Understanding Securitisation

Background – benefits – risks

IN-DEPTH ANALYSIS

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This publication aims to provide an introduction to securitisation. It describes the parties involved, the types and main products of securitisation, the potential benefits for issuers, investors, financial markets and the broader economy, as well as some of its risks, which played a role in amplifying the recent financial crisis. Finally it presents the current state of the EU securitisation market and looks at some of the main stakeholders' proposals to revive the market and make it less risky.

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EXECUTIVE SUMMARY

Securitisation is a financing technique by which homogeneous income-generating assets − which on their own may be difficult to trade − are pooled and sold to a specially created third party, which uses them as collateral to issue securities and sell them in financial markets. This presents advantages to original lenders and originators (e.g. it allows them to reduce funding costs and increase their funding capacity while still satisfying regulatory capital requirements), investors and markets, and it may even have broader economic and social benefits. At the same time, securitisation can be a source of risk to the financial system. A case in point is how it amplified the recent financial crisis by contributing to lengthening the intermediation chain, by creating conditions which resulted in misaligned incentives and interests between participants in the securitisation chain, by increasing the reliance on mathematical models and on external risk assessments and, finally, by increasing both individual and systemic bank risks.

Although the European securitisation market grew significantly in the run up to the crisis, it has dramatically contracted since, despite the fact that most European securitised products fared well in the recent financial crisis in comparison with their US counterparts.

In the current low-growth and cautious lending environment, a simple form of securitisation was proposed as a way to equip banks with the necessary funds to provide new lending to the real economy. Thus, in the context of the creation of the Capital Markets Union, various stakeholders have published their reflections and launched consultations on what possible changes could be brought to the process of securitisation itself, in order to simplify it, render it less opaque and, as a result, reduce its potential risk.

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Glossary

Structured finance: any financing transaction that utilises special-purpose vehicles (e.g. project finance, securitisation, complex leasing transactions, or structured risk transfer mechanisms). The common theme to all types of structured finance transactions is that the transaction is structured to modify or redistribute the risk of the collateral[1] among different classes of investors through the use of a structure.

Security: A financial instrument that represents an ownership position in a publicly-traded corporation (stock), a creditor relationship with a governmental body or corporation (bond), or rights to ownership as represented by an option.

Credit risk: The risk of loss of the principal (i.e. the original sum invested or lent), or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation.

Derivative: a contract where the payment obligations of the parties are *derived* from another set of assets or liabilities, which need not reflect any real assets or liabilities but is a notional amount.[2]

Credit derivative: a derivative where one party’s obligation to pay is conditioned on the occurrence of a credit event (usually a default) on another, sometimes notional, contract.

Credit Default Swap (CDS): a credit derivative under which one of the parties pays a fee periodically to the other, in exchange for which it obtains a guarantee that it will be compensated by the other party if a bond goes into default.

Par value: the nominal value shown on the side of a security or other type of financial instrument. The par value of a bond is the value at which it will be redeemed.

Secured debt: debt supported by particular assets of the borrower (e.g. mortgages secured by houses, car purchase loans secured by the vehicle). A borrower in financial difficulty must sell these assets to repay the lender.

'Synthetic' securitisation: transaction involving no transfer of legal title, but only the sale of the credit risk associated with the assets through the use of credit derivatives such as credit default swaps.[3] The underlying assets remain on the balance sheet of the originator.

'True sale' securitisation: transaction involving the effective legal transfer of the assets to the issuer of the securities (SSPE); as a result, the SSPE becomes entitled to the cash flows that are generated by the assets (including those resulting from a subsequent sale of the assets). The underlying assets are removed from the originator's balance sheet.

Sources: ECB, The Journal of Structured Finance, Duke Journal of Comparative and International Law, FT Lexicon, Investopedia.

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1 Its credit risk, interest rate risk, prepayment risk, and liquidity risk.

2 For more on notional amounts, see ISDA webpage.

3 European Central Bank, 'Securitisation in the Euro Area'.

1 Background and definition

Securitisation is part of structured finance. It is a financing technique by which homogeneous income-generating assets − which on their own may be difficult to trade − are pooled and sold to a specially created third party, which uses them as collateral to issue securities and sell them in financial markets.

Transactions within this process involve several parties and range from relatively simple and clear, to more complex and opaque.

Although securitisation was not directly responsible for the 2008 financial crisis, it contributed to it and played a role in its amplification.[4] The resulting opprobrium explains why issuances in Europe and the US have not returned to pre-crisis levels.[5] However, in the context of the current low-growth and cautious lending environment, a simple(r)[6] form of securitisation 'can provide banks with the necessary funds to provide new lending to the real economy';[7] and that is why it has been proposed by several stakeholders and recently taken up by the European Commission, which launched a consultation on the subject[8] in February 2015. In this context, this paper aims to provide an introduction to securitisation, the main parties involved, as well as its potential benefits and risks, before introducing the proposals made for future securitisations.

2 Main elements

2.1 Parties to a securitisation

A securitisation transaction involves several parties, the most important of which are the *Original lender*, the *Originator*, the *Sponsor,* the *Securitisation Special Purpose Entity (or 'issuer')*, the *Underwriter*, the *Credit Rating Agencies*, the *Third-party Credit Enhancers*, the *Swap counterparty*, the *Servicer*, the *Trustee*, and the *Investors*.

An *original lender* is any non-financial entity that has trade receivables, or 'exposures', (e.g. a car company) and wishes to securitise them.

A *sponsor* is a financial institution that establishes a securitisation transaction by purchasing exposures from another entity (e.g. the original lender).

A financial institution (e.g. a bank or insurance company) that initiates securitisation transactions, either by pooling income-producing assets and selling them to a Securitisation Special Purpose Entity, or by purchasing another party's exposures for its own account and then securitising them, is called an *originator*.

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4 See point 4 of this publication.

5 See M. Segoviano, B. Jones, P. Lindner, J. Blankenheim 'Securitization: The Road Ahead' pp. 5-6.

6 Different terms have been used according to the body that proposed them: the ECB and Bank of England, in a Green Paper refer to 'qualifying' and 'non-qualifying' securitisations; the Joint Task Force on Securitisations Markets of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO), as well as the Basel Committee on Banking Supervision (BIS) refer to 'Simple, Transparent and Comparable' securitisations; finally, the European Banking Authority (EBA) refers to 'Simple, Standard and Transparent' securitisations.

7 See ECB Asset-backed securities purchase programme.

8 European Commission 'Public consultation on securitisation'.

As the name implies, a Securitisation Special Purpose Entity (SSPE) is a legal entity (a limited partnership, a limited liability company, a trust, or a corporation) other than the originator or the sponsor, established to carry out some specific purpose − in this case, creating the securities and selling them in the market (hence the SSPE is the 'issuer'). SSPEs have no personnel, no physical location and no additional purpose.[9] By transferring the receivables[10] to the SSPE, the originator 'insulates' them from creditors:[11] in case of insolvency, the collateral held by the SSPE is still good and the servicer ensures that payments on the collateral continue to be made, so that investors still receive their principal[12] and interest. This, among other reasons, accounts for the fact that the securities issued by the SSPE can get a better rating than the rating of the originator.

An *underwriter* (usually an investment bank) serves as an intermediary between the issuer (SSPE) and investors in an offering. The underwriter analyses investor demand and – in collaboration with the Credit Rating Agency – provides guidance on structuring the transaction in an efficient and cost-effective manner, which includes devising one or more classes, or 'tranches' that are sold to investors in the public and private markets (for more information on tranching, see below). In this fashion, the cash flows generated by underlying financial assets can be allocated to different tranches of debt securities, which may exhibit different credit, payment, coupon, maturity and other investment characteristics, to meet the needs and preferences of individual investors. In addition to their contribution in structuring the transaction, underwriters market and sell the securities, as well as provide liquidity support in the secondary trading market.[13]

Rating agencies such as Standard & Poor's and Moody's provide credit ratings[14] on securities, based on their assessment of their credit risk: the lower the assessed risk, the higher the agency rating. Given the link between perceived risk and rating, securities that receive a better rating can, *other things being equal*, attract investors more easily than worse-rated securities and, thus, bear lower interest rates. An important difference between the approach used to rate 'traditional', versus that used to rate securitised debt, deserves to be mentioned here: in the first case, the bonds created are rated *ex post*, while in the later, they are rated *ex ante* − that is, a securitisation transaction will result in the creation and issuance of securities that meet a specific rating profile, in order to obtain a specific rating.

As will be seen in greater detail below, securitised products are often guaranteed by creditworthy third parties, such as insurers that specialise in securitisation (also called

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9 G. B. Gorton, N. S. Souleles, 'Special Purpose Vehicles and Securitization'.

10 Receivables are 'an asset designation applicable to all debts, unsettled transactions or other monetary obligations owed to a company by its debtors or customers'. For example, in case mortgage loans are the assets used for securitisation, the monthly repayments are receivables.

11 In the event of insolvency/bankruptcy of the originator, 'creditors can neither ask for them to be re-characterised as secured financing, nor to seek consolidation of the assets of the originator with those of the SPV'. (V. Bavoso, 'Financial innovation and structured finance: the case of securitisation').

12 In a loan, the principal is 'the amount borrowed or the amount still owed (separate from interest)'. In an investment, the principal is 'the original amount invested, separate from earnings'.

13 Nicola Cetorelli and Stavros Peristiani, 'The Role of Banks in Asset Securitization'

14 Assessments of the credit worthiness of a borrower in general or with respect to a particular debt or financial obligation. For more information, see Moody's symbols and definitions.

'monoline',[15] because they specialise in that single 'line' of insurance), and are usually referred to – collectively – as *third-party credit enhancers*.

Swap counterparties, financial institutions with the capability to create derivatives, are involved in the transaction to hedge[16] the interest rate and currency risks on the pool.

For a fee, the *servicer* performs a number of administrative duties on behalf of the SSPE – mailing billing statements, collecting payments and supervising delinquencies[17] – to collect payment on the assets acquired by the SSPE. This role may also be performed by the originator.[18]

Finally, the *trustee* ensures that the money is transferred from the servicer to the SSPE and that investors are paid in accordance with the contractually agreed priority.

2.2 Types of securitisation and main products

Depending on what the securitised product is and on whether derivative products are used, securitisation is viewed as 'traditional' or synthetic.

For the sake of simplification, two main product subsets can be distinguished in 'traditional' securitisations:

- *asset-backed securities (ABS)*[19] are securities whose collateral is composed either from mortgage loans (mortgage-backed securities – MBS) or from collections of other types of financial assets (non-mortgage securities). Most mortgage-backed securities are based on residential mortgages, but there is also a significant market in commercial mortgage-backed securities (CMBS).[20] Non-mortgage securities can be composed of various assets, including automotive loans, or even future returns on assets such as planes or copyrights;
- *collateralised debt obligations (CDO)* are securities whose collateral pool is composed, among others, by bonds, loans, or other types of debt, as well as by asset-backed securities. The term 'CDO' encompasses such securities as collateralised bond obligations (CBO),[21] collateralised loan obligations (CLO),[22] and collateralised fund obligations (CFO).[23]

In contrast to a 'traditional' securitisation, a 'synthetic' one refers to those transactions in which banks use credit derivatives to transfer only the credit risk of the asset pool –

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15 In 2007, the six major monoline insurers with a 'AAA' rating were Ambac Assurance Corporation, CIFG Guaranty, Financial Guaranty Insurance Company (FGIC), Financial Security Assurance (FSA), MBIA Insurance Corporation and XL Capital Assurance (XLCA). Together, they had obligations outstanding of approximately US$2.1 trillion with capital of US$44 billion in support of claims.

16 Reduce the risk of adverse price movements in an asset by (usually) taking an offsetting position in a related security.'

17 Such as situations where borrowers are late or overdue with a payment.

18 Among others, see A. Jobst 'What Is Securitization?'

19 For more details on asset-backed securities and collateralised debt obligations, please refer to M. Levinson 'The Economist Guide to Financial Markets: Why they exist and how they work' chapter 5 'Securitisation'

20 Securities secured by the loan on a commercial property such as apartment buildings, housing for the elderly, retail developments, warehouses, hotels, or office buildings.

21 Investment-grade bonds backed by a pool of 'junk' bonds.

22 Securities backed by a pool of debt, often low-rated corporate loans.

23 Securities backed by a pool of hedge fund investments.

and not the assets themselves – to third parties, such as insurance companies or other banks.[24] The rationale behind this is that many investors are not concerned whether or not the underlying assets are the 'property' of the SSPE, but rather that they receive cash flows from the security *as if* the SSPE actually owned them. Given that collateral itself is limited and that finding, buying and managing it entails costs and is time-consuming, issuers used swaps to gain exposure to assets in a 'synthetic' way, without owning them – thus, investors gained access to 'unlimited' collateral and originators lowered their costs.[25]

The downside to synthetic securitisation, as the crisis showed, was twofold:

- there was an extra layer of complexity in valuing them, as the securities did not depend on underlying assets, but on the capacity of a company (the CDS counterparty, for instance the insurer, AIG) to ensure that payments were met;
- given the actual collateral was not purchased but merely 'replicated' through the use of a derivative, 'numerous CDOs could reference the exact same underlying asset, meaning that if that asset were to default, it would have an outsized impact on the CDO marketplace.'[26]

Finally, when a pool of securities, issued by an SSPE in earlier securitisations, is bought by an originator and securitised again (usually in the form of a collateralised debt obligation), the transaction is called 're-securitisation'. Depending on the assets being securitised in the first securitisation, a re-securitisation can be either traditional, or synthetic. According to law firm Slaughter and May,[27] there are three main products of re-securitisation:

- 'CDO of ABS, when the receivables come from a pool of securities from an ABS securitisation;
- CDO of CDO, or CDO^2, when the receivables used come from a pool of securities from a CDO securitisation;
- CDO of ABS and CDO, when the receivables come from a pool of securities that is a mixture of ABS and CDO securitisation'.

2.3 How securitised assets can achieve better ratings

As mentioned earlier, a central element of securitisation is that the securities issued by the SSPE can get a *better rating* than the rating of the originator. This is achieved through three different means: credit enhancement, tranching and bankruptcy remoteness.

2.3.1 Credit enhancement

The aim of credit enhancement is to reduce the risk the investors bear, that the cash flows from the collateralised assets will be interrupted. Credit enhancement can be:

- either achieved *within* the transaction, through

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[24] See I. Bell, P. Dawson 'Synthetic securitisation: use of derivative technology for credit transfer', especially pp.18-21 for an example of the structure of funded transactions.

[25] According to Bates Research, 'To dramatically simplify, the cash flow stream to the writer of a Credit Default Swap or a Total Return Swap is the same as the cash flow stream realised by the owner of the underlying asset. So, rather than buying assets, the special purpose entity simply sells CDS protection, and then sells the cash flows from the CDS contracts onto investors, just like a regular CDO.'

[26] See I. Bell, P. Dawson, 'Synthetic securitisation: use of derivative technology for credit transfer'.

[27] Slaughter and May, 'Model guide to securitisation techniques'.

  - *tranching* (see 2.3.2 below);
  - *overcollateralisation*, that is, the use of collateral of a higher value than the value of the issued securities (an example would be pledging €110 million worth of assets as collateral in order to issue €100 million worth of securities), an enhancing technique present also in other structured products such as covered bonds;[28]
  - the creation of a *cash reserve* (e.g. from part of the debt proceeds) or the *use of excess spread* (i.e. the positive difference between the income earned on the assets and the payments to the liabilities) to absorb potential losses;
- or provided by a third party, through, e.g.
  - special guarantees from the third party;
  - letters of credit from a bank, which commits to reimburse credit losses up to a predetermined amount;
  - financial guarantees from insurance companies which pledge to perform the timely payment of principal and interest, if those cannot be satisfied from the cash flow from the loan pool.

Given that credit enhancement is done for a fee, the goal of an issuer would not be to enhance all tranches to the maximum, but rather to choose the type and amount of credit enhancement that will maximise the profits of a particular sale of securitised products.

2.3.2 Tranching

Tranching (or *subordinate financing*) is a technique used to distribute the risk of the collateral among different 'tranches' that match different investor risk profiles and relating demand. These tranches have different risk/return profiles − achieved through various forms of the aforementioned credit enhancement − and levels of seniority, as well as different degrees of priority with respect to cash inflows (which tranche is satisfied first from the receivables) and loss write-offs: initial losses are absorbed by the equity or 'junior' tranche up to the level where it is depleted, followed by mezzanine tranches which take some additional losses, again followed by more senior tranches. As a result, the most senior claims (which are enhanced to be the safest and thus get the highest credit rating) are expected to be insulated to an extent from the default risk of the asset pool.[29]

2.3.3 Bankruptcy remoteness

The third way in which a securitised product can achieve a better rating than traditional secured debt is by ensuring that the potential future bankruptcy of the originator will not impact the ability of investors in securities issued by the SSPE to be paid from collections on the financial assets. This bankruptcy remoteness rests on two elements: the transfer of the assets to the SSPE is structured as a 'true sale' and the SSPE will be

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28 For more information on covered bonds, see EPRS Briefing 'Covered bonds – ripe for expansion?'.

29 A highly simplified example of tranching is provided by Schwarcz and adapted here: an SPV with €1 000 of assets issues €900 of liabilities, composed of €700 of senior securities and €200 of 'junior' or subordinated securities. If €150 of the assets are written off, the remaining €1 000 – €150 = €850 of collections would still be enough to repay the senior securities in full, but would only leave €850 – €700 = €150 to pay the €200 of subordinated securities. Therefore, investors in the subordinated securities would only be repaid up to €150 on their €200 of claims, that is 75% or '75 cents on the dollar' in industry parlance. By accepting this risk, holders of subordinated securities will ask for a higher interest rate on their securities.

legally established in such a way as only to be able to engage in the securitisation transactions, thus preventing it from engaging in other transactions and incurring debt to other creditors, who might be able to force it into involuntary bankruptcy if their claims are not paid.

2.4 A traditional securitisation transaction[30]

A securitisation transaction starts when the originator or sponsor identifies a pool of homogeneous assets that satisfy certain features that make them acceptable for securitisation – e.g. when a retail bank decides to isolate the amounts received (i.e. the principal and interest) from its mortgage lending. The collateral is assessed, cash flows are modelled and risk is quantified via stress tests[31] or other techniques.

The pool of assets (receivables) is then transferred to the SSPE at par value. Prior to issuing the securities, the SSPE engages in *tranching*, with the underwriter and the credit rating agencies, and in *credit enhancement* (through subordination, over-collateralisation, etc. or through third-party credit enhancers). The rating agencies carry out a detailed statistical analysis to evaluate the potential losses from the receivables and determine how much credit enhancement is required for the bond classes in a proposed structure to achieve the targeted rating sought by the issuer. The insurance company agrees to pay interest and principal in line with the original payment schedule for the securities issued to the investors, if the SSPE defaults on its payment obligations. The SSPE pays the transfer price for the receivables on the transfer.

The originator or sponsor may decide to hedge, if necessary,[32] against unfavourable interest rate and currency exchange rate movements, by arranging for the SSPE to enter into hedging and risk-management derivative contracts − e.g. interest rate swaps or currency swaps − with the swap counterparty.

The SSPE issues (privately or publicly) securities − usually bonds, notes, or sometimes even equity securities − structured into different classes with different payment priorities and risk/return characteristics. It sells them to underwriters, which will buy them at a discount, to compensate for the risk taken, before reselling them to investors.

The securities are usually ultimately sold to institutional investors, such as banks, insurance companies, pension plans and portfolio managers. The proceeds from the issuance of these securities provide the SSPE with the funds needed to purchase the receivables from the originator or sponsor. The purchase takes the form of a 'true sale' (see glossary). The proceeds from the sale of the receivables allow the originator or sponsor to pay the remaining parties (the swap counterparty, the third-party credit enhancers, etc.).

Lastly, each month, the difference between the cash flow generated by the pool of loans and receivables and the interest paid to the holders of the asset-backed securities and the fees paid (primarily for servicing), i.e. the *excess spread* (in effect the monthly profit), is either distributed to the equity investors or retained.

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[30] For the sake of simplification in the examples provided in points 2.4 and 2.5, it will be assumed that the SPV has already been established and is bankruptcy remote.

[31] A stress test is an analysis conducted 'under unfavourable economic scenarios' so as to determine 'whether a bank has enough capital to withstand the impact of adverse developments'.

[32] In case the underlying assets are denominated in one or more currencies that differ from the currency in which the securitised products' payments are made.

2.5 A synthetic securitisation transaction

While a synthetic securitisation is similar to a traditional one, here there is no actual transfer of the receivables to the SSPE. Instead, some form of derivative product, such as a credit default swap (CDS) is used to gain risk exposure to a specified pool of receivables; the swap counterparty in the derivative contract agrees to pay the losses suffered by the owner of the assets (usually the originator) if a 'credit event' such as payment default occurs in the assets. In return, the originator agrees to pay the swap counterparty premiums based on the perceived probability of such 'credit events' occurring in the assets. As a result, the swap counterparty gains exposure to the risks attached to the reference assets, without a true sale taking place, that is, without title or other rights in them passing to it.

3 Potential benefits of securitisation

Whether seen from the perspective of the entity involved in securitising an asset, the investor, or the broader markets, securitisation can generate benefits.

3.1 Original lenders and originators

Originators can use securitisation:

- to *increase their funding capacity* while still satisfying regulatory capital requirements:[33] banks are required by regulators to maintain capital according to the size and type of their assets. 'Tying' capital this way increases the institution's ability to absorb the potential loss of value of the loan(s), but reduces its opportunities to use that capital for other purposes that may generate better returns for shareholders. By securitising the assets and removing them from their balance sheet, banks in effect lower the amount of capital they need to keep and can therefore use it for other purposes;

Original lenders or originators use securitisation:

- to *transfer to investors* (and thus 'eliminate') *the risk* that loans will not be serviced[34] in a timely manner; and more broadly, partly reduce the problem of asset-liability mismatch;[35]
- to decrease their interest costs, by de-linking the rating of the securitised products from their own rating;[36]
- to diversify funding sources, since securitisation extends the investor pool available to an entity.

[33] For more on capital requirements, see the Citizens' summary provided by the European Commission.

[34] Loan servicing refers to the administrative aspect of a loan, from the time the proceeds are dispersed until the loan is paid off. It includes among others, sending payment statements, collecting payments, and following up on delinquencies.

[35] In banking, this refers to a situation when assets that earn interest do not balance with liabilities upon which interest must be paid, because of a difference in maturities – e.g. banks usually borrow for the 'short term', while making long-term loans.

[36] See AAII journal, 'How Credit Ratings Affect Bond Valuations'.

3.2 Investors

From the standpoint of investors, securitised instruments:

- cater to the needs of both conservative and less risk-averse[37] investors, since they provide a wide variety of product choices and offered interesting yield premiums[38] over securities of comparable rating and maturities (such as AAA sovereign or corporate bonds);
- can be tailored in a manner that responds to specific, and sometimes unique, investor needs.

3.3 Markets

Finally, from the perspective of the markets:

- according to Marc Levinson,[39] the sale of securitised assets 'creates publicly available prices, which can be useful for some types of assets (such as property or equipment leases) which are complicated to trade and can be difficult to value';[40]
- securitisation offers a useful mechanism by which financial institutions can transfer concentrated (credit, interest rate and market) risks associated with their portfolio activities to the more broadly dispersed capital markets, thus reducing risks to individual institutions.

3.4 Potential economic and social benefits

According to the European Securitisation Forum, a number of social and economic benefits have been realised in markets where securitisation has been employed on a broader scale. For example, 'liquid and efficient secondary securitisation markets can reduce geographical and regional disparities in the availability and cost of credit throughout a particular jurisdiction by linking local credit extension activities to national, and increasingly global, capital markets systems'.[41]

4 The recent US financial crisis and the role of securitisation

To speak about the role of securitisation in the recent financial crisis,[42] it is useful to put that crisis in context.

According to the Financial Crisis Inquiry Commission report[43] 'The financial crisis of 2007 and 2008 was not a single event, but a series of crises that impacted the financial

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[37] A risk-averse investor leans more towards safer investments, with lower but safer returns.

[38] The 'yield' is the amount of return an investor will realise. A yield 'premium' is the extra return in comparison with other investments.

[39] M. Levinson 'The Economist Guide to Financial Markets: Why they exist and how they work' (2014) chapter 5 'Securitisation'.

[40] According to M. Levinson (see previous note) ABS are usually easier to trade than the underlying assets themselves. Therefore, 'If securities backed by office-building mortgages are selling for half the price they were two years ago, investors, ... will have a reasonable idea of what a lender's portfolio of commercial mortgages might be worth'.

[41] European Securitisation Forum, 'European Securitisation - a resource guide'.

[42] Although the crisis did spread to Europe and the cases of Northern Rock in the UK, or IKB and Sachsen LB in Germany resonated in the press, the build-up to the crisis and the main 'trigger' were in the United States. Therefore, the analysis on the role of securitisation will focus on the US crisis and not on the subsequent international contagion.

system first, before contaminating the real economy ... 'While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble ... that was the spark that ignited a string of events, which led to a full-blown crisis in the fall of 2008.'

4.1 General developments that contributed to the bubble

The price rise which developed later into the aforementioned housing bubble, started in the late 1990s and peaked in 2006. It is attributed to a multitude of factors, among which several stand out: *the dot-com bubble and subsequent crash* − the bubble increased the wealth of many investors, thus indirectly creating demand for houses; *the actions of the Federal Reserve* − the mild recession that followed the dot-com crash and the large capital inflows from abroad, especially from Asian countries,[44] contributed to the decision of the Federal Reserve to lower interest rates; this reduction, in turn, had the indirect consequence of lowering mortgage rates, which prompted more people to seek a mortgage − and the *government's home-ownership policy*[45] − which, it is claimed, resulted in an industry-wide loosening of underwriting standards in an effort to promote affordable housing.[46]

These factors, as well as the fact that house prices had appreciated nationally in the United States since the 1930s,[47] added a speculative element to the price increase of houses. The underlying belief was that, since prices kept increasing, potential repayment problems would be reduced, if not eliminated, by higher house market prices. Thus, 'assuming an ongoing increase in home values, homebuyers became willing to pay even higher housing prices, believing that the increasingly valuable investment would soon pay for itself. Knowing this, real estate agencies started charging inflated rates based not on rising real demand for houses, but on speculation that housing prices would continue to rise'.[48] In addition, changes that took place in the US mortgage market made it easier for homeowners to refinance their mortgages including through 'cash-out refinancing',[49] which resulted in homeowners increasing their leverage – i.e. the proportion of debt in relation to the total value of their possessions. According to a paper by Khandani, Lo and Merton,[50] 'Once property values decline, a wave of defaults becomes unavoidable because mortgage lenders have no

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43 Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States.

44 Asian countries bought US securities both to peg exchange rates at export-friendly levels and – in the aftermath of the 1997 south-east Asian crisis − to hedge against a depreciation of their own currencies against the dollar.

45 For more information, see the official government document, 'Blueprint for the American dream'.

46 See among others D. G. Tarr, 'The Political, Regulatory and Market Failures That Caused the US Financial Crisis', or E. J. Pinto, 'Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study'.

47 See R. Dodd, P. Mills, 'Outbreak: U.S. Subprime Contagion'. This rationale held even more during the first years of the new millennium, because of the price rise explained earlier.

48 B. Beachy, 'A Financial Crisis Manual Causes, Consequences, and Lessons of the Financial Crisis'

49 Cash-out refinancing is a mortgage refinancing transaction in which the new mortgage amount is greater than the existing mortgage amount, plus loan settlement costs. For example, if a home is worth €400 000 and the owners have a mortgage for €250 000, they have €150 000 in equity. With cash-out refinancing, they can receive a portion of this equity in cash. This cash (e.g. €50 000) will then be added to the mortgage, which in this example will increase to €300 000.

50 A. E. Khandani, A. W. Lo, R. C. Merton, 'Systemic Risk and the Refinancing Ratchet Effect'.

mechanism such as a margin call[51] to compel homeowners to add more equity to maintain their leverage ratio, nor can homeowners reduce their leverage in incremental steps by selling a portion of their homes and using the proceeds to reduce their debt.'

4.2 The burst of the housing bubble

The reservoir of potential buyers gradually started to diminish as of end-2005. With construction contracts still being fulfilled,[52] the increase in housing supply exceeded the increase in demand, which resulted in many new homes remaining unoccupied and prices starting to decrease. The downward spiral began with foreclosures, which started to rise after the price tipping point in 2006. The increase in foreclosures caused the average house price to fall.[53] As a result of the fall in home prices, borrowers who were relying on refinancing for loan repayment could not refinance. Furthermore, many subprime mortgage loans were 'teaser' loans[54] and when their teaser period expired, their rates started increasing, leading many other borrowers to default and adding to the downward spiral.

Two things must be noted here. Firstly, this was not the first housing crash the US has faced since the beginning of the 20th century,[55] which means that normally, there were (or at least should have been) backstops, to protect the rest of the economy. Secondly, the role of capital markets on financing the real economy is much larger in the US than in Europe, which means that even if the crash had an impact on the balance sheets of banks, it should not have had the deep impact it did.[56]

One plausible explanation of the propagation is that, with the wider acceptance of new forms of financing, a complex network of credit intermediation outside the regulated banking sector emerged. This 'shadow banking' system[57] took over many risky financial

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51 This is a term borrowed from the investment world. A margin call is a broker's demand on an investor using margin to deposit additional money or securities so that the margin account is brought up to the minimum maintenance margin.

52 According to Beachy, over 2 million new housing units were constructed in 2005 alone.

53 Beachy identifies four factors that explain this: (1), each foreclosed house adds to the excess supply of housing, bringing down the general price; (2) foreclosed houses can have a direct negative effect on the value of nearby homes, bringing down their price; (3) a rise in foreclosures leads to banks restrict eligibility criteria and charge higher interest rate, thus reducing the demands for mortgages; and (4) the aforementioned elements limit the number of new homebuyers, which reduces housing demand even more.

54 Adjustable-rate mortgage loans, in which the borrower pays an (artificial) very low initial interest rate, which increases after a few years.

55 According to a paper from S. M. Wachter and A. W. Orlando, 'Booms and Busts in Real Estate', real estate booms and busts 'have been a recurring feature of the global economy for decades, including in the 20th century'.

56 Back in 1999, reflecting on the Asian Twin crises of 1997, a paper by R. J. Herring and S. Wachter noted that, 'Real estate crises may occur without banking crises … but the phenomena are correlated in a remarkable number of instances … The consequences for the real economy depend on the role of banks in the country's financial system. In the US, where banks hold only about 22% of total assets, most borrowers can find substitutes for bank loans and the impact on the general level of economic activity is relatively slight.'

57 See 'Shadow Banking: Background and Policy Issues'. For a study of how this system contributed to amplifying the financial crisis, see 'The Shadow Banking System and the Financial Crisis: A securities production function view'. More generally, for a summary list of all possible causes that together led to the financial crisis, see 'Causes of the Financial Crisis'.

activities which were outside the explicit government safety net provided by deposit insurance. But by conducting maturity, liquidity, and credit transformation without explicit public sector credit guarantees or access to liquidity (since this was extended only to non-shadow banks), those institutions became vulnerable to liquidity risk in the form of 'non-bank' runs. That is, the fact that they relied on short-term credit to fund, for instance, mortgage loans waiting to be securitised,[58] meant that they could fail if markets lost confidence and refused to roll it over – which is what eventually happened to Lehman Brothers.[59]

Following Lehman's bankruptcy, trust in counterparties, which is essential in banking and non-banking activities alike, disappeared. Firms reduced lending to each other and started selling assets to increase their buffers against potential losses. But since everyone did the same at the same time, the effect was to depress prices, which eventually affected the real economy.

The discussion about the role securitisation played in the financial crisis is usually placed in this context. Securitisation, it is argued, may not have directly caused the crisis, but it did play an amplification role.

4.3 Securitisation and the recent financial crisis

Securitisation amplified the crisis by contributing to lengthening the intermediation chain, by creating conditions for incentives and interests between participants in the securitisation chain to be misaligned, by increasing the reliance on mathematical models and on external risk assessments and, finally, by increasing both individual and systemic bank risks.[60]

4.3.1 Lengthening of the intermediation chain

With the multitude of parties involved, securitisation has contributed to the lengthening of the intermediation chain, which made the system more complex and increased its potential instability. Tobias Adrian and Hyun Song Shin[61] provide an example to highlight the contrast. In the traditional model, a bank would take retail deposits from household savers and lend the proceeds to borrowers such as firms or other households.

With securitisation, however, the chain between intermediaries is longer, stretching from *banks* (who give mortgages to *households* and then sell them) to *SSPEs*, (who

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58 According to A. Krishnamurthy ('How Debt Markets Have Malfunctioned in the Crisis') 'Before the crisis, market participants commonly borrowed 90% of the value of AAA-rated MBS', a fact that D. Luttrell, H. Rosenblum, J. Thies ('Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned') note 'would be a relatively high leverage ratio for even genuinely high-quality, AAA assets. But the AAA assets and liabilities that collateralised and funded the shadow banking system were found to be less than the highest quality, weakened by poorly underwritten loans and aggressively structured securities.'

59 See D. Luttrell, H. Rosenblum, J. Thies, 'Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned': 'As Lehman's financial status became increasingly precarious before its collapse, market participants became wary of extending credit to the firm. Lehman struggled to fund its levered illiquid assets and could not exit its positions at prices necessary to shore up its capital base. Ultimately, the firm could not continue financing its operations, declaring bankruptcy on 15 September 2008'.

60 For a more elaborate treatment of the risks associated with securitisation, see Finance Watch's, position paper, 'A missed opportunity to revive "boring" finance?'.

61 T. Adrian, H. S. Shin, 'The Changing Nature of Financial Intermediation and the Financial Crisis of 2007-09'.

package them into MBSs, which in turn might be owned by) *ABS issuers*, (who pool and tranche them into another layer of claims, such as CDOs) *investment banks*, (who finance such assets through repurchase agreements with) *larger commercial banks*, (which in turn may fund their lending to the investment bank by issuing short-term liabilities and selling them to) *money market mutual funds*, to *households*, who may own the shares of those mutual funds.

4.3.2 Misaligned incentives that resulted in the weakening of due diligence

According to a 2011 report from the Bank for International Settlements,[62] 'Securitisation markets before the crisis were ... affected by what are termed 'misaligned incentives' .... These refer to situations where certain participants in the securitisation chain have incentives to engage in behaviour which, while furthering their own interests, is not in the interests of (and may be detrimental to) others in the securitisation chain or the broader market.' According to the same report, developments during the decade before the crisis which created the conditions for incentives and interests to be misaligned include the aforementioned lengthening of the intermediation chain. The primary consequence of these misalignments and conflicts was 'a weakening of due diligence along the securitisation chain. This resulted in poorly underwritten assets being securitised by originators, and those securities being bought by many investors who did not understand the extent of the risks they were taking on. Originators/sponsors, in particular, weakened their asset screening and monitoring practices.' An earlier empirical examination of the issue (2008) by Keys, Mukherjee, Seru and Vig,[63] reached similar conclusions.

4.3.3 Complex structures which allowed speculation and did not feed the real economy

Forms of securitisation such as synthetic securitisation or re-securitisation added additional complexity and obscured the quality of the original assets, reducing investors' ability to assess risk themselves. Furthermore, especially regarding synthetic securitisation, 'because they are not limited by the number of existing mortgages and other loans, one could create an unlimited number of synthetic CDOs referencing a single pool of loans, amplifying dramatically the exposure and the losses linked to the loans defaults…Synthetic securitisation thus enabled speculators to increase the size of their bets on the property market without financing a single house'.[64]

4.3.4 Overreliance on mathematical models and on external risk assessments

According to Steven L. Schwarz, models − which are essential to securitisation[65] − can bring insight and clarity if they are realistic and their data are reliable; but, if those two conditions are not met, they can be misleading. 'Subprime mortgage securitisation models relied on assumptions and historical data which, in retrospect, turned out to be incorrect and therefore made the valuations incorrect.'[66]

Furthermore, the more complicated the models became, the more investors relied 'automatically' on external risk assessments provided by credit rating agencies. This turned out to be problematic, because 'the shift from an investor-pay to an issuer-pay

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62 Basel Committee on Banking Supervision, 'Report on asset securitisation incentives'.

63 B. J. Keys, T. K. Mukherjee, A. Seru, V. Vig, 'Did Securitization Lead to Lax Screening? Evidence from Subprime Loans'.

64 Finance Watch, position paper 'A missed opportunity to revive “boring” finance?'.

65 In order to pay the securities issued by the SPV, it is necessary to statistically predict what future cash flows will become available from the underlying financial assets.

66 S.L. Schwarcz, The Future of Securitization.

business model (which was inherent to securitisation, as the originator pays the credit rating agency, to tranche the product) degraded the value of the evaluations provided, because the agencies faced little risk from inaccurate ratings'.[67]

4.3.5 An increase in individual and systemic bank risks

Back in 2004, reports[68] had shown that 'banks had increasingly retained the riskiest first-loss (equity) tranches of synthetic CDOs'. In addition, 'Banks wanted to increase their leverage so as to spice up their short-term profit. So, rather than dispersing risks evenly throughout the economy, banks bought each other's securities with borrowed money',[69] keeping the risk concentrated in themselves, and thus their potential to incur losses simultaneously and to trigger downward price spirals.[70]

5 Current state of the EU securitisation market

5.1 State of the market – issuance and retention

Although the European securitisation market grew significantly in the run-up to the crisis,[71] it has dramatically contracted since − with amounts outstanding dropping by one third to €1.5 trillion by the end of 2013 − and has failed to rebound, in contrast to the US market. From Table 1 it can be seen that, in parallel with the change in the *volume* in issuance − which peaked in 2008 at €819 billion, before dropping to €216 billion in 2014 − there was also a significant change in the retention rate: whereas in 2006-2007, most primary issuance was placed with end-investors and other banks. In the period 2008-2014, the composition of placed versus retained securitisation changes significantly; as a result, in 2014, the majority of issued transactions were retained by originators.

Table 1: European issuance

Values (billion euros)	2006	2007	2008	2009	2010	2011	2012	2013	2014
Placed	478	418	106	25	90	89	87	76	78
Retained	0	175	713	399	289	287	166	105	138
Total EU	478	594	819	424	379	376	253	180	216
EU retention %	*0%*	*30%*	*87%*	*94%*	*76%*	*76%*	*66%*	*58%*	*64%*
Total US	2 456	1 254	916	1 352	1 170	1 031	1 555	1 496	1 070

Source: Association for Financial Markets in Europe.[72]

According to an Association for Financial Markets in Europe report,[73] this can be explained by the fact that, 'In early 2008, at the height of the financial crisis, central banks started accepting securitisation as collateral for commercial bank funding, as

[67] D. Luttrell, H. Rosenblum, J. Thies, Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned.

[68] See ECB, Credit risk transfer by EU banks: activities, risks and risk management.

[69] H.S. Shin, Securitisation and financial stability.

[70] R. Nijskens, W. Wagner, Credit Risk Transfer Activities and Systemic Risk: How Banks Became Less Risky Individually But Posed Greater Risks to the Financial System at the Same Time.

[71] With the amount outstanding peaking in the years 2008-2009 at over €2 trillion in Europe, according to the EBA and the ECB.

[72] AFME, Securitisation Data Snapshot: Q1 2015.

[73] AFME, High-quality securitisation for Europe - The market at a crossroads, June 2014, chapter 4, 'The state of securitisation markets today'.

normal sources of interbank credit stopped flowing. As a result, banks started to retain securitisations on their balance sheets, using it as collateral for repo or other forms of secured funding', instead of placing it with investors.

5.2 Market composition

According to the EBA, the jurisdictions with the largest markets in securitised products in the European Union are the United Kingdom, the Netherlands, Spain and Italy. As for product composition, the largest market segment is occupied by residential mortgage-backed securities (59% of total issuance), with the second-largest class (asset-backed securities from SMEs) coming a distant second with around 8% of European new issuance by the end of 2013.

5.3 Possible explanations for reduced EU issuance

According to the EBA, 'different classes of securitisation products performed very differently during the recent financial crisis'. For example, while the default rates of US sub-prime RMBS and CDOs 'AAA' products'[74] peaked at 16% in the period 2006-2008, US CMBS default rates remained below 2%, while 'the performance of other asset classes considered observed almost zero default rates throughout the crisis period'.[75] According to the same report, 'The performance of securitisations in terms of losses appears to be equally heterogeneous across classes of securitisation products' with 'EMEA[76] RMBS and ABS products' displaying 'almost zero losses over the same reference period.'

The EBA and ECB reports identify several possible factors that could explain why EU securitisation issuance remains subdued in contrast to the US market. These factors include the absence of an Agency MBS market;[77] the 'post-crisis stigma attached to the market by investors'; the difference in accounting treatment;[78] the role of alternative funding instruments available to institutions in the EU,[79] as well as the availability of central bank funding; the tightening of the main credit rating agencies' rating methodologies and rating policies, affecting the securitisation asset class; the lack of a sufficient investor base; the potential regulatory uncertainty resulting on issuers and investors from the numerous regulatory initiatives yet to be finalised, at both EU and global level.

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74 The default rates were significantly higher in 'BBB'-rated products, e.g. 'BBB'-rated US RMBS sub-prime default rates peaked at slightly more than 60% at end 2007/beginning 2008.

75 See EBA report on qualifying securitisation.

76 'Europe, Middle East and Africa' region.

77 According to the ECB report, the aggregate US issuance has been driven mainly by Agency MBS, that is 'securities backed by loans that conform to specified standards and are structured so as to reduce the credit risk borne by investors through a guarantee from the so-called Government Sponsored Enterprises (or GSEs), primarily Fannie Mae and Freddie Mac.'

78 According to the same report, 'US banks, which report on a US Generally Accepted Accounting Principles (GAAP) basis, may have had stronger incentives to issue securitisations than European banks, which follow International Financial Reporting Standards (IFRS)'.

79 In Europe, there is a 'deep and liquid covered bond market', which may have partially offset the reduction in securitisation issuance.

6 Outlook – stakeholder proposals

To respond to the financial crisis, the European Union reviewed, updated and enhanced its regulatory framework to make it more resilient. In this context, it has adopted various regulations and directives in the areas of banking,[80] insurance,[81] asset management,[82] credit ratings,[83] and prospectuses,[84] which all regulate aspects of securitisation.

In parallel to this regulatory overhaul, in order to restore trust in these instruments in the absence of Government Sponsored Enterprises, various stakeholders have published their reflections and launched consultations on what possible changes could be brought to the process of securitisation itself, in order to simplify it, render it less opaque and, as a result, reduce its potential risk.

6.1 European Central Bank and Bank of England joint discussion paper

The European Central Bank (ECB) and the Bank of England jointly published a discussion paper[85] in May 2014, in which they examined the potential benefits of securitisation and outlined 'various impediments that may currently be preventing the emergence of a robust securitisation market'. Those impediments may concern investors (e.g. regulatory considerations, behavioural constraints, or risk assessment and management issues), issuers, (e.g. regulatory considerations, availability of underlying loans and facilities, data processing systems and information management issues, or the reliance on credit rating agencies), and also market structure and liquidity.[86] Taking into account those impediments, as well as the overarching principles of 'limiting tendency to concentrate risk in systemic institutions' and 'embodying features that improve the chances of predictable performance', the paper proposes some 'high-level principles that identify 'qualifying securitisations'.[87] Those relate to the nature of the assets and their history, the structure of the securitisation, its transparency, as well as the role of external parties in the credit assessment of the securitised products.[88]

6.2 EBA discussion paper

The EBA paper on simple standard and transparent securitisations (October 2014)[89] starts by noting that 'one of the most important lessons of the 2007-2009 crisis is that defaults and losses associated to securitisation positions have varied substantially

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80 Provisions in Regulation 575/2013/EU (Capital Requirements Regulation), Commission Delegated Regulation 2015/62 ('LCR' Delegated Act), Commission Delegated Regulation 625/2014, and Commission Implementing Regulation 602/2014.

81 Provisions in Directive 2009/138/EC (Solvency II) and Commission Delegated Regulation 2015/35 (Solvency II Delegated Act).

82 Provisions in Directive 2011/61/EU (AIFMD) and Delegated Regulation 231/2013 (AIFM Regulation).

83 Provisions in Regulation 1060/2009 (CRA III Regulation) and Commission Delegated Regulation 2015/3).

84 Provisions in Commission Regulation 809/2004 (Prospectus-Regulation).

85 ECB-BOE, The case for a better functioning securitisation market in the European Union.

86 *Idem*, pp.15-18.

87 The ECB and BOE take care, however, to note that '"qualifying securitisations" would not be "risk free" and investors would still need to conduct proper due diligence around them' and that 'the use of "qualifying securitisation" should not be regarded as a one-size-fits-all approach'.

88 *Idem*, pp.23-24.

89 EBA, discussion paper on simple standard and transparent securitisations.

across different asset classes and regions'.[90] For this reason, it acknowledges that 'a one-size-fits-all regulatory approach to securitisations appears to be no longer appropriate, as it may result in a too lenient treatment of transactions that are structurally risky and in an unduly conservative treatment of transactions that are simple, standard and transparent, as well as being backed by less risky exposures'.

Therefore, it is of the view that the regulatory approach to securitisations should incorporate a distinction between 'qualifying' and 'other' securitisations. The regulatory definition of 'qualifying' securitisation should follow a two-stage approach whereby, in order to qualify for different treatment, a securitisation transaction should:

a. first meet a list of criteria ensuring *simplicity, standardisation* and *transparency* (first step);[91]

b. and then (after those criteria have been satisfied), meet criteria of *minimum credit quality* of the underlying exposures.[92]

6.3 BCBS-IOSCO criteria

In 2014, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) established a joint task force to identify the factors that may be hindering the development of sustainable securitisation markets, and develop criteria for identifying simple, transparent and comparable securitisations (December 2014, issued for comment in February 2015).[93]

The joint task force identified 14 − non-exhaustive and non-binding − criteria[94] for *simple* (i.e. homogeneous underlying assets with simple characteristics, and a transaction structure that is not overly complex), *transparent* (i.e. providing investors with sufficient information on the underlying assets, the structure of the transaction and the parties involved in the transaction) and *comparable* (to assist investors in their understanding of such investments and enable more straightforward comparison across securitisation products within an asset class) securitisations, in three main categories that each relate to the different risks inherent in the securitisation process:

- Criteria on asset risk relate to the nature of the assets, their performance history, payment status, consistency of underwriting, and asset selection and transfer, as well as initial and ongoing data;
- Criteria concerning the securitisation structure (structural risk) relate to the redemption cash flows, currency and interest rate asset and liability mismatches, payment priorities and observability, voting and enforcement rights, documentation disclosure and legal review and alignment of interests;
- Finally, criteria that relate to fiduciary and servicer risk cover fiduciary and contractual responsibilities and transparency to investors.

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90 *Idem* p.12.

91 *Idem* pp.39-47.

92 *Idem* pp.47-49

93 BCBS-IOSCO, Criteria for identifying simple, transparent and comparable securitisations.

94 *idem* pp. 14-21.

6.4 European Commission's new legislative proposals

In its work programme for 2015,[95] the European Commission announced that it would develop an 'EU framework for high-quality securitisation'. The creation of 'a sustainable market for high-quality securitisation' was also identified in another initiative[96] as one of five areas in which short-term action was needed. In this context, the Commission launched a consultation (February-May 2015),[97] with the goal of 'gather[ing] information and views from stakeholders on the current functioning of European securitisation markets and how the EU legal framework can be improved to create a sustainable market for high-quality securitisation'.[98] Based on the results of this consultation, the European Commission proposed, on 30 September 2015, a package[99] including two legislative proposals.

6.4.1 A proposal for a regulation laying down common rules on securitisation

The first legislative proposal[100] builds on the aforementioned initiatives of the BCBS-IOSCO, the BOE-ECB and the EBA. It stipulates the criteria to be met by securitisations, provides the necessary supervisory framework and brings together the existing provisions in EU law related to risk retention,[101] disclosure,[102] due diligence[103] and supervision.[104] It contains two main parts: the first provides common rules that apply to all securitisations,[105] while the second contains criteria that define specifically simple, transparent and standardised (STS) securitisations.[106]

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95 COM(2014) 910 final.

96 The Investment Plan for Europe, COM(2014) 903 final.

97 European Commission, An EU framework for simple, transparent and standardised securitisation.

98 Stated goal of the Commission in: An EU framework for simple, transparent and standardised securitisation.

99 According to the European Commission, the two Regulations form a legislative package. As such, 'Capital requirements for positions in securitisation, including the more risk-sensitive treatment for STS securitisation' are set out in the proposal to amend the CRR, while 'eligibility criteria for STS securitisations, together with other cross-sectoral provisions' are contained in the Regulation laying down common rules on securitisation.

100 Proposal for a Regulation 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

101 There is a shift from the current 'indirect regime' −under which investors should check whether the originator, sponsor or original lender has retained risk− to a new approach which 'imposes a direct risk retention requirement and a reporting obligation on the originator, sponsor or the original lenders'.

102 Originators, sponsors and SPVs should be *jointly* responsible for the compliance with the STS requirements and for the notification to ESMA.

103 Investors still have to perform due diligence, but may place appropriate reliance on the STS notification and the information disclosed by the originator, sponsor and SPV on compliance with STS (see previous footnote).

104 Member States should designate competent authorities in accordance with existing EU legal acts in the area of financial services. In European level, the European Supervisory Authorities (EBA, ESMA and EIOPA) should coordinate the work of competent authorities across financial sectors and assess practical issues which may arise with regards to STS securitisations.

105 It puts the rules −previously scattered in different legal document− applying to credit institutions, asset management and the insurance sector in relation to securitisation in one legal act.

106 Notably, only 'true sale' securitisations can become STS.

6.4.2 A proposal to amend the Capital Requirements Regulation

The second legislative proposal aims to amend the Capital Requirements Regulation,[107] in order to incorporate into EU law the revisions to the securitisation framework made in 2014 by the BCBS,[108] and to make the capital treatment of securitisations more risk-sensitive and able to reflect properly the features of STS securitisations. The most important elements of this proposal are:

- a new hierarchy of approaches to calculate the capital charge for underlying exposures: an institution should start with an internal ratings-based approach, and only if it cannot calculate this, should it use the external ratings-based approach or the securitisation standardised approach for the calculation of the risk-weighted exposure amounts;
- a more risk-sensitive treatment of STS securitisations, that should generate lower capital charges in positions in transactions qualifying as STS securitisations;
- caps on the maximum risk weight for senior securitisation positions and on the maximum capital requirements;
- the elimination of special treatments currently provided for in the CRR for certain exposures, in order to reduce the framework's complexity; and
- the treatment of specific exposures, such as re-securitisations or senior positions in SME securitisations.

Three years after the entry into force of these two legislative acts the European Securities and Markets Authority (ESMA) would publish a report on the functioning of the transparency requirements and the level of transparency of the securitisation market in the EU, and the Commission would report to the Council and the Parliament on the impact of the new regulatory capital framework on EU securitisation markets. Finally, one year later, the Commission would review and report on the functioning of the STS regulation to the European Parliament and the Council, and − if needed − propose new legislation.

[107] Proposal for a Regulation amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

[108] Basel Committee on Banking Supervision 'Revisions to the securitisation framework'. The revisions aimed at addressing shortcomings such as the 'mechanistic reliance on external ratings, excessively low risk weights for highly-rated securitisation exposures or excessively high risk weights for low-rated senior securitisation exposures'.

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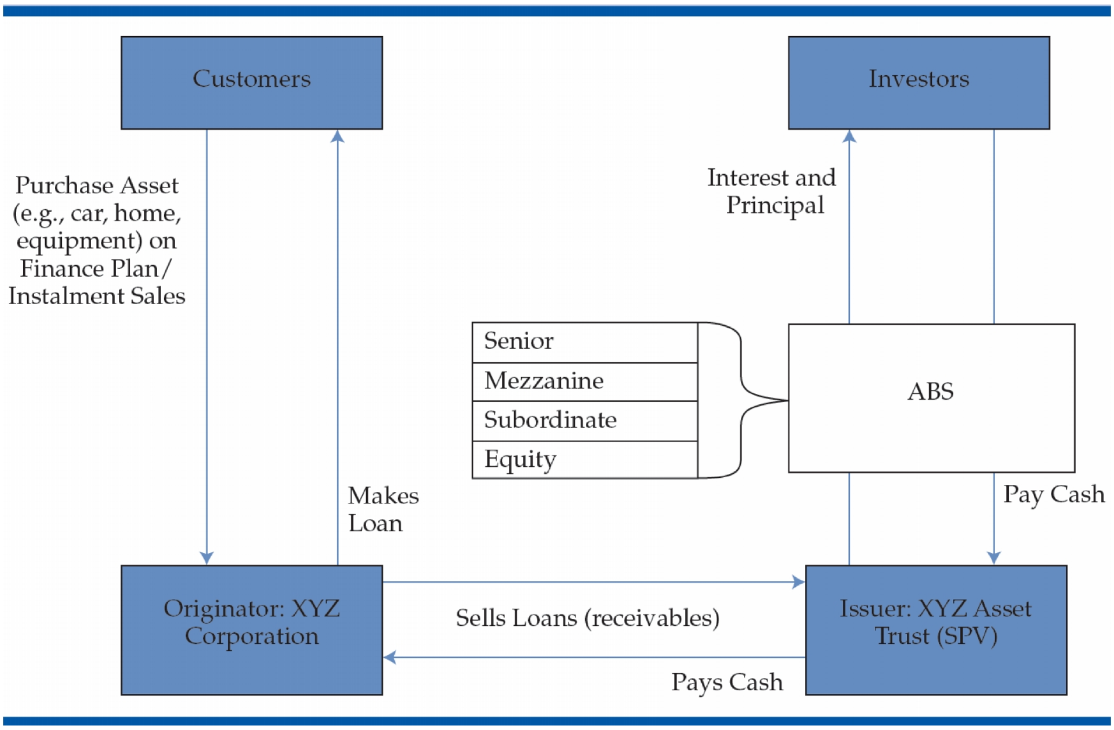
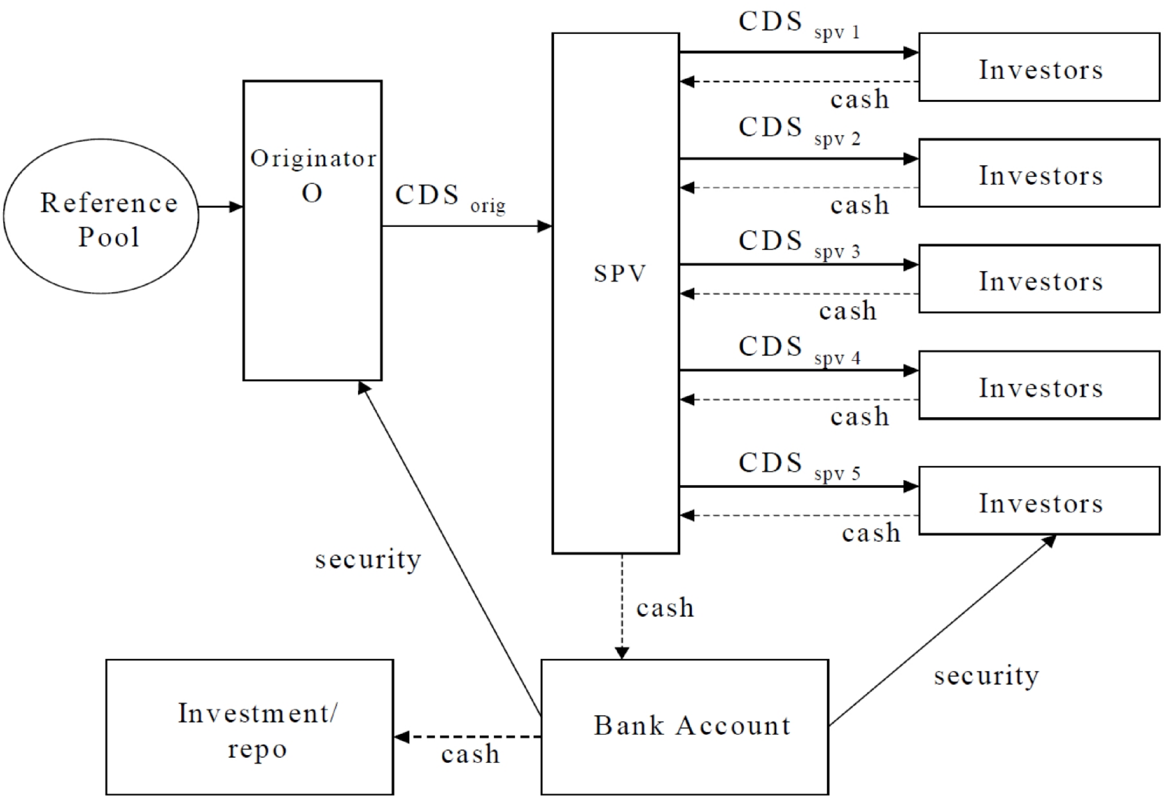
8 Annex

Figure 1: a traditional securitisation



Source: CFA Institute.

Figure 2: a synthetic securitisation



Source: I. Bell, P. Dawson, 'Synthetic securitisation: use of derivative technology for credit transfer'.

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In the blame game that followed the recent financial crisis, securitisation was held up as one of the main culprits. This reputation, amongst other factors, translated into a significant drop in issuance since the crisis, both in Europe and in the US. Nevertheless, the true picture is more nuanced – although securitisation presents real risks, it can also bring benefits to issuers, investors and the economy in general. Given this, and in the context of the current low-growth economic environment, a simpler and more transparent form has been proposed by various stakeholders, in the context of the creation of the Capital Markets Union, as a way to boost the European economy.

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