²

Article 122a also included two distinct disclosure requirements for sponsors, originators and original lenders regarding individual securitisation transactions: The institutions acting in such a capacity were required to disclose to investors their level of risk retention,¹¹³ as well as to ensure that investors had readily available access to materially relevant data on a number of issues.¹¹⁴ These disclosure requirements on individual transactions were coupled with a 'Pillar 3' general disclosure requirement on behalf of credit institutions, introduced via CRD III.¹¹⁵

¹⁰⁶ Leonard Ng, 'Changes to Basel II and the EU Capital Requirements Directive: Implications for Securitisation' (2010) 25(6) *Journal of International Banking Law & Regulation* 265. For Basel see McCormick (n 66) 168-169.

¹⁰⁷ CRD II Recital 24ff; Ng (n 106) 271.

¹⁰⁸ These rules can be characterised as market-based, since they aim at boosting market confidence by increasing efficiency and transparency and offering safeguards to the investors, see Moloney Legacy (n 28) 119.

¹⁰⁹ By introducing art 122a of the CRD.

¹¹⁰ CRD II introducing art 122a paras 1-3. Surprisingly, the wording of the new rule imposed the onus on the investor, rather than the originator/sponsor/original lender, by forbidding the former to invest, unless the latter explicitly disclosed that it had indeed retained the interest. Thus, the risk retention rule was in reality an indirect obligation of the originator/sponsor/original lender.

¹¹¹ Frank Will, Florian Eichert, 'Covered Bonds in Regulation' in ECBC *European Covered Bond Factbook* (2014) 36, 39.

¹¹² See for instance the proposal by the European Parliament in the context of the Securitisation Regulation (European Parliament, 'Report on the Proposal for a Regulation of the European Parliament and of the Council Laying Down Common Rules on Securitisation and Creating a European Framework for Simple, Transparent and Standardised Securitisation and Amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (COM(2015)0472 – C8-0288/2015 – 2015/0226(COD))' (19 December 2016) 21.

¹¹³ CRD II introducing art 122a para 1 of the CRD.

¹¹⁴ *ibid* introducing art 122a paras 7-9 of the CRD.

¹¹⁵ CRD III introducing amendment of Annex XII, Point 14 of the CRD, see Ng (n 106) 269.

Furthermore, in an attempt to prevent the OTD model from resurfacing and align the interests of banks and borrowers, originators and sponsors were required to apply the same criteria for credit granting to assets (ie loans) that would be used as collateral in a securitisation, as they did for assets they intended to keep in their banking book.¹¹⁶

So far as investors were concerned, CRD II introduced extensive, ongoing due diligence obligations, by stipulating that investing credit institutions must be able to demonstrate for each of their securitisation positions that they had a ‘comprehensive and thorough understanding’ of a number of issues and had implemented ‘formal policies and procedures’ to analyse and record such issues. In addition, credit institutions were henceforth obliged to conduct periodical stress tests to assess their securitisation positions and establish ongoing monitoring procedures for their investments.¹¹⁷

With regard to complexity, CRD III amended the original CRD (specifically Directive 2006/48/EC), defined re-securitisation as ‘a securitisation where the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitisation position’,¹¹⁸ and introduced new, stringent risk weights for re-securitisation positions.¹¹⁹ Whilst the risk weights for securitisation positions under CRD III remained the same as under the CRD, for example, AAA rated securitisations attracted a risk weight of 7-20%, depending on the approach utilised,¹²⁰ the newly defined ‘re-securitisation’ positions with the same rating attracted a much higher risk weight of 20-40%.¹²¹ In the same spirit, lower rated BB+ to BB- securitisation positions were assigned a risk weight of 250-650% under the new CRD regime depending on the approach,¹²² whereas BB+ to BB- rated re-securitisations were assigned a higher risk weight of 350-850%.¹²³ This regulatory change was the first step to make all re-securitisations prohibitively expensive and deter market participants from either creating or investing in them.

In addition to significantly increasing risk weightings for certain types of securitisation, the new regime maintained certain key concepts of the original pre-crisis CRD, for example, the requirement of ‘significant risk transfer’,¹²⁴ and the prohibition on implicit support being provided by originators and sponsors.¹²⁵ The new framework also aligned the rules for calculating securitisation positions in the banking book with those that applied to the trading book, in order to tackle the problem of capital arbitrage,¹²⁶ an issue the previous regulatory regime had failed to address.

The conventional narrative also heavily influenced the approach taken to the new Solvency II regime.¹²⁷ Under this framework, in order for insurance or reinsurance undertakings to be able to invest in securitisation positions, the same 5% risk retention (as in CRD II) regarding originators, sponsors and original lenders applied and was explicitly required to be disclosed

¹¹⁶ CRD II introducing art 122a para 6 of the CRD. This obligation was also not included in Basel 2.5.

¹¹⁷ *ibid* introducing art 122a paras 4-5 of the CRD.

¹¹⁸ CRD III introducing art 4(40a) of the CRD. This definition includes structured finance-backed CDOs.

¹¹⁹ *ibid* introducing amendment of Annex IX of the CRD.

¹²⁰ See Directive 2006/48/EC Annex X, pt 4, Point 6, Table 1 for the Standardised Approach (‘SA’) and Point 46, Table 4 for the Internal Ratings Based Approach (‘IRBA’). For mapping see Committee of European Banking Supervisors (‘CEBS’), ‘Standardised Approach: Mapping of ECAIs’ credit assessments to Credit Quality Steps’ (2006) <https://eba.europa.eu/sites/default/documents/files/documents/10180/16166/9b891d16-3bf0-4c39-8f6d-82b9cbf49788/4%20August%202006_Mapping.pdf?retry=1> accessed 16 March 2021.

¹²¹ CRD III introducing amendment to Annex VII, Part 4, Table 1 of the CRD.

¹²² See Directive 2006/48/EC Annex IX, pt 4, Point 6, Table 1 for the SA and Point 46, Table 4 for the IRBA. For mapping see CEBS (n 120).

¹²³ CRD III introducing amendment to Annex VII, pt 4, Table 1 of the CRD. See also Ng (n 106) 271.

¹²⁴ Directive 2006/48/EC art 95.

¹²⁵ *ibid* art 101.

¹²⁶ Ng (n 106) 273; cf CRD III Recital 33.

¹²⁷ EBF (n 101) 4.

to investors.¹²⁸ In addition, insurance and reinsurance undertakings that held securitisation positions as investments were required to conduct extensive due diligence concerning compliance with the new risk retention rule,¹²⁹ perform periodical stress tests to assess their securitisation positions,¹³⁰ and establish ongoing monitoring procedures for their investments.¹³¹

So far as capital requirements for investing insurance and reinsurance undertakings were concerned, the Solvency II regime introduced capital requirements for spread risk¹³² on securitisation positions, distinguishing between Type 1 securitisations, Type 2 securitisations, and re-securitisations.¹³³ It has been calculated that under this regime a three-year Type 1 securitisation of the highest quality would have a spread risk of 6.3%, whereas a Type 2 securitisation of the same maturity and quality would have a spread risk of 37.5%. By way of comparison, a three-year top-tier corporate bond would have a spread risk of just 2.7%.¹³⁴

Finally, with regard to the position of AIFMs, the Alternate Investment Fund Managers Directive ('AIFMD') also introduced an identical 5% risk retention rule as a condition to any investment made by a regulated AIFM.¹³⁵ As with the CRD II and Solvency II regimes, the 5% risk retention was also required to be disclosed by the originator/sponsor/original lender to the AIFM¹³⁶ and fund managers were required to conduct due diligence regarding the sponsor and originator of the securitisation,¹³⁷ be able to demonstrate for each of their securitisation positions that they had a 'comprehensive and thorough understanding' of a number of issues, and had implemented 'formal policies and procedures' to analyse and record such issues.¹³⁸

The Second Wave of Regulation: CRR¹³⁹

It is important to note that the regulatory regime implemented post the GFC via Basel III¹⁴⁰ (introduced in phases from 2010 onwards),¹⁴¹ retained the framework for securitisation

¹²⁸ Solvency II art 135(2) and Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) [2015] OJ L12/1 (hereinafter Delegated Regulation 2015/35) arts 254-255.

¹²⁹ Delegated Regulation 2015/35 art 256 paras 2-3.

¹³⁰ *ibid* art 256 para 6.

¹³¹ *ibid* art 256 para 4.

¹³² Spread risk, a sub-category of market risk, is defined in Solvency II art 105(5)(d) as 'the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of credit spreads over the risk-free interest rate term structure'.

¹³³ The distinction between Type 1 and 2 is based on a number of credit, structural, and rating criteria, with securitisations not meeting them classified as Type 2, see Delegated Regulation 2015/35 art 177 paras 1-3. See also Raines (n 4) 547.

¹³⁴ Raines (n 4) 547; Delegated Regulation 2015/35 arts 176 para 3, and 178 paras 1-2.

¹³⁵ AIFMD art 17 and Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision [2013] OJ L83/1 (hereinafter Delegated Regulation 231/2013) art 51.

¹³⁶ Delegated Regulation 231/2013 art 51 para 1.

¹³⁷ *ibid* art 52.

¹³⁸ *ibid* art 53.

¹³⁹ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1 (hereinafter CRR).

¹⁴⁰ Basel Committee on Banking Supervision, 'Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems' (rev June 2011, Basel: BIS 2010), <<http://www.bis.org/publ/bcbs189.pdf>> accessed 16 March 2021.

¹⁴¹ Chiu (n 13) 372.

contained in Basel II, as reformed via Basel 2.5.¹⁴² Similarly, the CRR that implemented Basel III into EU law regarding securitisation, retained, by and large, the securitisation framework introduced in the CRD (Directive 2006/48/EC), as revised via CRD II and CRD III, with only minor tweaks.¹⁴³ Specifically, the CRR maintained the key concepts of ‘significant risk transfer’¹⁴⁴ and the prohibition of implicit support on behalf of originators and sponsors,¹⁴⁵ and the ‘market regulation toolkit’ introduced via CRD II.¹⁴⁶ It also maintained the revised risk weighting regime for securitisation and re-securitisation positions.¹⁴⁷

So far as the changes introduced via the CRR are concerned, arguably the most significant was the use of a Regulation (as opposed to Directives which was the previous approach), as the means for implementing the securitisation framework into EU law. That change reinforced how seriously the European regulator considered the matter and ensured the new securitisation framework would be implemented throughout the EU in a more direct and harmonised fashion and reduced the risks associated with national implementation.¹⁴⁸

The inclusion of investment firms within the scope of the new risk retention rules, due diligence requirements, and related penalties,¹⁴⁹ was a significant feature of the new regulatory regime, as was the move to require banks and other regulated investors to rely more on their own analysis of the risks in investing in securitisation products rather than relying on external credit ratings which was considered another significant contributory factor to the GFC.¹⁵⁰

The new CRR regime included two other very important new features to the regulatory framework of securitisation which focussed on the liquidity coverage ratio (‘**LCR**’) and rules for collateral for credit risk mitigation.¹⁵¹

In the context of LCR, the CRR included securitisations in the list of eligible assets that could be used by credit institutions and investment firms to form a ‘liquidity buffer’ that was required to adequately cover any potential imbalance between liquidity inflows and outflows under gravely stressed conditions for a 30-day period.¹⁵² However, investments in securitisation products were only eligible as Level 2B assets and even then, only if they were AAA rated, were backed by a pool of homogeneous assets such as residential loans, auto loans, consumer loans etc., and satisfied certain other conditions.¹⁵³

¹⁴² Basel III para 12. When Basel III was published in 2010, the Basel Committee on Banking Supervision (‘**BCBS**’) was conducting a ‘more fundamental review of the securitisation framework, including its reliance on external ratings’, see Basel III para 15. This review led to the 2014 publication of BCBS’s final revision to the Basel securitisation framework, referred to by the BCBS as the ‘Basel III securitisation framework’. This final revision has since been updated in 2016, and again in 2017.

¹⁴³ Allen & Overy, ‘Capital Requirements Directive IV Framework. The Securitisation Framework’ (2014) 7 Allen & Overy Client Briefing Paper 3.

¹⁴⁴ CRR arts 243-245.

¹⁴⁵ *ibid* art 248.

¹⁴⁶ See CRR arts 405 (risk retention); 406 (due diligence); 408 (common approach for assets in the banking book and assets in the trading book); 409 (disclosure); and 449 (‘pillar 3’ disclosure).

¹⁴⁷ *ibid* arts 251ff.

¹⁴⁸ Allen & Overy (n 143) 3.

¹⁴⁹ The CRD II referred to credit institutions regarding risk retention, due diligence, and penalties. In the CRR the word ‘credit’ has been omitted from arts 405 (risk retention); 406 (due diligence); and 407 (penalties).

¹⁵⁰ Allen & Overy (n 143) 4. More detailed due diligence requirements and procedures were introduced via Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk [2014] OJ L174/16.

¹⁵¹ See Raines (n 4) 548-549 for further analysis.

¹⁵² CRR art 412 and Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions [2014] OJ L174/16 (hereinafter Delegated Regulation 2015/61) art 12.

¹⁵³ Delegated Regulation 2015/61 art 13 para 2(g).

All re-securitisations and synthetic securitisations were by definition excluded from the list of eligible assets.¹⁵⁴ It is noteworthy that even eligible securitisations were subject to heavy haircuts (minimum 25% haircut for securitisations backed by residential loans, and auto loans and leases, and minimum 35% haircut for securitisations backed by SME-heavy loans and loans and credit facilities to individuals resident in a Member State for personal, family or household consumption purposes).¹⁵⁵ By way of comparison, Type 1 assets such as ‘extremely high quality’ covered bonds, that had hitherto been viewed largely consistently with AAA rated RMBS products, and Type 2A assets, which included certain top-rated corporate debt securities that met certain requirements were subject to a much lower haircut of at least 7%¹⁵⁶.

On credit risk mitigation, the CRR stipulated that securitisation products could only be used as ‘eligible collateral’, if they were not re-securitisations, were rated as CQS 3 or above, and subject to risk weights that were significantly higher compared to risk weights for top-rated corporate issuers.¹⁵⁷

Overall Assessment of the Initial Regulatory Response

The initial regulatory response can be characterised as a desire by the regulator to be seen to be addressing the conventionally perceived problem as quickly as possible. Since that conventional perception was, at best, misconceived, it is not surprising the resulting regulatory framework was largely miscalibrated. Perhaps more significantly in light of the economic challenges facing Europe in the aftermath of the GFC, specifically the dire state of the banking sector and its ability to finance the needs of the real economy, particularly SMEs, the approach resulted in the regulator failing to differentiate between those securitisation transactions which had not been a significant contributor to the crisis, which had in fact continued to perform very well throughout the crisis, and which were entered into for entirely appropriate commercial reasons, to finance the real economy and as an effective regulatory balance sheet tool, and those entered into purely for arbitrage reasons.

Taking first the approach taken to tackle perceived perverse incentives via risk retention, due diligence, and disclosure rules, this was, at best, wide of the mark.

As we have already stated, regulated credit institutions typically retained a significant amount of risk, either in their capacity as originators/sponsors (eg by overcollateralising their securitisations), or as investors, prior to the GFC. Bearing in mind European securitisation did not suffer significant credit losses, the imposition of a risk retention rule for all transactions aimed at forcing regulated credit institutions, insurers and AIFMs to retain part of the credit risk for the entire term of the transaction was an unbalanced response aimed at addressing a problem which was not as significant as suggested.

With regard to the imposition of ongoing due diligence obligations on investors, their extended scope and high-cost implications were deemed potential roadblocks to re-securitisations, rendering them simply too expensive or impractical to establish.¹⁵⁸ In addition, to the extent investors performed similar due diligence in securitisations even prior to the GFC, these obligations were considered as ‘paternalistic and unnecessary’.¹⁵⁹

In similar vein, the effectiveness of the new disclosure regime is questionable: It could be argued that prior to the crisis, the relevant risks in the vast majority of securitisation transactions were fully disclosed to investors via the detailed information included in the securities offering

¹⁵⁴ *ibid* art 13 para 2(h).

¹⁵⁵ *ibid* art 13 paras 2(g) and 14.

¹⁵⁶ *ibid* art 10 para 2 and art 11 para 2.

¹⁵⁷ CRR arts 194 para 3, 197 para 1(h), and 224, Tables 1 and 2. See also Raines (n 4) 549.

¹⁵⁸ Ng (n 106) 270-271.

¹⁵⁹ Schwarcz Post-Crisis (n 75) 129.

documentation, specifically the relevant prospectus. However, as we have indicated, in a number of transactions, particularly in the CDO market, investors were often primarily focussed on the ratings of the relevant securities and the arbitrage opportunities those ratings afforded.¹⁶⁰

Finally, the requirement for originators to apply the same criteria for credit granting both to assets that would be kept in the banking book and to assets that would be securitised indicates an overly simplistic view of the business of banking and the way in which the financial markets operate. By effectively forcing banks to conduct only one type of business, the regulator fails to recognise that different assets, each with its own risk profile, are more or less attractive to different types of investors who will have a different risk appetite. It also fails to recognise that originating loans with the purpose of refinancing them via ‘distribution’ in a securitisation is not socially problematic per se, provided the proceeds from the relevant securitisation are then channelled to the real economy.

Notwithstanding the strength of the conventional narrative, there was much from the existing regulatory regime that remained unaffected by the new framework. The risk weights for securitisation positions held by credit institutions remained at their pre-GFC levels, despite the fact that those risk weights were considered by the regulator to be ‘excessively low...for highly-rated securitisation tranches and, conversely, excessively high...for low-rated tranches’, only a few years later.¹⁶¹ More significantly, the first phase of the post-GFC regulation of securitisation made no distinction between those transactions which were used for perfectly legitimate regulatory balance sheet purposes, and which provided much needed funding for the real economy, and which continued to perform very well throughout the GFC, and more complex products that were entered into primarily for arbitrage purposes. Instead, the regulator opted for a collective dismissal of all forms of securitisation as a toxic waste worthy of punitive regulatory treatment.

This punitive, one size fits all, approach by the regulator and its perception of securitisation as an ‘intrinsically dangerous financing technique’¹⁶² is further illustrated by the regulator’s crack down on re-securitisation and the ‘penal requirements’¹⁶³ applied to it. This is more apparent, if one takes into account that, once again, no distinction was ever made between re-securitisations the proceeds of which were used to finance the real economy, and re-securitisations that were used to facilitate arbitrage. All re-securitisations were bundled together and considered to be inherently problematic.

The regulator’s perception is also evident when one compares the treatment of securitisation in this regulatory framework with other financial instruments. As previously mentioned, securitisation products eligible to be included in the liquidity buffer of the LCR were subject to haircuts that were significantly greater than those applied to comparable financial products such as covered bonds and type 2A assets (25% and 35% > 7% and 15%). In addition, under Solvency II the spread risk for securitisation products held by insurance and reinsurance undertakings was very high compared to the spread risk applied corporate bonds with the same characteristics (6.3% and 37.5% > 2.7%). Finally, whereas corporate debt rated as BB+ to BB- would attract under the CRD and the CRR a risk weight of 100%,¹⁶⁴ securities issued as part of a securitisation transaction which enjoyed the same rating attracted punitive risk weightings of 250-650% using the same approach.¹⁶⁵

¹⁶⁰ Schwarcz Secured Transactions (n 56) 58-59.

¹⁶¹ Regulation 2017/2401 Recital 3.

¹⁶² Raines (n 4) 535.

¹⁶³ Paterson Introductory (n 49) 98.

¹⁶⁴ Directive 2006/48/EC Annex VI, Point 7, Table 6; CRR art 122. For mapping see CEBS (n 120).

¹⁶⁵ Chiu (n 13) 360.

In light of the economic challenges facing Europe in the aftermath of the GFC, specifically the dire state of the banking sector and its ability to finance the needs of the real economy, particularly SMEs, the effect of this punitive regulatory approach on the European securitisation market was devastating. Large parts of the market ceased to exist and in those parts that survived issuance volumes were reduced to a fraction of pre-GFC levels. It would take years before the regulator fully understood the importance of securitisation to provide funding to the real economy, especially in the context of the low-growth and cautious lending environment that followed the GFC. At precisely the time funding for the real economy was most needed, a key source was all but wiped out.

PART III. THE MOVE TOWARDS A MORE ACCEPTING PHASE OF REGULATION

The Regulator Gives its Qualified Support

Despite the European regulator's claim that 'Following the US subprime crisis in 2007-08, public authorities took a number of steps to make securitisation transactions safer and simpler',¹⁶⁶ the reality is that at the European level the steps taken by the regulator all but closed the market. It was a number of years, during which much lobbying was undertaken by market participants, the European Central Bank ('ECB') and the European Banking Authority ('EBA'), before the regulator was willing to reconsider its stance.

It is well recognised that the ECB supported securitisation long before the GFC,¹⁶⁷ and remained a firm proponent of the technique even during the height of the crisis when it was considered 'toxic waste' by regulators and investors alike.¹⁶⁸ With the central bank continuing to support securitisation, industry bodies became increasingly vocal in their demand for the adoption of a new approach,¹⁶⁹ and eventually the EC was persuaded to seek advice from the EBA on how to treat securitisation.¹⁷⁰ The EBA gave its blessing,¹⁷¹ and the EU regulator finally provided its qualified support recognising the importance of securitisation and acknowledging that it has the potential to support the wider European economy, by functioning 'as a bridge between credit institutions and capital markets with an indirect benefit for businesses and citizens...and provide relevant investors with exposure to asset classes decoupled from the credit risk of the originator.'¹⁷² Indeed, the rehabilitation process was so significant that securitisation became a cornerstone of the Capital Markets Union.¹⁷³

Notwithstanding the regulator's apparent change of heart, it was not accompanied by a corresponding change in its regulatory stance on the conventional narrative. That much was clear from statements made in 2014 to the effect that reviving securitisation in Europe only makes sense if the mistakes of the past can be avoided,¹⁷⁴ that is, make sure the perverse

¹⁶⁶ European Commission STS Proposal (n 84) Explanatory Memorandum 2.

¹⁶⁷ Since 2000 the ECB has been including securitisation products into its collateral-eligibility framework, see Braun (n 40) 12.

¹⁶⁸ As noted by Braun (n 40) 14, ECB officials were actively promoting securitisation in 2010, when even investors were still suspicious of the technique. As he claims (Braun (n 40) 15), 'no other public agency has done more for the European securitization market than the ECB'.

¹⁶⁹ Kastelein (n 41) 468.

¹⁷⁰ Braun (n 40) 16.

¹⁷¹ EBA, 'Report on Qualifying Securitisation. Response to the Commission's Call for Advice of January 2014 on Long-Term Financing' (July 2015) (hereinafter EBA Report on Qualifying Securitisation).

¹⁷² European Commission STS Proposal (n 84) Explanatory Memorandum 2.

¹⁷³ Aikaterini Lagaria, *EU Capital Markets: A Constantly Changing Regulatory Framework* (Nomiki Vivliothiki 2017) 319.

¹⁷⁴ European Commission, 'An Investment Plan for Europe' (2014) 15.

incentives of the OTD model do not resurface and complexity remains curbed. The regulator's change of stance can be characterised as one of cautious and qualified acceptance of certain aspects of the technique coupled with a pragmatic recognition of the challenges facing banks in providing the funds necessary to lend to the real economy.

The New Securitisation Framework

In order to achieve its goal of reviving securitisation and leveraging it to support the real economy, the European regulator introduced two Regulations which, when taken together, form a legislative package governing securitisation.¹⁷⁵ The first Regulation (2017/2402) built on the work of the joint task force established by the BCBS and the International Organization of Securities Commissions ('IOSCO') to identify the reasons that were hindering the re-emergence of securitisation markets following the GFC, introduce new supervision rules, and develop specific eligibility criteria 'for identifying simple, transparent and comparable [standardised] ('STS') securitisations'.¹⁷⁶ This Regulation also drew from the earlier work of the joint ECB/BOE discussion paper¹⁷⁷ and the EBA discussion paper¹⁷⁸, and aimed at recalibrating the market-based rules aligning the interests of originators, investors, and borrowers, and make them applicable across all financial sectors.

The second Regulation (2017/2401) builds on the proposals developed by the BCBS¹⁷⁹ to amend the regulatory capital treatment of securitisation positions, and the recommendations of the EBA¹⁸⁰ to introduce a tailor-made, more risk-sensitive microprudential treatment for STS securitisations.¹⁸¹

Despite their distinct aims, these two Regulations, which came into force in January 2019 form a comprehensive legislative package, with STS securitisation functioning as the connecting link between the two.¹⁸² In the EC's view, creating a substantial framework for simple, transparent and standardised securitisation products would not suffice; in order for securitisation to achieve the wider goals set by the regulator, these products also needed to be promoted in terms of their micro-prudential treatment.¹⁸³

This approach highlights the conflict that characterises the new framework: It includes a somewhat novel, more positive approach towards securitisation, whilst at the same time remaining rooted in aspects of the previous punitive regulatory approach (reflected, for example, by the rules that aim at aligning the interests of the various parties to a securitisation). This conflict in approach, disappointing as it is, will have surprised few market participants and is consistent with various statements made by various EU authorities at the time. A publication by the European Parliamentary Research Service ('EPRS') in October 2015 describing the EC's new legislative proposals is a good example. On its cover a stick of

¹⁷⁵ European Commission, 'Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms' COM (2015) 473 final (hereinafter Proposal Amending CRR 2015) Explanatory Memorandum 2.

¹⁷⁶ The concept of STS securitisation refers to the procedure by which these simple, transparent and standardised products are structured, see European Commission STS Proposal (n 84) Explanatory Memorandum 3-4.

¹⁷⁷ ECB and BoE, 'The Case for a Better Functioning Securitisation Market in the European Union' (May 2014).

¹⁷⁸ EBA Report on Qualifying Securitisation (n 171).

¹⁷⁹ See n 142. See also Kastelein (n 41) 481.

¹⁸⁰ EBA Report on Qualifying Securitisation (n 171).

¹⁸¹ Regulation 2017/2401 deletes pt Five (arts 404-410) of the CRR and all references to pt Five shall henceforth be read as references to ch 2 (arts 5-9) of Regulation 2017/2402. The only exception is art 407 that becomes art 270a in the (amended) CRR. In addition, arts 242-270 of the CRR are replaced.

¹⁸² European Commission STS Proposal (n 84) Explanatory Memorandum 9.

¹⁸³ European Commission Proposal Amending CRR 2015 (n 175) Explanatory Memorandum 7.

dynamite labelled AAA is about to explode.¹⁸⁴ Almost a decade after the start of the GFC the European regulator was unable to view securitisation as anything other than a disaster waiting to happen again.

Towards a More Positive Regulatory Approach

Focussing first on the positives that come from the new securitisation framework, it seeks to recalibrate the regulatory capital requirements for securitisation positions and, most importantly, recognises the crucial distinction between simple structures that performed well in Europe, and some of the more complex products that undoubtedly contributed to the crisis.

With regard to the recalibration of capital requirements, Regulation 2017/2401 focusses on credit institutions and investment firms,¹⁸⁵ and seeks to address the problems that stemmed from the assignment of ‘excessively low risk weights for highly-rated securitisation tranches and, conversely, excessively high risk weights for low-rated tranches’.¹⁸⁶

The new Regulation assigns, indicatively, a risk weight of 15-20% for senior tranches of AAA rated securitisations, depending on the approach and the credit assessment (short-term or long-term), whereas non-senior tranches can attract a risk weight up to 70%.¹⁸⁷ Compared to the 7-20% risk weight assigned to AAA securitisations under the previous regime, it is evident that the new regulation treats highly-rated tranches more strictly. At the opposite end of the credit spectrum, tranches rated BB+ to BB- attract a risk weight of 1250% (short-term credit assessment) or 140-225% (long-term credit assessment), whereas non-senior tranches attract a risk weight of 470-860% (long-term credit assessment).¹⁸⁸ Although this is an overall increase over the previous framework which assigned a risk weight of 250-650% depending on the approach, the weight floor for BB+ and BB- securitisations is now significantly lower.

Undoubtedly the most important achievement of the new securitisation framework however is the introduction of a distinct regulatory framework for STS securitisations. This framework is set out in Chapter 4 (Articles 18-28) of Regulation 2017/2402. Products that satisfy the requirements set out in this Chapter can qualify for the important ‘STS’ kitemark.¹⁸⁹

So far as non-ABCP securitisations are concerned, the ‘simplicity’ requirements include a ‘true sale’ of the underlying assets to the SPV and an absence of severe clawback provisions regarding title to the assets. The assets must not be encumbered or otherwise in a condition that can be foreseen to adversely affect the enforceability of the ‘true sale’ they are required to satisfy. They are also required to meet predetermined and documented eligibility criteria which must not permit active portfolio management of the exposures on a discretionary basis. The asset pool must also possess a certain level of homogeneity in terms of asset type, it cannot include securitisation positions and repayment to the investors must not depend (predominantly) on the sale of assets that have been included in the securitisation pool.¹⁹⁰

¹⁸⁴ European Parliament Research Service Understanding Securitisation (n 58).

¹⁸⁵ According to CRR art 2 ‘institution’ means a credit institution or an investment firm. This definition remains intact in the new securitisation framework.

¹⁸⁶ Regulation 2017/2401 Recital 3.

¹⁸⁷ See Regulation 2017/2401 art 259 for calculations under the Internal Ratings-Based Approach (‘**SEC-IRBA**’) and art 263 for calculations under the External Ratings-Based Approach (‘**SEC-ERBA**’). For mapping see Commission Implementing Regulation (EU) 2016/1801 of 11 October 2016 on laying down implementing technical standards with regard to the mapping of credit assessments of external credit assessment institutions for securitisation in accordance with Regulation (EU) No 575/2013 of the European Parliament and of the Council [2016] OJ L275/27 (hereinafter Implementing Regulation 2016/1801) Annex II.

¹⁸⁸ *ibid.*

¹⁸⁹ Regulation 2017/2402 art 19. For an analysis of these requirements see Schwarcz Post-Crisis (n 75) 122-123.

¹⁹⁰ Regulation 2017/2402 art 20. This effectively excludes CMBS structures.

The ‘standardisation’ requirements refer, *inter alia*, to the need for the originator, sponsor or original lender to have satisfied the 5% risk retention requirements provided for in Article 6 of Regulation 2017/2402. In addition, interest rate and currency risks must be hedged, but derivatives cannot be utilised for any other purpose. Standardisation requirements also include rules regarding priorities, enforcement, and the contents of the transaction documentation.¹⁹¹

The ‘transparency’ requirements include an obligation on the part of the originator or sponsor to make available to the investors data regarding the historic default and loss performance of assets that are substantially similar to those included in the pool, to subject a sample of the underlying assets to external verification and make available to potential investors a liability cash flow model.¹⁹²

For regulatory (micro-prudential) purposes, securitisations that qualify as STS are given preferential capital treatment, provided they fulfil a number of additional requirements set out in the new Article 243 of the CRR, introduced by Regulation 2017/2401.¹⁹³ These include¹⁹⁴ a limit regarding exposures to a single obligor, maximum risk weights for assets included in the pool, and an obligation to include loans with higher ranking security rights in the asset pool, in order for loans with lower ranking security rights to become eligible as collateral.¹⁹⁵

If the requirements of both Regulation 2017/2401 and Regulation 2017/2402 are met, AAA rated STS securitisations attract under the SEC-ERBA a risk weight of 10% (in short-term credit assessment, and long-term credit assessment in the case of senior tranches), whereas non-senior tranches are assigned a risk weight of up to 40%. BB+ and BB- rated STS securitisations attract a risk weight of 1250% (short-term) and 120-195% (long-term in the case of senior tranches). Non-senior tranches attract a risk weight of 405-740%.¹⁹⁶ Under the SEC-IRBA and the Standardised Approach (‘SEC-SA’), STS securitisations are assigned a risk weight floor of 10%.¹⁹⁷

Aware that capital relief is vital not only for credit institutions and investment firms, but also for many institutional investors,¹⁹⁸ the EC has also expanded its STS preferential capital treatment to insurance and reinsurance undertakings.¹⁹⁹ The distinction made in the Solvency II framework between Type 1 and Type 2 securitisations no longer applies, and the crucial distinction is now between STS and non-STS securitisations.²⁰⁰

Caution Remains

¹⁹¹ *ibid* art 21.

¹⁹² *ibid* art 22.

¹⁹³ Kastelein (n 41) 481.

¹⁹⁴ So far as non-ABCP securitisations are concerned.

¹⁹⁵ Regulation 2017/2401 replacing art 243 of the CRR.

¹⁹⁶ *ibid* replacing art 264 of the CRR. For mapping see Implementing Regulation 2016/1801 Annex II.

¹⁹⁷ *ibid* replacing arts 260 and 262 of the CRR respectively.

¹⁹⁸ Norton Rose Fulbright, ‘Securitisation framework: Ten things you need to know’ (April 2018)

<<https://www.nortonrosefulbright.com/en/knowledge/publications/20c69602/securitisation-framework-ten-things-you-need-to-know>> accessed 16 March 2021.

¹⁹⁹ It is noteworthy that the EC has not expanded its STS capital relief to pension funds. Pension schemes were after all excluded from the scope of Solvency II, despite relevant talks, see Lexisnexis, ‘Solvency II and Pensions Practice Note’ <<https://www.lexisnexis.co.uk/legal/guidance/solvency-ii-and-pensions>> accessed 16 March 2021.

²⁰⁰ See Commission Delegated Regulation (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertakings [2018] OJ L227/1 (hereinafter Delegated Regulation 2018/1221) introducing amendment to art 178 of Delegated Regulation 2015/35.

The new securitisation framework is not completely new, it retains many of the previous regime's punitive aspects, for example the rules seeking to prevent 'perverse incentives' are reinforced, as is the effort to discourage market participants creating complex securitisation products and/or investing in them.

With regard to perverse incentives stemming from the OTD model, the new framework does not stray far from its predecessors:²⁰¹ The market regulation toolkit aimed at aligning the interests of originators, investors, and borrowers is recalibrated and reintroduced via Regulation 2017/2402.²⁰² The previously fragmented 'hodge-podge' of regulation²⁰³ that spread risk retention, due diligence, and disclosure requirements over a number of different pieces of legislation, depending on the type of the institution that held securitisation positions²⁰⁴ is now replaced by a collective set of rules that apply to 'institutional investors'²⁰⁵ in general.²⁰⁶

The new regime includes expanded due diligence obligations, both pre- and post-closing,²⁰⁷ and a 5% risk retention rule²⁰⁸ (now stipulated as a direct obligation of the originator, sponsor or original lender).²⁰⁹ Transparency/disclosure requirements are also reinforced. Originators, sponsors and SPVs are now obliged to disclose significantly more information, not just to potential investors, but also to the competent authorities.²¹⁰ Originators, sponsors and original lenders continue to be obliged to apply the same criteria for credit granting to assets (ie loans) that would then be used as collateral, as they do for assets that they intend to keep in their banking books.²¹¹

On the issue of complexity, the new framework intensifies the effort to discourage market participants from creating complex securitisation products and/or investing in them.²¹² This stance is reflected in a number of provisions. For example, Article 20 of Regulation 2017/2402 provides that 'true sale' securitisations can qualify as STS,²¹³ but effectively excludes commercial mortgage-backed security ('**CMBS**') products (even if structured as a 'true sale')²¹⁴ because it deems them as too complex and vulnerable.²¹⁵ Most importantly, by limiting the STS kitemark only to transactions based on a 'true sale', the regulator excluded (at least initially) all types of synthetic securitisations because, in its view, they introduce 'an additional

²⁰¹ Regulation 2017/2402 Recital 28.

²⁰² *ibid* ch 2 (arts 5-9).

²⁰³ Schwarcz Post-Crisis (n 75) 121.

²⁰⁴ See pt II.

²⁰⁵ Regulation 2017/2402 art 2.

²⁰⁶ For the list of provisions of the previous regime that referred to risk retention, due diligence, and disclosure, and are now being replaced see Rupert Wall, Rachpal K. Thind and Kai Zhang, 'Securitisation: Regulatory Framework and Reforms' (2019) 14.

²⁰⁷ Regulation 2017/2402 art 5.

²⁰⁸ That would have been equal to 20% if the European Parliament's proposal had been accepted, see European Parliament Report on the Proposal for a Regulation (n 112).

²⁰⁹ Regulation 2017/2402 art 6.

²¹⁰ *ibid* arts 7, 29.

²¹¹ *ibid* art 9.

²¹² European Commission STS Proposal (n 84) Explanatory Memorandum 3-4; Schwarcz Ten Years (n 59) 764.

²¹³ Regulation 2017/2402 art 20 para 1; Kastelein (n 41) 472.

²¹⁴ *ibid* art 20 para 13, according to which the repayment of the investors must not depend (predominantly) on the sale of assets that have been included in the securitisation pool. This provision aims clearly at excluding CMBS.

²¹⁵ *cf* Regulation 2017/2402 Recital 29. This is a reflection of the EBA's stance regarding CMBS as illustrated in its 2015 Report on Qualifying Securitisation (n 171). Interestingly, according to the data provided by the EBA, in the years 2001-2010 European CMBS experienced relatively low default rates, especially within the AAA segment (below 2%), see EBA Report on Qualifying Securitisation (n 171) 11-12. On the other hand, for the period 2007-2014, compared to other securitisation products (except for ABS-backed CDOs), the default rates and downgrades for CMBS were clearly higher, see S&P 2014 (n 80) 3, Table 1.

counterparty credit risk and potential complexity related in particular to the content of the contract'.²¹⁶ Interestingly, the EC did allow senior positions in SME balance sheet synthetic securitisations that have been retained by the originator to receive the preferential capital treatment of STS securitisations, provided the credit risk associated with the positions not retained by the originator is transferred to specific types of third-parties using a guarantee or counter-guarantee (and not derivatives) as credit protection mechanism.²¹⁷

Evidence of the ongoing punitive approach is also evident in the way the new framework treats re-securitisation: Article 20 of Regulation 2017/2402 prohibits the inclusion of securitisation positions in the pool of underlying assets,²¹⁸ so that re-securitisations cannot qualify as STS. In addition, instead of 'merely' punishing structured finance-backed CDOs and other similar products, by imposing risk weights that are higher as provided under the previous regimes,²¹⁹ Article 8 of Regulation 2017/2402 introduces a (qualified) ban on re-securitisations. The approach is justified on the basis that they 'could hinder the level of transparency that this Regulation seeks to establish'.²²⁰ Henceforth re-securitisations are only allowed if they serve 'legitimate purposes'.²²¹

Overall Assessment of the New Framework

The second phase of post-GFC regulation of securitisation in Europe, which could be characterised as indicating a qualified acceptance of the technique, is undoubtedly a step in the right direction. The regulator is no longer preoccupied solely with punishing the technique and although the new framework fails to match the rhetoric (the Securitisation Regulation aims explicitly at restarting the European securitisation market that has remained subdued since the beginning of the crisis),²²² it does suggest the regulator is prepared to adopt a more objective approach.

After spending a decade implementing punitive policies that prevented a meaningful recalibration of the market, certainly outside the area of RMBS, following the GFC,²²³ officials appear finally to be making a conscious effort to engage with market participants in order successfully to rebrand securitisation. To that end, simple and transparent structures are now being promoted and the regulator appears finally to have recognised securitisation is a spectrum capable of producing quite different financial products. However, it is apparent aspects of its

²¹⁶ European Commission STS Proposal (n 84) Explanatory Memorandum 15. It must be noted that, unlike 'true sale', synthetic structures were not supported by any EU Authority during the discussions for the finalisation of the Securitisation Regulation, with the ECB and the European Parliament being the most critical, see ECB, 'Opinion of the European Central Bank of 11 March 2016 on (a) a Proposal for a Regulation Laying Down Common Rules on Securitisation and Creating a European Framework for Simple, Transparent and Standardised Securitisation; and (b) a Proposal for a Regulation Amending Regulation (EU) No 575/2013 on Prudential Requirements for Credit Institutions and Investment Firms' (11 March 2016) 8; and European Parliament Report on the Proposal for a Regulation (n 111) 10-11. On the other hand, in its Report on Synthetic 2015 (n 85) 5-6, the EBA regarded the expansion of the STS framework to synthetics as 'too premature at this stage'.

²¹⁷ CRR art 270, introduced via Regulation 2017/2401. In that regard, the EBA was indeed supportive, since it recommended extending the scope of the preferential capital treatment to encompass a broader range of synthetics, see EBA Report on Synthetic 2015 (n 86) 55.

²¹⁸ Regulation 2017/2402 art 20 para 9.

²¹⁹ See pt II.

²²⁰ Regulation 2017/2402 Recital 8.

²²¹ *ibid* art 8; Raines (n 4) 542.

²²² European Commission STS Proposal (n 84) Explanatory Memorandum 3.

²²³ Kastelein (n 41) 467-468.

previous punitive approach remain and some important market representations continue to be ignored²²⁴.

The market-based regulatory toolkit that aims at aligning the interests of originators, investors, and borrowers remains intact and reinforced in places, making our critique about it being unnecessary, costly, and potentially dangerous even more relevant. The new framework's harsher stance towards complexity is equally troubling: Notwithstanding arguments that the regime does not prohibit innovation and experimentation,²²⁵ it certainly imposes artificial barriers that will make all types of financial innovation more challenging. The distinction between innovation and complexity is not always clear, and the regulator has evidenced its inability effectively to distinguish between the two.

Although officially the regulator has lessened some of its punishing of securitisation, traits of the adverse treatment of the technique vis-à-vis other financial products, a characteristic of the previous regimes, can still be found in the current framework.

Preferential capital treatment has been extended to insurance and reinsurance undertakings, and the spread risk for STS securitisations is evidently lower compared to the spread risk of Type 1 and Type 2 securitisations of the previous regime.²²⁶ Nevertheless, corporate bonds of the same quality and maturity are still treated as less dangerous, attracting a lower spread risk.²²⁷ In addition, although STS securitisations have been included in the LCR regime of the CRR and only STS securitisations can henceforth qualify as Level 2B assets,²²⁸ the level of haircut remains the same, that is, significantly higher than the haircut imposed on other debt instruments such as covered bonds and top-rated corporate debt securities.²²⁹

Finally, under the new framework the risk weights assigned to securitisations used as eligible collateral for credit risk mitigation purposes remain intact and thus higher than risk weights for top-rated corporate issuers.²³⁰ The same holds true for the haircuts imposed on securitisations that are used as collateral in non-centrally cleared OTC derivative contracts: They remain twice as high than the haircuts imposed on corporate bonds and central government bonds of the same quality and maturity.²³¹

And some of the novel provisions of the new securitisation framework are not completely free from controversy. The recalibration of risk weights for securitisation positions held by credit institutions and investment firms was necessary to address problems in the previous regime that was both extremely lenient and extremely harsh at turns. Nevertheless, Regulation 2017/2401 increases the risk weight floor for all non-STS securitisation positions by more than

²²⁴ One of the most recent examples being the introduction of a new capital charge for synthetic excess spread in respect of the proposed STS framework for on-balance sheet synthetic securitisations which was included in the EC's final 'Capital Markets Recovery Package' proposals published on 16 December 2020.

²²⁵ Schwarcz Post-Crisis (n 75) 134-135.

²²⁶ Delegated Regulation 2018/1221 introducing amendment to art 178 of Delegated Regulation 2015/35. A senior three-year top tier STS securitisation will have a spread risk of 3%, whereas Type 1 and Type 2 securitisations of the same quality and maturity would be assigned a spread of 6.3% and 37.5% respectively under the previous regime.

²²⁷ A three-year top-tier corporate bond will be assigned a spread risk of 2.7%. See Raines (n 4) 547.

²²⁸ Commission Delegated Regulation (EU) 2018/1620 of 13 July 2018 amending Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for credit institutions [2018] OJ L271/10 (hereinafter Delegated Regulation 2018/1620) introducing amendment to art 13 para 1 of Delegated Regulation 2015/61.

²²⁹ Delegated Regulation 2015/61 art 13 para 14. STS securitisations will have a minimum haircut of either 25% or 35%, depending on the assets included in their pool, whereas Type 1 assets such as 'extremely high quality' covered bonds are subject to a haircut of at least 7%, whereas Type 2A assets are subject to a haircut of at least 15%. See Raines (n 4) 548.

²³⁰ CRR art 224, Tables 1 and 2.

²³¹ Raines (n 4) 546.

100% compared to the position that applied under the CRR.²³² Even for STS securitisations, despite the fact that the reduction in risk weights that has been achieved is no less than 25% compared to capital surcharges for non-STs securitisations,²³³ the new risk weight floor is higher than previously applied.²³⁴ In addition, the new framework has introduced more than a 100 requirements that need to be met in order for a securitisation to qualify as STS.²³⁵

Although important aspects of the new framework remain work in progress, it is already clear important aspects continue to be anchored in the (misdirected) provisions of the previous regimes and the regulator remains mistrustful towards certain types of securitisation, for example, CMBS, and every type of re-securitisation.

As indicated, full implementation of the new framework remains subject to the development of a number of technical standards and implementation of the important Level 2 legislation that will complement the new framework. A number of provisions have been published²³⁶ but progress is relatively slow and a number of delays have been reported, the Regulatory Technical Standards ('RTS') on risk retention being a prime example.²³⁷

A number of the key outstanding technical standards on disclosure and reporting requirements, STS notification requirements, and the authorisation of securitisation repositories were finally published on 3rd September 2020, and came into force later that month, but a number of other issues continue to cause uncertainty and require further clarification.²³⁸

This is not surprising, since the new framework is nothing if not complex and ongoing guidance and interpretation from the European regulator will be required for some time. Indeed, the regulator recognised that the new framework would continue to be 'work in progress' ever since it introduced it as a proposal back in 2015 when it was contemplated that within a few years after its entry into force, the European Supervisory Authorities ('ESAs') and then the EC would re-assess the new framework and amend it accordingly.²³⁹ The Report by the Joint Committee of the ESAs that would provide this assessment was due by 1st January 2021²⁴⁰ but has not yet been published. As a result, it can be expected that the Report by the EC to the European Parliament and the Council assessing the functioning of the new framework and, if appropriate, putting forward further legislative proposals, which is required under Article 46 of Regulation 2017/2402 to be delivered by January 2022, is also likely to be significantly delayed.

Notwithstanding ongoing delays to full implementation of the new framework and the likely delay in the EC reporting on how well (or not) it is functioning and making proposals for further legislative change, which is currently required by end July 2020, the EC recently published a package of legislative proposals aimed specifically at bolstering recovery from the economic shock caused by the Covid-19 pandemic. Those proposals included important

²³² *ibid.* The previous risk weight floor was 7%, whereas the current floor is 15% for non-STs securitisations.

²³³ Schwarcz Post-Crisis (n 75) 128-129.

²³⁴ Kastelein (n 41) 483. The risk weight floor for STS securitisations is 10%, ie higher than the previous floor of 7%.

²³⁵ Raines (n 4) 549-550.

²³⁶ AFME, 'Securitisation Data Report: European Structured Finance Q3: 2020' 5ff <<https://www.afme.eu/Portals/0/AFME%20Q3%202020%20Securitisation%20Report0.pdf?ver=2020-12-10-094752-607>> accessed 16 March 2020.

²³⁷ Despite the fact that the EBA published the draft RTS on risk retention in July 2018, the EC has not yet adopted them, see Merryn Craske, 'The Revised securitisation Regulation Regime in the UK' (Mayer Brown, 8 February 2021) <<https://www.mayerbrown.com/en/perspectives-events/publications/2021/02/the-revised-securitisation-regulation-regime-in-the-uk>> accessed 16 March 2021.

²³⁸ Bryan (n 46) 198-199, 201.

²³⁹ European Commission STS Proposal (n 84) Explanatory Memorandum 12.

²⁴⁰ Regulation 2017/2402 art 44.

changes to the new securitisation framework expanding the STS framework to include on-balance sheet synthetic securitisation and facilitating the securitisation of non-performing loans or ‘non-performing exposures’ (‘NPEs’) as referred to in the proposal.

It can be argued these amendments, to both Regulation 2017/2402 and the CRR,²⁴¹ constitute an admission on the part of the Commission that, in its original form, the new securitisation framework has not been effective in revitalising the European securitisation market and fostering economic recovery.²⁴² More positively, however, they do illustrate the regulator’s flexibility and its willingness to listen to the needs of the market, even if these clash with the conventional narrative.

The imminent extension of the STS framework to on-balance sheet synthetic securitisation,²⁴³ and the expansion of the preferential STS capital treatment to a wider range of retained senior tranches of balance sheet synthetics²⁴⁴ are welcome developments which should greatly facilitate and streamline lending to corporates and especially SMEs.²⁴⁵ The removal of regulatory obstacles to the securitisation of NPEs,²⁴⁶ so as to facilitate the regulatory transfer of such exposures, that is expected to grow due to the ongoing pandemic²⁴⁷, is also viewed positively.

These amendments and especially the recognition that synthetic securitisation can indeed be beneficial are a significant step forward and a sign that the regulator finally has a more balanced view of securitisation in all its forms. However, the detailed proposals, particularly those relating to the implementation of a capital charge for synthetic excess spread, are already subject to market criticism and may limit the potential of the proposed STS regime for on-balance sheet synthetic securitisation. It remains to be seen how the EC will respond to these and other recommendations for change that have been made by market participants since the new regulatory regime was introduced, including those contained in the final report of the High-Level Forum on the Capital Markets Union of 10th June 2020 which set out a number of recommendations aimed at improving the functioning of the new framework.²⁴⁸

CONCLUSION: STILL SEARCHING FOR THE OPTIMAL REGULATORY FRAMEWORK

²⁴¹ See European Commission Coronavirus Response (n 44).

²⁴² European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic’ COM(2020) 282 final (hereinafter Proposal for Synthetic STS) Explanatory Memorandum 1.

²⁴³ Via the addition of a new Section 2a in Regulation 2017/2402, see European Commission Proposal for Synthetic STS (n 242) art 1(6).

²⁴⁴ See European Commission, ‘Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 pandemic’ COM(2020) 283 final (hereinafter Proposal Amending CRR 2020) art 1(3) replacing art 270 of the CRR to extend the preferential capital treatment of STS securitisation to retained senior positions in synthetic securitisations in general, and not just SME synthetic securitisations (as in the previous regime).

²⁴⁵ European Commission Coronavirus Response (n 44).

²⁴⁶ European Commission Proposal Amending CRR 2020 (n 244) art 1(2) introducing art 269a to the CRR to address specifically the risk weight treatment of NPE securitisations.

²⁴⁷ *ibid* Explanatory Memorandum 2.

²⁴⁸ These included proposals to recalibrate the capital charges applicable to the most senior tranches of securitisation transactions and capital charges for securitisation tranches under the Solvency II regime; unlocking the significant risk transfer (“SRT”) assessment process; differentiating the disclosure and due diligence requirements for public and private securitisations; and reducing the costs of SME financing: see the Final Report of the High Level Forum on the Capital Markets Union – A New Vision for Europe’s Capital Markets 10 June 2020.

There is now widespread consensus that the first phase of post-GFC regulation badly damaged the European securitisation market. In addition to being perceived as punitive by market participants the regulatory initiatives were fragmented, slow-moving and unpredictable, a combination that created uncertainty and stifled growth in securitisation issuance.²⁴⁹ The adverse regulatory treatment of securitisations vis-à-vis other financial products also undermined confidence and resulted in many institutional investors exiting the European securitisation market.²⁵⁰ Overall, although restoring market confidence was identified early as a pressing need,²⁵¹ the regulator failed spectacularly to achieve this goal.

By failing to appreciate the fundamental difference between securitisation products that financed the real economy and/or were used for legitimate regulatory balance sheet management purposes, and those whose aim was generating profit via arbitrage, the regulator effectively precluded credit institutions from engaging in both types of business activity.

Instead of focussing on the ‘perverse’ practice of ‘securitising for the sake of securitising’, the first phase of regulation rendered ‘classic’ securitisation products like the MBS and the ABS prohibitively expensive. Ultimately, unable to tap the capital markets in order to finance their real economy lending, regulated credit institutions became less able to satisfy the borrowing needs of the real economy. By pursuing a regulatory approach that sought to punish securitisation, many of the catastrophic consequences of the GFC were exacerbated. And the problem goes way beyond retail borrowers: the stigmatisation and subsequent contraction of the synthetic segment of the European securitisation market dealt a serious blow to lenders and corporate borrowers (especially SMEs) alike.²⁵²

This is deeply ironic, considering the ultimate goal of the CMU was to decrease dependency on banks and facilitate access to the capital markets, as a means of regenerating the European ‘real’ economy.

This negative view of the impact of the initial regulatory response is reinforced by examination of issuance volumes for the period from 2006 until 2019 (when the new framework became applicable).²⁵³ After peaking in 2006 when all primary issuances (€481 bn) were placed with end-investors,²⁵⁴ placed issuance of European securitisation decreased slightly in 2007 (approximately €400 bn) and then dramatically in 2008 (€100 bn).²⁵⁵ By 2009, placed issuance had all but collapsed to €24.8 bn.²⁵⁶ In every year until 2017 placed issuance in Europe was less than ¼ of what it was in 2006 and only managed to go beyond the €100 bn threshold in one year, 2018.²⁵⁷ These numbers confirm beyond doubt that investor appetite for European securitisation almost disappeared following the crisis and the regulator’s initial response achieved very little in terms of restoring it.²⁵⁸

²⁴⁹ S&P 2017 (n 92) 4, 20; Standard & Poor’s Ratings Services, ‘Global Structured Finance Outlook 2020: Another \$1 Trillion-Plus Year On Tap’ (6 January 2020) (hereinafter S&P 2020).

²⁵⁰ Segoviano (n 81) 57-59; S&P 2017 (n 92) 20; Raines (n 4) 547.

²⁵¹ de Larosière Report (n 37) 13; CRD II Recital 27.

²⁵² According to the findings of the European Council, the amount of SME securitisation in Europe more than halved from €77 bn in 2007 to €36 bn in 2014, see European Council, ‘Securitisation: Improving the Financing of the EU Economy’ (2014) <<https://www.consilium.europa.eu/en/policies/capital-markets-union/securitisation/>> accessed 16 March 2021.

²⁵³ ECB and BoE The Impaired EU Securitisation Market (n 39) 2; Raines (n 4) 539.

²⁵⁴ AFME Q4: 2015 (n 20) 7; ECB and BoE The Impaired EU Securitisation Market (n 39) 2.

²⁵⁵ ECB and BoE The Impaired EU Securitisation Market (n 39) 3 Chart 2.

²⁵⁶ Raines (n 4) 539.

²⁵⁷ *ibid*; S&P 2020 (n 249) Chart 14.

²⁵⁸ The aggregate value Outstanding Securities also fell dramatically during that period, see ECB and BoE The Impaired EU Securitisation Market (n 39) 2 and AFME, ‘Securitisation Data Report: European Structured Finance Q4: 2018’ 11

By 2015 the regulator finally recognised that in order to revive the European securitisation market, it needed to have the market on-side. As a result, the ‘CMU-inspired revival’ of securitisation and the new comprehensive regulatory framework is a product of collaboration between the EC and the industry: In the wider context of the CMU, the regulator prioritised market-driven solutions,²⁵⁹ by asking the market and listening to its concerns.²⁶⁰ The detailed responses made by various industry bodies called for a fundamental reconsideration and adoption of a different, positive approach towards the technique. These responses have clearly influenced the regulatory approach taken in the new framework.²⁶¹

It is too early to predict whether the new securitisation regime will ultimately succeed where its predecessors failed, that is, in reviving the European securitisation market. As we have already indicated, its full implementation remains subject to the development of a number of technical standards, detailed Level 2 legislation and guidance. Market participants have already identified a number of areas in which changes are required, some of which have been addressed, at least in part, by the changes proposed in the EC Capital Markets Recovery package, but others remain, and it seems likely we will now have to wait until the EC report to the European Parliament pursuant to Article 46 of Regulation 2017/2402 before the final regulatory framework emerges. Unfortunately, that report is now likely to be delayed until the end of 2022 at the earliest so ongoing uncertainties will remain.

Notwithstanding these ongoing concerns, confidence in the new regime did increase throughout 2019.²⁶² Following a slow start earlier in the year,²⁶³ placed securitisation issuance recovered and was equal to €102 bn by the end of 2019, down just 5% compared to 2018,²⁶⁴ and 35% of that placed issuance enjoyed the STS kitemark. In terms of outstanding amounts, European securitisations were worth €1,000 bn (excluding CDOs and collateralised loan obligations (‘CLOs’)) by the end of 2019,²⁶⁵ a decrease compared to the amounts at the end of 2018 (€1,110 bn, again excluding CDOs and CLOs).²⁶⁶

The data from 2020 however paints a rather bleaker picture: Overall issuance in 2020 was equal to €195 bn, marking the lowest issuance of European securitisation since 2013.²⁶⁷ Of this, €81.4 bn (41.8%) was placed and €119.2 bn (58.2%) was retained, whereas €76.3 bn (approx. 39%) was under the STS label, an increase compared to 2019.²⁶⁸ Concerning outstanding amounts, these in 2020 were equal to €992.2 bn (excluding CLOs), slightly decreased compared to 2019 and significantly decreased compared to 2018.²⁶⁹ Although little data is currently available for 2021, there is hope that activity and issuance will increase in the second half of the year, especially in STS qualified issuance.²⁷⁰

<<https://www.afme.eu/Portals/0/globalassets/downloads/data/securitisation/2019/AFME%20Securitisation%20Data%20Report%20Q%202018.pdf?ver=2019-09-11-144443-567>> accessed 16 March 2021.

²⁵⁹ Lagaria (n 173) 461.

²⁶⁰ Danny Busch, Emiliios Avgouleas, Guido Ferrarini, ‘Capital Markets Union after Brexit’ in Danny Busch, Guido Ferrarini, and Emiliios Avgouleas (eds), *Capital Markets Union in Europe* (OUP 2018) 6.

²⁶¹ European Commission STS Proposal (n 84) Explanatory Memorandum 10ff.

²⁶² S&P 2020 (n 249).

²⁶³ AFME, ‘Securitisation Data Report: European Structured Finance Q3: 2019’ 6

<<https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Data%20Report%20Q3%202019-1.pdf>> accessed 16 March 2021.

²⁶⁴ S&P 2020 (n 249).

²⁶⁵ AFME Q3: 2020 (n 236) 17

²⁶⁶ AFME Q3: 2019 (n 263) 10.

²⁶⁷ AFME, ‘Securitisation Data Report Q4: 2020’ <<https://www.afme.eu/Publications/Data-Research/Details/AFME-Securitisation-Data-Report-Q4-2020>> accessed 16 March 2021. For issuance in previous years see AFM Q3: 2020 (n 236) 11.

²⁶⁸ AFME Q4: 2020 (n 267).

²⁶⁹ *ibid.*

²⁷⁰ Tom Brown, ‘Banks Seen Returning to STS Supply in H2’ (Global Capital, 1 March 2021).

So far therefore, it is fair to conclude that the regulator has not yet managed to fully convince investors to return to securitisation and fuel its revival. There is hope that the new Delegated Regulation 2018/1221 that recalibrated capital requirements for insurance and reinsurance undertakings will incentivise the latter to join pension funds in their return to the European securitisation market.²⁷¹ However, the significant haircuts imposed on securitisations that qualify as Level 2B assets under the LCR regime will remain in place and continue to disincentivise credit institutions from investing in securitisations.²⁷²

The first signs of the market's reaction to the new framework give mixed signals but there is a general recognition that things are changing, and for the better. Key to this is the regulators' willingness to listen to the market and by re-embracing certain aspects of the financing technique, the regulator appears finally to be working in tandem with market participants to revive securitisation.

This willingness to listen to the market, and the realisation on behalf of the Commission that financial regulation has indeed a crucial role to play in accommodating the market's needs is most of all evident in the long-anticipated amendments to the new securitisation framework allowing on-balance sheet synthetic securitisations to qualify as STS and facilitating the securitisation of NPE exposures.

Although it is telling that it took a global pandemic for the regulator to publicly acknowledge that its attempt in reviving the European securitisation market has so far been unsuccessful,²⁷³ the inclusion of on-balance sheet synthetics in the STS framework provides hope that segment of the market will continue its revival.²⁷⁴

However, despite the rhetoric and the willingness to accommodate the needs of the market, the new STS framework for on-balance sheet synthetics is not entirely free from the all-familiar punitive perception of securitisation that has characterised the regulator's stance over the last decade. The significance of the amendments notwithstanding, the provisions on cash collateral and synthetic excess spread that have been included are an example of the ongoing punitive approach. By including such provisions that will undoubtedly make the new framework more complex and increase the relevant costs,²⁷⁵ the regulator is once again proving that it is not yet ready to truly embrace the market and its needs. Moreover, no hopes for revival currently exist for the CMBS segment of the market, that is yet to be re-embraced by the European regulator and remains a fraction of what it was before the crisis.²⁷⁶

The explicit primary objective of the European regulator is (and has been) 'to promote a safe, deep, liquid and robust market for securitisation, which is able to attract a broad and stable investor base to help allocate finance to where it is most needed in the [real] economy'.²⁷⁷

Has that been achieved? Not yet. What we have so far is undeniably a good start and the acceleration provided by the pandemic in terms of stimulating early amendment to the

²⁷¹ Mark Daley, 'LCR vs CMU: EC Scores an Own Goal?' (2018) <<https://www.lexology.com/library/detail.aspx?g=8a5a51e4-37af-4d1f-9568-83196fca45c4>> accessed 16 March 2021.

²⁷² *ibid.*

²⁷³ European Commission Proposal for Synthetic STS (n 242) Explanatory Memorandum 1.

²⁷⁴ EBA Report on Synthetic 2020 (n 85) 15, 83; Kaya (n 86) 1. See also European Commission, 'Report from the Commission to the European Parliament and the Council on the Creation of a Specific Framework for Simple, Transparent and Standardised Synthetic Securitisation, Limited to Balance-sheet Synthetic Securitisation' (24 July 2020) 5, Figure 4.

²⁷⁵ AFME Q3: 2020 (n 236) 6.

²⁷⁶ Manus Clancy, Kelvin Lin, and Pinar Ogun, '2020 European CMBS Outlook: Will the Rebound Continue?' (4 March 2020) <<https://info.trepp.com/trepp-talk/2020-european-cmbs-outlook-will-the-rebound-continue>> accessed 16 March 2021. Indicatively, total CMBS issuance in 2019 was equal to €5.8 bn, ie 2.6% of total issuance, whereas in 2020 it was equal to merely €2.4 bn, ie 1.2% of total issuance, see AFME Q4: 2020 (n 267).

²⁷⁷ European Commission Proposal for Synthetic STS (n 242) Explanatory Memorandum 1.

framework is to be welcomed. The proposed amendments, however, do not go far enough and it is unfortunate the market will in all probability need to wait until the EC makes its report to the European Parliament pursuant to Article 46 of Regulation 2017/2402 before a fully revised framework is published.

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