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**Article**

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# The European Securitization Market: Effects of an Uneven Regulatory Playing Field

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**ABSTRACT**

This article critically assesses the European securitization industry's claim of the existence of an uneven regulatory playing field for securitization structures vis-à-vis financial instruments deemed 'neighbouring' to securitization by the industry, like whole loan pools, corporate bonds, and covered bonds. According to market participants, the adverse regulatory treatment of securitization is negatively affecting the European securitization market, by pushing issuers and investors towards other financial instruments that are treated preferentially. Ultimately, this prevents the securitization market from escaping the subdued state in which it has been ever since the global financial crisis. To address this problem, market participants are advocating a fundamental recalibration of the existing regulatory framework. By examining the regulatory framework that applies to securitization structures, against the backdrop of regulation for whole loan pools, corporate bonds, and covered bonds, this article confirms that securitization structures are indeed treated adversely, as claimed by the industry. Nevertheless, a valid comparison can only be drawn between 'true sale' residential mortgage-backed securities (RMBS) structures and mortgage covered bonds, given the structural-economic similarities between the two financial instruments. In that regard, the adverse regulatory treatment of RMBS is found to be negatively impacting the European securitization market, by fuelling a 'crowding out' of RMBS by covered bonds.

**KEYWORDS:** financial law, financial regulation, debt financing, securitization, covered bonds

## I. INTRODUCTION

The new European regulatory framework for securitization, consisting of Regulation 2017/2402[1] (the Securitization Regulation or 'SECR') and Regulation 2017/2401[2] (amending the

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1 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 'SECR').

2 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.

Capital Requirements Regulation (CRR)),[3] was launched in January 2019 with the aim of jump-starting the European securitization market, which had remained subdued ever since the 2007–09 global financial crisis (GFC).[4] The same goal also underpinned the amendments to this new framework, introduced via Regulation 2021/557[5] and Regulation 2021/558,[6] as part of the European Union's 'Capital Markets Recovery Package' (CMRP).[7]

In and of itself, this re-embrace of securitization, on behalf of the European regulator, is striking, taking into account the mistrust (if not outright hostility) that characterized officials' perception of the financial technique from 2007 onwards, as a result of the role that securitization (was thought to have) played in Europe during the GFC.

As explained in greater detail in section II, the European regulator is no longer treating securitization as the poster child of 'bad financial innovation',[8] or as the 'root of all evil' that lay at the heart of the catastrophe that unfolded in 2007–09. As exemplified by the introduction of the simple, transparent, and standardized (STS) regime, the regulator is now recognizing (at least in theory) that European securitization, and particularly simpler, benign transactions, such as residential mortgage-backed securities (RMBS), performed exceptionally well during the crisis, and they therefore do not really deserve to be treated punitively. Instead, they should be embraced, and leveraged for the benefit of the wider European economy.[9]

Despite this 'newfound love' for securitization, however, it is fair to suggest that still today, four years after the new framework came into force, and almost three years after its CMRP amendments became applicable, the regulator's goal of reviving the European securitization market has not yet been achieved.

Regardless of any claims to the contrary, on behalf of the European regulatory authorities,[10] the numbers leave little room for doubt. In 2019, the year that SECR became applicable, total European placed securitization issuance was €119bn.[11] In 2020 this number dropped to €81.4bn, whereas in 2021 placed issuance was equal to €126bn.[12] In 2022, total placed

3 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').

4 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 'SECR Proposal') Explanatory Memorandum, at 2–3.

5 Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 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 crisis [2021] OJ L116/1.

6 Regulation (EU) 2021/558 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 crisis [2021] OJ L116/25.

7 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 Explanatory Memorandum, at 1.

8 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) 135–36.

9 SECR Proposal (n 4) Explanatory Memorandum 2.

10 See for instance the European Commission's comment about the European securitization market faring relatively well, having stabilized after years of decline, in European Commission, 'Report From the Commission to the European Parliament and the Council on the Functioning of the Securitisation Regulation' (10 October 2022) (hereinafter the 'EC Report'), at 4–5, 25. Cf also Joint Committee of the ESAs, 'Joint Committee Advice on the Review of the Securitisation Prudential Framework (Banking)—Response to the Commission's October 2021 Call for Advice to the JC of the ESAS—JC 2022 66' (12 December 2022) (hereinafter the 'ESA Joint Advice Banking'), at 7, where it is argued that the European securitization market is now more robust in terms of quality, compared to the period of the GFC. Nevertheless, fairly recently the European Securities and Markets Authority (ESMA) acknowledged that, compared to its pre-GFC state, the European securitization market has shrunk dramatically, see Sylvain Canto and others, 'The EU Securitisation Market—An Overview' (21 September 2023), at 4.

11 Association for Financial Markets in Europe (AFME), 'Securitisation Data Report Q4 2020' <https://www.afme.eu/Publications/Data-Research/Details/AFME-Securitisation-Data-Report-Q4-2020> accessed 2 January 2024, at 12.

issuance declined sharply to €79.7bn.[13] In Q3 2023, €26.1bn of securitized product was placed, compared to €19bn in Q3 2022.[14]

To put those numbers in perspective, the market is clearly in a better shape than 2009, when, amid the GFC, total placed issuance fell to a record low of €25.2bn.[15] But compared to the period prior to the introduction of the SECR, things are looking rather bleak.[16]

A look at the outstanding amounts of European securitization also serves as confirmation of the fact that the market has not been not faring well during the last few years. In 2018 the market for securitization in Europe was worth €1,112bn,[17] significantly more than the €957.5bn it was worth in Q3 2023.[18]

Of course, the period that followed the introduction of the SECR in 2019 can hardly be described as 'normal'. The Covid-19 pandemic and the very accommodative monetary policy of the European Central Bank (ECB) and other central banks, which aimed to mitigate the pandemic's effects (resulting in a very low interest rate environment), were followed by severe inflationary pressures and a policy of quantitative tightening that is still being unfolded. Such extraordinary events have cast a heavy shadow on the wider European economy, including its financial market, and securitization has hardly been an exception.[19] It is therefore undoubtable that the continuous shrinking of the European securitization market can, at least partly, be attributed to wider historic events and their economic repercussions.

Quantifying the precise effect of those events on the European securitization market is evidently complicated. According to the securitization industry, it is nonetheless clear that those events alone cannot shoulder the entire blame for the aforementioned dire condition of the market. As the industry points out, placed securitization issuance in other major markets such as the US, which were equally affected by the pandemic and were faced with similar monetary policies, has been much more vibrant throughout this period, compared to Europe.[20]

The securitization industry also points to other 'neighbouring' segments of the wider European financial market, such as the covered bond market, which seem effectively to have withstood the turbulence that unfolded from 2020 onwards.

Leaving aside for the time being the question of the validity of any comparison drawn between securitization structures and covered bonds (more on that below), it is true that, despite contracting in 2020–2021, European placed (benchmark) covered bond issuance staged an impressive comeback in 2022, when more than €160bn of covered bonds were bought by investors. This set a record that greatly surpassed the issuance levels of 2018 and 2019.[21] In 2023 covered bond supply is expected to be above €150bn.[22] In terms of outstanding amounts,

12 AFME, 'Securitisation Data Report Q4 2021' <https://www.afme.eu/Portals/0/AFME%20Q4%202021%20Securitisation%20Report.pdf?ver=2022-03-15-105526-747> accessed 2 January 2024, at 16.

13 AFME, 'Securitisation Data Report Q1 2023' <https://www.afme.eu/publications/data-research/details/securitisation-data-report-q1-2023-> accessed 2 January 2024, at 19.

14 AFME, 'Securitisation Data Report Q3 2023' <https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Report%20Q3%202023_.pdf> accessed 2 January 2024, at 22.

15 AFME/ESF, 'Securitisation Data Report, 2010 Q4' <https://www.sifma.org/resources/research/afme-esf-securitisation-data-report-2010-q4/> accessed 2 January 2024, at 3.

16 By way of example, in 2018, the last year prior to the introduction of the SECR, total European placed securitization issuance was equal to €136.2bn, see AFME, 'Securitisation Data Report Q4 2018' <https://www.afme.eu/publications/data-research/details/securitisation-data-report-q4-2018> accessed 2 January 2024, at 7.

17 Excluding collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs), see AFME Q4 2018 (n 16) 11.

18 AFME Q3 2023 (n 14) 30.

19 Cf European Systemic Risk Board (ESRB), 'Monitoring Systemic Risks in the EU Securitisation Market' (July 2022), at 26 fn 47.

20 PCS, 'Response to the Consultation on the Securitisation Regulation' (26 September 2021), at 4–5.

21 S&P Global, 'Covered Bonds Outlook 2023: Sailing Through Choppy Waters' (December 2022), at 7.

22 Ibid.

the European covered bond market had a size of €2.25tn in 2018.[23] By the end of 2022, that market was worth €2.46tn.[24]

According to the securitization industry, the conclusion is evident: unlike the European securitization market, which has experienced a severe and prolonged contraction, the covered bond market showed remarkable resilience during the pandemic and the other extraordinary events mentioned above, and has even managed to grow.

What is it then that makes the European securitization market so distinct, and prevents it from flourishing, unlike its US counterpart and the market for covered bonds?

In the securitization industry's view, the new European regulatory framework introduced in 2019 has played a crucial role in that regard. In fact, not only has the SECR and its amendments failed so far, regarding their aim to revitalize the subdued European securitization market, but they also seem to be functioning as an effective roadblock to securitization by creating even greater distortions than their predecessors.

If this claim is accurate, it is without a doubt remarkable, taking into account that the SECR was deemed to signify a shift in the treatment of securitization and an active attempt to help the European securitization market to grow.

Indicatively, in the industry's response to the consultation regarding the functioning of the new European securitization framework, launched by the EC in July 2021,[25] more than 70% of the respondents argued that the new framework has been unsuccessful in improving access to credit for the real economy, particularly for small and mid-size enterprises (SMEs); in widening the investor base for securitization products in Europe; and in convincing financial institutions to increase their engagement in issuing and originating securitizations. As a matter of fact, the only objective that the SECR has been somewhat successful in achieving so far, according to market participants, is providing a high(er) level of investor protection.[26]

Market participants point to various shortcomings of the new framework in order to explain why it has so far been unsuccessful. The complexity and narrowness of scope that characterize the STS regime; the jurisdictional scope of the new framework and in particular the hurdles created by article 5, para 1(e) of the SECR, when it comes to investing in 'third-country securitizations'; and the system of ex ante assessment by competent authorities regarding the significant risk transfer (SRT) process, are just a few of the criticisms levelled against the new framework.[27]

While acknowledging the significance of all those criticisms, this article focuses on one specific claim put forward by the securitization industry, which features prominently in the list of market participants' concerns when they attempt to explain why the SECR has so far failed to achieve its objectives. This is the claim that the existing regulatory framework results in an

23 Otmar Stöcker and Cristina Costa, 'Overview of Covered Bonds' in *ECBC European Covered Bond Fact Book* (2019), at 158.

24 Joost Beaumont, Cristina Costa and Otmar Stöcker, 'Overview of Covered Bonds' in *ECBC European Covered Bond Fact Book* (2023), at 142.

25 European Commission, 'Targeted Consultation on the Functioning of the EU Securitisation Framework' (23 July 2021).

26 EC Report (n 10) 6, fig 1. This focus on the opinion of market participants should not be perceived as an attempt to ignore, or minimize the significance of opinions regarding the regulation of securitization, expressed by other stakeholders, in the context of the European Commission's 2021 consultation and/or elsewhere. Indeed, the response to the consultation comprised a wide variety of replying stakeholders, including public authorities, non-governmental organizations, and academic/research institutions, a number of which diverged from market participants in the opinion they expressed about securitization, and cautioned against any kind of regulatory easing. Nevertheless, the fact that almost 73% of the respondents were either business organizations or business associations (cf European Commission, 'Summary Report: Targeted Consultation on the Functioning of the EU Securitisation Framework 23 July 2021—17 September 2021' (29 September 2022) (hereinafter 'EC Targeted Consultation Summary'), at 2, table 1), allows us to treat the findings of the response to the European Commission's consultation as primarily reflective of the securitization industry's opinion.

27 For a more comprehensive analysis of those concerns, see EC Targeted Consultation Summary (n 26); High Level Forum, 'Final Report of the High Level Forum on the Capital Markets Union—A New Vision for Europe's Capital' (10 June 2020); and EBF, 'Relaunching the European Union's Securitisation Market: What Needs to be Done in the Context of the Capital Markets Union' (2 September 2021) (hereinafter 'EBF Relaunching').

uneven regulatory playing field for European securitization structures vis-à-vis other financial instruments that the industry deems 'neighbouring' to securitization, such as whole loan pools, corporate bonds, and especially covered bonds.[28]

To elaborate, the industry claims that the regulatory disadvantages that European securitization faces are discouraging potential issuers and investors from engaging in relevant securitization transactions. At the same time, those disadvantages are prompting active market participants to migrate to other financial instruments that receive a more favourable regulatory treatment, in the sense that they impose less stringent obligations to issuers and investors, and/or the prudential treatment they receive is more advantageous to the interests of those who hold such financial instruments in their books.

In order to reverse this trend, and allow the securitization market to flourish, to the benefit of the wider European economy, market participants have been consistently pushing for a fundamental reform of the new securitization framework, which will lead to a more favourable treatment of securitization and thus to a level regulatory playing field.[29]

This article critically assesses this claim put forward by the European securitization industry, by contextualizing it, in section II, through a brief review of the regulatory treatment that securitization has received in Europe ever since the GFC. The objective is to understand why the industry is complaining by examining the rationale behind the original, 'punitive' post-GFC treatment of securitization; whether this rationale was valid; and how the currently applicable, 'accepting' regulatory framework differs to its predecessor.

Section III focuses on specific provisions of the existing regulatory framework that apply to securitization structures, whole loan pools, corporate bonds, and covered bonds, and examines whether the regulatory playing field is indeed uneven, as market participants claim.

This analysis confirms that European securitization structures receive an adverse regulatory treatment vis-à-vis the aforementioned financial instruments, in respect of four main regulatory areas: (i) disclosure and due diligence obligations imposed on sell-side entities and buy-side entities respectively under the SECR; (ii) regulatory capital requirements imposed on credit institutions under the CRR; (iii) inclusion of assets in the liquidity portfolios of credit institutions under the liquidity coverage ratio (LCR);[30] and (iv) capital requirements imposed on (re)insurance undertakings under Solvency II.[31]

Section IV explores the response of the European regulator to the industry's concerns, by assessing its view on the currently applicable regulatory framework. More precisely, it examines whether the regulator agrees with market participants that the playing field is uneven regarding securitization and, if so, whether a levelling of the playing field, through a fundamental recalibration of the existing framework, is ultimately warranted.

It is pertinent to note at the outset the significant divergence in opinion between the regulator and market participants. Indeed, notwithstanding some very recent signs that some sort of regulatory easing might be on the table, the regulator appears convinced that the existing regulatory



[28] Cf EC Targeted Consultation Summary (n 26) 3.

[29] See for instance the recommendations put forth by the High Level Forum—an expert group comprising industry executives and international experts and scholars that was created in 2019 under the auspices of the EC: High Level Forum (n 27) 52–54.

[30] 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, as amended via 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.

[31] 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, and associated legislation.

playing field is sufficiently levelled, and that any disparity in the way that securitization is being treated vis-à-vis other financial instruments is justified, given that securitization is inherently riskier than whole loan pools, corporate bonds, and covered bonds.

For those reasons, there is no prospect of any fundamental recalibration of the existing framework, at least in the near future. The only realistic hope for market participants is an indirect levelling of the playing field, via certain 'targeted' amendments that have been proposed.

Against the backdrop of this divergence in opinion, section V distinguishes between the adverse regulatory treatment that securitization structures receive in Europe vis-à-vis whole loan pools, corporate bonds, and covered bonds—an objective fact—and whether this adverse treatment also signifies an uneven regulatory playing field for securitization—a subjective question, to which the industry responds affirmatively and the regulator negatively.

It is submitted that an uneven regulatory playing field could only exist if a valid comparison can be drawn between specific securitization structures and the other financial instruments (whole loan pools, corporate bonds, and covered bonds), which the industry deems 'neighbouring' to securitization. In addition, arguing that the playing field is uneven to the detriment of a specific securitization structure presupposes that this structure is less, or equally, risky (but certainly not riskier) than its 'neighbouring' financial instrument, and yet the former is treated more harshly than the latter by the regulator.

The conclusion reached is that such a comparison can only validly be drawn between 'true sale' RMBS structures and residential mortgage-backed covered bonds, given the structural-economic similarities between the two financial instruments. In fact, regarding RMBS and covered bonds, a competitive dynamic is identified in their interrelationship. Existing academic literature and empirical findings confirm that covered bonds have historically functioned as a substitute for, and have effectively 'crowded out', European RMBS, because of, inter alia, the preferential regulatory treatment that covered bonds have received vis-à-vis RMBS. Crucially, this 'crowding out' of RMBS by covered bonds is observed to be still taking place today.

Moreover, the analysis in this article shows that the risks that 'true sale' RMBS poses for (senior) investors are comparable to, if not less severe than, the risks that covered bondholders face at the post-insolvency stage of the covered bond issuer.

In light of the above, it is argued that the claim put forward by market participants about the existence of an uneven regulatory playing field, to the detriment of securitization, is valid, so far—but only so far—as RMBS vis-à-vis covered bonds is concerned.

Finally, section VI provides some concluding remarks.

## II. THE POST-GFC REGULATORY TREATMENT OF SECURITIZATION

Assessing the validity of the securitization industry's claim about the adverse treatment of securitization, and the existence of an uneven regulatory playing field, necessitates an understanding of the currently applicable regulatory framework for securitization in Europe; how that framework aims to fix the shortcomings of its predecessor; and the extent to which this objective has been fulfilled.[32]

[32] For a detailed analysis of the regulation of securitization in Europe in the aftermath of the GFC; the extent to which the original 'punitive' post-GFC framework was justified and effective; and how/whether the new 'accepting' framework that was launched in 2019 addresses the shortcomings of its predecessor, see Graham Penn and Thomas Papadogiannis, 'Regulating Securitisation in the Aftermath of the Global Financial Crisis: Lessons from Europe' (2021) 36(6) Journal of International Banking Law & Regulation 225.

### 1. Re-embracing securitization

As mentioned in section I, the new securitization framework, launched in 2019, explicitly aims to help the European securitization market to grow and to escape the subdued state in which it has found itself ever since the GFC.

This re-embrace of securitization reflects the regulator's realization that this financial technique has the potential to function as a 'bridge between credit institutions and capital markets with an indirect benefit for businesses and citizens', and can also 'provide relevant investors with exposure to asset classes decoupled from the credit risk of the originator'.[33]

It is also an acknowledgement of 'the much stronger performance of EU securitizations compared to US ones'.[34] This is an official recognition by the regulator that securitization, and particularly its simpler, benign variations, such as 'true sale' prime RMBS, were not the main culprits of the troubles that plagued Europe in the context of the GFC (and beyond). Far from it, those simple securitization products performed very well, allowing originators to refinance their loans and achieve regulatory capital relief, while insulating investors from major market and credit losses.

As noted by the European Commission, 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 US AAA and BBB RMBS was between 3% and 16%[35] and between 46% and 62%[36] respectively.[37]

Crucially, this realization on behalf of the regulator is no longer limited to classic 'true sale' securitizations, but also encompasses 'balance sheet' synthetic structures[38] which, throughout the GFC, 'appear to perform better than true sale tranches across asset classes'.[39] As of 2014, the average default rate for highly-rated 'balance sheet' synthetics was 2%, whereas the default rate for comparable, 'true sale' ABS was 3.4% for the same year.[40] Furthermore, senior tranches of balance sheet synthetics that included SME loans in their pools had, as of the end of 2018, a 0% lifetime default rate.[41]

The STS regime, originally developed for classic 'true sale' securitization, and now extended (via Regulation 2021/557) to also cover 'balance sheet' synthetics, is the most obvious example of this re-embrace.

Securitization transactions or tranches that meet the requirements of articles 20–22 ('true sale' term securitizations), or articles 24–26 (asset-backed commercial paper (ABCP) securitizations), or articles 26b–26e ('balance sheet' synthetic securitizations) of the SECR, as amended via Regulation 2021/557, can qualify for the 'STS kitemark', as a recognition, on behalf of the regulator, of the simplicity, transparency, and standardization which characterizes the process by which those transactions are structured.[42]

33 SECR Proposal (n 4) Explanatory Memorandum 2.

34 Ibid 10.

35 The default rate for prime US AAA rated RMBS was 3%, whereas the rate for the subprime AAA RMBS was 16%.

36 The default rate for prime US BBB rated RMBS was 46%, whereas the rate for the subprime BBB RMBS was 62%.

37 SECR Proposal (n 4) Explanatory Memorandum 3.

38 To be distinguished from 'arbitrage' synthetic structures. Unlike 'balance sheet' synthetics, that are used for risk management purposes (transfer of credit risk), and for achieving regulatory capital relief, 'arbitrage' synthetics seek to capture the arbitrage opportunity or profit by capturing the spread between the yields paid to securitization investors and the yield realized on the underlying assets, see 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) (hereinafter 'EC SynthSec July 2020'), at 1.

39 EBA, 'The EBA Report on Synthetic Securitisation' (December 2015) 17.

40 Orçun Kaya, 'Synthetic Securitisation: Making a Silent Comeback' Deutsche Bank Research (21 February 2017), at 6.

41 EBA, 'Report on STS Framework for Synthetic Securitisation under Article 45 of Regulation (EU) 2017/2402' (6 May 2020) 26, fig 16.

42 SECR Proposal (n 4) Explanatory Memorandum 3–4. Importantly, as the European Commission points out, non-STS securitizations can also be structured in a fashion that guarantees their quality.

Going beyond the (substantive) STS regime, the European regulator has also recalibrated the prudential treatment of securitization, ie the capital requirements for credit institutions, investment firms, and (re)insurance undertakings that invest in securitization positions.

To elaborate, the regulator now provides for a stricter treatment of AAA rated tranches, senior and non-senior. Such tranches are now subject to both a higher risk weight floor (15% instead of 7%), and to a higher risk weight ceiling (70% instead of 20%).[43] At the same time, the risk weight floor for BB+ rated tranches has been lowered from 250% to 90% (senior tranches under the Securitization External Ratings-Based Approach (SEC-ERBA)), whereas for BB− rated tranches it has been lowered from 650% to 140% (senior tranches under the SEC-ERBA).[44]

Most importantly, the introduction of the (substantive) STS regime has been coupled with the creation of a dedicated framework for the prudential treatment of STS securitizations. As argued by the regulator, developing STS eligibility criteria would not suffice, in and of itself, to achieve the goal of reviving the European securitization market, unless accompanied by a prudential framework that promoted STS securitizations by better reflecting their specific features.[45]

As a means of incentivizing credit institutions to invest, senior STS tranches that also meet certain additional requirements set out in the amended CRR[46] are subject to a risk weight floor of 10%[47] (instead of 15% for all other securitizations). AAA rated STS securitizations have a risk weighting of 10%–40%[48] (instead of 15%–70% for all other securitizations). In addition, as a recognition of the good liquidity performance of simple securitizations during the GFC, highly-rated senior STS tranches have now been included in the LCR, replacing non-STS tranches as eligible Level 2B assets.[49]

Furthermore, in an effort to incentivize (re)insurance undertakings to become once again active in the securitization market, Solvency II also provides for the preferential prudential treatment of STS securitization. The old distinction between Type 1 and Type 2 securitizations is abolished, and now the crucial distinction is between STS and non-STS tranches. The spread risk assigned to STS tranches is evidently lower compared to the spread risk of Type 1 and Type 2 securitizations of the previous regime.[50] Indicatively, it has been calculated that a senior 3-year AAA rated STS securitization will have a spread risk of 3%, whereas Type 1 and Type 2 securitizations of the same quality and tenor would be assigned a spread of 6.3% and 37.5% respectively under the previous regime.[51]

43 Compare the original CRR, article 251ff, with the new article 259 and article 263, introduced via Regulation 2017/2401.

44 Compare the original CRR, article 261, table 4 with the new article 263, table 2, introduced via Regulation 2017/2401.

45 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 Explanatory Memorandum, at 7.

46 CRR, new article 243, introduced via Regulation 2017/2401. Leaving ABCP transactions aside, those requirements include 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 collateral.

47 CRR, new articles 260, 262, introduced via Regulation 2017/2401.

48 CRR, new article 264, table 4, introduced via Regulation 2017/2401.

49 Regulation 2015/61, article 13, as amended via Regulation 2018/1620.

50 Compare 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, article 178, with the new article 178, introduced via 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.

51 Marke Raines, 'UK Regulation of Term Securitisation Following a Hard Brexit' (2018) 13(4) Capital Markets Law Journal 534, at 547.

## 2. A break from the punitive past (?)

Of course, by re-embracing securitization, the European regulator is not entirely absolving the financial technique for the catastrophe of 2007–09. On the contrary, the new framework contains a number of provisions that reflect the regulator's concern about more 'opaque' securitization structures, and the role that such structures played in exacerbating the problems that became apparent during the GFC.[52]

The de facto ban on re-securitization[53] across the board[54] because it is deemed to hinder the transparency that the SECR seeks to establish,[55] and its exclusion from the STS regime,[56] along with CLOs and commercial mortgage-backed securities (CMBS),[57] due to the latter's perceived complexity,[58] are clear indications that the regulator is still somewhat wary of securitization, and the effects that this financial technique can have on the wider economy if left unchecked. Compared to the previous framework however, that was developed in the immediate aftermath of the GFC,[59] the regulator is now much more willing to accommodate securitization and its industry.

To elaborate, the previous framework had been heavily criticized by market participants as overly punitive and disproportionate because it effectively bundled all types of securitization, and treated them all as inherently risky and problematic, without drawing any distinction between simple and complex transactions, or between transactions that legitimately aimed at financing the real economy and/or achieving regulatory capital relief (which performed very well during the crisis) and transactions that perversely securitized 'for the sake of securitising' (and resulted in significant losses for investors).[60]

To the extent that the new framework engages in such a distinction between simple, benign structures that insulated investors from losses, and opaque 'perverse' structures that hurt investors and jeopardized the stability of the wider financial system, it has been warmly welcomed by the securitization industry in Europe.

At the same time however, there is concern amongst market participants that the European regulator is still somewhat tethered to the punitive perception of securitization which characterized the previous regulatory framework.



52 In particular, the regulator is concerned about the use of securitization as an 'end in itself', with an aim to profit through arbitrage, instead of using securitization as a means of financing the real economy and/or achieving (legitimate) regulatory capital relief. It was this 'perverse' use of securitization that arguably contributed to the catastrophe of 2007–09, because it incentivized credit institutions to lower their lending standards, and create securitizations that were backed by other structured finance products, a practice that exponentially increased complexity and risks. For additional analysis on this issue, see Penn and Papadogiannis (n 32) 227–28.

53 Defined in SECR, article 2(4), as a securitization 'where at least one of the underlying exposures is a securitisation position'.

54 SECR, article 8. The sole exception is for re-securitizations that are to be used 'for legitimate purposes'.

55 SECR, Recital 8.

56 SECR, article 20 para 9.

57 Cf SECR, article 20 para 7, that prevents STS pools from being actively managed on a discretionary basis, and para 13, according to which the repayment of investors cannot be structured to depend predominantly on the sale of assets that have been included in the securitization pool.

58 SECR, Recital 29.

59 The previous regulatory framework surrounding securitization was introduced in 'stages', beginning in the immediate aftermath of the GFC with 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 (CRD II); 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-securitizations, and the supervisory review of remuneration policies [2010] OJ L329/3 (CRD III); Solvency II; and 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 (AIFMD), and culminating in the CRR and the LCR that were introduced a few years later.

60 See Penn and Papadogiannis (n 32) 231–35 for a comprehensive critique of the original post-GFC framework for securitization.

According to the securitization industry, despite officially aiming at the further development of a European securitization market for simple transactions, such as 'true sale' STS RMBS, the new framework ends up disincentivizing market participants, because, inter alia, it still treats securitization (including benign variations) more harshly than other financial instruments that the industry considers 'neighbouring' to securitization, such as whole loan pools, corporate bonds, and covered bonds.[61]

This article now turns to this claim, on behalf of market participants, in order to assess its accuracy.

## III. THE SECURITIZATION INDUSTRY'S CONCERNS REGARDING THE UNEVEN REGULATORY PLAYING FIELD

As already explained, the adverse regulatory treatment that securitization structures receive vis–vis whole loan pools, corporate bonds, and covered bonds, features prominently in the market participants' list of concerns. The four main regulatory areas around which this criticism on behalf of the industry revolves are disclosure and due diligence obligations; capital requirements imposed on credit institutions under the CRR; inclusion of assets in the LCR's liquidity portfolios; and capital requirements imposed on (re)insurance undertakings under Solvency II.

This section examines each of those regulatory areas in turn.

### 1. Disclosure and due diligence obligations

As market participants point out, 'securitisation legislation imposes the heaviest burdens on both securitisation issuers in terms of disclosure and investors in terms of due diligence'.[62]

It is important to bear in mind that such obligations are not a novelty of the SECR. In fact, disclosure and due diligence requirements were first imposed on sell-side entities and buy-side entities respectively in the immediate aftermath of the GFC. Along with 'skin-in-the-game' requirements for sell-side entities, disclosure and due diligence obligations were introduced in the context of the second iteration of the Capital Requirements Directive (CRD II), as part of a bundle of rules that aimed at tackling the 'perverse incentives' that the originate-to-distribute (OTD) model of securitization was thought to have fuelled, by more closely aligning the interests of originators and investors.[63]

In the context of the original 'punitive' post-GFC framework, disclosure and due diligence obligations were imposed regardless of the type of securitization transaction in which the investor engaged, ie regardless of how simple or complex the specific securitization was. As mentioned in section II, the SECR distinguishes between STS and non-STS securitizations. Nevertheless, disclosure and due diligence obligations still apply across the board, and are in fact considerably reinforced.

#### *a. Disclosure obligations*

To elaborate, regarding disclosure obligations, those are reinforced in substance as well as in scope: The relevant information now has to be made available not just to holders of a

[61] It is important to bear in mind that not all stakeholders share this opinion. In fact, others have cautioned against any further regulatory convergence between securitization structures and other financial instruments like covered bonds, given the higher systemic risks that securitization entails in their opinion, see for instance Frédéric Hache, 'A Missed Opportunity to Revive "Boring Finance"?' *Finance Watch* (December 2014), at 67.

[62] PCS (n 20) 14.

[63] See Penn and Papadogiannis (n 32) 231–33 and 236–38 for a detailed analysis of the 'perverse incentives' criticism levelled against securitization in the aftermath of the GFC, and the measures adopted by the European regulator as a response to that criticism.

securitization position (as was the case under the previous framework),[64] but also to the competent authorities and, upon request, to potential investors.[65]

Furthermore, market participants claim that the information required from sell-side entities under article 7 of the SECR is both gravely disproportionate and unfit for purpose, especially so far as private securitization deals are concerned.[66]

More precisely, market participants argue that article 7 obliges originators and other entities to disclose information that is too granular and excessive, considering that, especially in private deals,[67] investors are usually able to obtain all the data they need in order properly to conduct their due diligence by requesting it directly from the originator. By forcing sell-side entities to produce and then disclose information that is irrelevant to investors, the SECR ends up significantly elevating the cost of setting up a securitization transaction, while increasing inefficiency.[68] Ultimately, this creates artificial barriers to entry into the market that stifle market growth.[69]

At the same time, the format in which information has to be disclosed under article 7, ie the standardized templates that the SECR has mandated ESMA to develop, has also been heavily criticized, to the extent that the use of said templates is also mandatory for private securitizations.

Indeed, the industry considers the current ESMA templates inappropriate for use in private deals, given that they involve a number of unnecessary elements, whereas some of the fields included in those templates require sell-side entities to provide data that is sometimes confidential.[70]

Focusing on simple, benign structures that the SECR is (at least in theory) promoting, ie STS securitizations, it is important to bear in mind that, in their case, disclosure obligations are arguably even more extensive, in order for a relevant transaction to be deemed 'transparent',[71] especially if it is a 'balance sheet' synthetic STS transaction.[72]

### *b. Due diligence obligations*

Regarding the due diligence obligations that the SECR imposes on institutions investing in securitizations (STS and non-STS) under article 5, the industry has consistently complained that those requirements create an unnecessary and costly burden.

More specifically, market participants point out that the very concept of standardizing due diligence obligations is problematic, given that the due diligence that each institution conducts prior to investing in a securitization is tailor-made, so as to reflect the specificities of each transaction. In other words, the information that will be requested from sell-side entities will differ from case to case, exactly because the needs of each individual investor will differ.[73] This is

64 Cf CRR, article 409 (now deleted via Regulation 2017/2401).

65 SECR, article 7 para 1.

66 EC Targeted Consultation Summary (n 26) 13.

67 In the context of the SECR, private deals are those securitizations for which no prospectus has to be drawn up in compliance with Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64 (see SECR, article 7 para 2).

68 EBF Relaunching (n 27) 27–28; Australian Securitisation Forum, 'Targeted Consultation on the Functioning of the EU Securitisation Framework' (30 September 2021), at 5–8; AFME, 'Targeted Consultation on the Functioning of the EU Securitisation Framework' (30 September 2021) (hereinafter 'AFME Response'), at 25.

69 EC Targeted Consultation Summary (n 26) 10.

70 Ibid 14.

71 SECR, article 22.

72 Mayer Brown, 'Amendments to the EU Securitisation Regulation—the New Synthetic STS Framework and Adjustments in Relation to Non-Performing Exposures' (April 2021), at 2; Allen & Overy, 'The New EU STS Framework for On-Balance Sheet (Synthetic) Securitisations' (January 2021), at 26. By way of example, article 26c of the SECR, introduced via Regulation 2021/557, provides for extended disclosures on credit risk and currency risk mitigants for synthetic STS, compared to the requirements under article 21 of the SECR for 'true sale' STS.

73 EC Targeted Consultation Summary (n 26) 11; Fédération Bancaire Française, 'FBF Response to the Targeted Consultation on the Functioning of the EU Securitisation Framework' (30 September 2021), at 10.

especially the case in private deals, where investors are often able to request specific data directly from the originator.

Despite the above, article 5 of the SECR obliges investors across the board to include in their due diligence exercise all the information that sell-side entities are required to disclose under SECR article 7.[74] Investors also have to verify that sell-side entities have made this information available in accordance with the stipulated frequency and modalities.

By leaving no room for discretion to investing institutions, and forcing them to review a significant number of documents, regardless of whether the information included therein is actually useful to them, the SECR creates an unnecessary and costly burden. At the same time, investors continue to request all the information they *actually* need, in order to assess the risks they assume, even if this information is not contained in the templates that sell-side entities use to disclose information, as per article 7. This further increases costs for buy-side and sell-side entities alike.

Even worse, by standardizing due diligence obligations, and forcing investors to review documents that are more or less irrelevant to them, the SECR effectively dilutes the critical information, and creates a risk that important documents will not receive the requisite attention.[75]

### *c. Industry recommendations*

Among the recommendations put forward by the industry,[76] in order to alleviate the burden imposed on sell-side and buy-side entities, via disclosure and due diligence obligations respectively, it is proposed that articles 5 and 7 of the SECR are more closely aligned to the relevant provisions that apply to covered bond issuers and investors.[77]

The new regulatory covered bond framework, introduced via Directive 2019/2162[78] and Regulation 2019/2160[79] (amending the CRR), imposes a number of disclosure obligations to issuing credit institutions, which are admittedly more stringent compared to the previous regime.[80]

For instance, issuers are now under an obligation to inform investors about the market risk, credit risk, and liquidity risk that the relevant covered bond transaction entails. They also have to disclose information about the levels of required and available coverage, including overcollateralization.[81] In addition, such information needs to be provided to investors on at least a quarterly basis, instead of an at least semi-annual basis, as was previously the case.

Finally, it is worth noting that under the new covered bond framework, the disclosure obligations of the issuer are no longer owed solely to credit institutions and investment firms, nor are they a mere condition that needs to be met in order for the relevant bonds to be eligible for preferential prudential treatment. Instead, those obligations are applicable vis-à-vis every covered bond investor, regardless of its status, and they are no longer linked to the prudential

74 This is the effect of article 5 para 1(e) cross-referring to article 7 of the SECR.
75 EBF Relaunching (n 27) 27.
76 For those various recommendations see High Level Forum (n 27) 64; Fédération Bancaire Française (n 73) 11–12; AFME Response (n 68) 17–19.
77 Cf PCS (n 20) 11, 15; Groupe Crédit Agricole, 'GCA Response to the European Commission's Targeted Consultation on the Functioning of the EU Securitisation Framework' (27 September 2021), at 5; Paris EUROPLACE, 'Paris EUROPLACE's response to the European Commission's targeted consultation on the functioning of the EU securitisation framework' (17 September 2021), at 4; Insurance Europe, 'Response to Consultation on EC Call for Feedback on Securitisation Framework' (September 2021) (hereinafter 'Insurance Europe'), at 2.
78 Directive (EU) 2019/2162 of the European Parliament and of the Council of 27 November 2019 on the issue of covered bonds and covered bond public supervision and amending Directives 2009/65/EC and 2014/59/EU [2019] OJ L328/29.
79 Regulation (EU) 2019/2160 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards exposures in the form of covered bonds [2019] OJ L328/1.
80 Compare Directive 2019/2162, article 14 with CRR, article 129 para 7 (prior to its amendment via Regulation 2019/2160).
81 Directive 2019/2162, article 14 para 2 (c), (f).

treatment of the financial instrument.[82] In that sense, the covered bond issuer's obligations are indeed wider.

However, even the more comprehensive requirements of the new covered bond framework pale in comparison to what sell-side entities in a securitization transaction have to disclose.

And when it comes to due diligence obligations, the difference between the two regimes is even more striking. Under the original article 129 of the CRR, covered bondholders were required to demonstrate to the competent authorities that they had received portfolio information on a number of matters (in that sense the disclosure obligations of the issuer were indirect). This provision was understood to create a (minimum) due diligence obligation for those investing in covered bonds.[83]

Directive 2019/2162 on the other hand, makes the disclosures obligations of the covered bond issuer direct, and omits any reference to the requirement, on behalf of investors, to demonstrate that portfolio information has actually been received. In that sense, investors owe no due diligence obligations under Directive 2019/2162. Compared to that, the stringent requirements of article 5 of the SECR are another clear indication of the adverse treatment that securitization receives.

As market participants argue, this difference in regulatory treatment effectively means that a covered bond can receive an AAA rating, even if the information on the underlying assets, eg mortgage loans, that the issuer discloses to covered bondholders is just a *small fraction* of the information that would have to be disclosed to investors by sell-side entities in a securitization transaction, if the same mortgage loans were instead backing an AAA senior securitization tranche. And this is despite the fact that, similar to securitization, covered bonds also (partially) depend on the pool of assets that backs them for the repayment of investors.[84]

The risk of regulatory arbitrage, stemming from the higher burden that investing in securitization entails, is evident. So is the risk of investors migrating to lower-due diligence financial instruments, just like covered bonds, and thus creating additional hurdles to the revival of the European securitization market. In fact, according to some market participants, such a migration is already underway.[85]

### 2. Regulatory capital requirements under the CRR

Moving on to regulatory capital requirements under the CRR, the most pressing concern of the industry in that regard seems to be revolving around the capital non-neutrality rules created by the new securitization framework.[86]

The concept of 'non-neutrality' stems from the idea that securitized assets are inherently riskier than non-securitized assets, and involves a capital surcharge (the so-called 'p' factor) on capital requirements for banks when the latter invest in securitization positions, as well as a minimum risk weight on (senior) securitization positions, which is known as the 'risk weight floor'.[87]

At the EU level, the 'p' factor is set by the CRR at a minimum 0.3 when calculating capital requirements using the Securitization Internal Ratings-Based Approach (SEC-IRBA).[88] This

82 This is the case because the covered bond issuer's disclosure obligations are no longer provided for in the CRR (the scope of which is limited to credit institutions and investment firms), but rather in Directive 2019/2162, which creates a substantive covered bond framework, and therefore has a much wider scope.

83 Cf Fritz Engelhard, Florian Eichert and Richard Kemmish, 'Regulatory Issues' in *ECBC European Covered Bond Fact Book* (2013), at 156.

84 PCS (n 20) 14.

85 Ibid 11.

86 EBF Relaunching (n 27) 11.

87 European Commission, 'Call for Advice to the Joint Committee of the ESAs for the Purposes of the Securitisation Prudential Framework Review' (18 October 2021), at 3.

88 CRR new articles 259 para 1, and 260, introduced via Regulation 2017/2401.

effectively translates into a 30% capital surcharge on securitization tranches. When capital requirements are calculated using the Securitization Standardized Approach (SEC-SA), the 'p' factor is set at 0.5 for STS securitizations and at 1 for non-STS securitizations.[89] The risk weight floor on the other hand is set at 10% for senior STS tranches and at 15% for non-STS tranches.[90]

According to market participants, the current calibration of capital non-neutrality rules at the European level is unduly harsh and ultimately unjustifiable, since it does not constitute an accurate reflection of European securitization and its performance, past or present.[91] As they point out, even if modelling and agency risks were significant in the past, when the Basel Committee on Banking Supervision (BCBS) first conceived the concept of non-neutrality, an idea that is in and of itself controversial, today those risks have clearly lost their significance. After all, bank models have improved significantly, whereas rules that aim at tackling 'perverse incentives' and complexity have been applied across the board.[92]

Focusing on the 'p' factor, the industry has consistently highlighted how important it is to recalibrate it, especially in the context of the SEC-SA, in view of the upcoming output floor introduced in the Basel III framework. As the industry notes, when coupled with the output floor which will be calibrated on the standardized approach, the currently punitive calibration of the 'p' factor under the SEC-SA is expected to have a severe negative effect on securitization, especially retained tranches in synthetic SRT deals, and significantly discourage its use.[93] This will be due to an effectively double layer of conservatism that will be introduced once the reforms of Basel III come into force.[94]

It is important to note that capital non-neutrality rules are a 'peculiarity' of the securitization framework, since they aim at addressing the specific modelling and agency risks that are thought to arise when assets are securitized. Therefore, they do not apply to other financial instruments, resulting in overall lower risk weights.

A comparison to covered bonds suffices to illustrate this disadvantage. Using the Standardized Approach (SA), highly-rated (AAA to AA) covered bonds are assigned a 10% risk weight.[95] So are unrated covered bonds, provided that senior unsecured exposures to the covered bond issuer are assigned a 20% risk weight.[96] Using the Internal Ratings-Based Approach (IRBA) on the other hand, it has been calculated that covered bonds with a short maturity can be assigned a risk weight as low as 2.01%.[97]

Compared to the 10–15% risk weight floor that applies to securitization, covered bonds are evidently treated preferentially by the regulator.[98]

Faced with this adverse regulatory treatment, market participants are pushing for a recalibration of capital requirements for senior securitization tranches, in order to bring them in line

89 For STS securitizations, see CRR, new article 262, introduced via Regulation 2017/2401. For non-STS securitizations see CRR, new article 261 para 1, introduced via Regulation 2017/2401.

90 For STS tranches see CRR, new articles 260, 262, 264, introduced via Regulation 2017/2401. For non-STS tranches see CRR, new articles 259, 261, 263, introduced via Regulation 2017/2401.

91 EC Targeted Consultation Summary (n 26) 47.

92 EBF, 'Annex to the EBF Response to the European Commission's Targeted Consultation on the Functioning of the EU Securitisation Framework' (1 October 2021) (hereinafter 'EBF Response') 4–6.

93 EC Targeted Consultation Summary (n 26) 47. See also Fédération Bancaire Française (n 73) 29; EBF Response (n 92) 4.

94 The phase-in of Basel III reforms in the EU is now expected to begin in 2025, see Lorenzo Migliorato, 'EU's Basel III Delay Invites All to Play for Time' (15 November 2021) <https://www.risk.net/our-take/7897626/eus-basel-iii-delay-invites-all-to-play-for-time> accessed 2 January 2024.

95 CRR, article 129 para 4, table 6a.

96 Ibid articles 129, 120–21.

97 Frank Will, 'Regulatory Issues' in *ECBC European Covered Bond Fact Book* (2022), at 161.

98 Moreover, it is pertinent to note that current calibrations also put European securitization at a disadvantage vis-à-vis US securitization, since the US regulator has made use of the discretion provided under Basel rules to assign a 'p' factor of 0.5 when using the SEC-SA, instead of a factor of 1, as chosen by the European regulator (regarding non-STS securitizations), see PCS (n 20) 32.

with capital requirements for covered bonds and make them reflective of the actual risk profile of securitization.[99]

### 3. Inclusion in LCR portfolios

The frustration of market participants regarding the way that securitization is treated under the currently applicable LCR rules permeates their responses to the European Commission's targeted consultation, as well as other industry reports.[100]

Focusing on the shortcomings of the current calibration, it is important to note at the outset that the introduction of the STS regime in the context of the LCR resulted in an exclusion of (previously eligible) non-STS tranches from all levels of the liquidity ratio, and the replacement of those tranches by senior STS tranches at the same LCR level (Level 2B).

Adding insult to injury, in order to qualify for inclusion in Level 2B, a securitization tranche now needs to meet a much more stringent and comprehensive standard compared to the previous regime.[101] At the same time, the applicable haircuts remain unchanged. Thus, senior STS tranches backed by residential loans and auto loans and leases are subject to a minimum haircut of 25%,[102] whereas tranches whose underlying assets are SME-heavy loans and consumer loans are subject to a minimum 35% haircut.[103] There is also a five-year maturity cap applicable to securitizations that aim at qualifying for the LCR, introduced under the previous framework, and maintained following the introduction of the STS regime.[104]

As the industry argues, this adverse prudential treatment of securitization under the LCR is plainly unjustifiable, because it fails to acknowledge the performance of European securitization structures from a liquidity perspective since the GFC and until today.

Beginning with the period of the GFC, market participants claim that, quite contrary to the findings of the European Banking Authority (EBA),[105] simple securitization structures exhibited a liquidity performance that was equally as good as, and in certain respects superior to, the performance of other financial instruments, including covered bonds.[106]

To elaborate, for certain securitization structures, such as auto loan-backed securities, deemed by the EBA as completely illiquid, studies have illustrated that from 2010 onwards the most senior AAA tranches exhibited liquidity that was comparable to that of covered bonds. In early 2012, during the peak of the sovereign debt crisis in Europe, the most liquid AAA auto loan securitizations are found to have been more liquid than top-rated covered bonds.[107] During the same period, the most liquid AAA RMBS in countries with an active securitization market like Spain and the UK, appeared to perform on par with, and at times even better than, similarly rated covered bonds, even though RMBS spreads did exhibit a long tail with some particularly illiquid issues.[108]

99 EBF Relaunching (n 27) 14; Fédération Bancaire Française (n 73) 31. See also High Level Forum (n 27) 52–53.

100 Cf High Level Forum (n 27); and EBF Relaunching (n 27).

101 Prior to the introduction of the STS regime, securitizations could qualify for inclusion in Level 2B of the LCR, provided they met a number of requirements included in article 13 paras 2–14 of Regulation 2015/61. Today, this set of requirements has been replaced with the requirement to qualify as STS, see Regulation 2015/61, article 13 (as amended via Regulation 2018/1620). Qualifying as STS however, means complying with more than 100 separate criteria, set out in the new securitization framework. As such, the bar for inclusion in the LCR is now much higher than it was before.

102 Regulation 2015/61, article 13 para 2 points g(i), (ii) and (iv), and para 14(a).

103 Ibid article 13 para 2 points g(iii) and (v), and para 14(b).

104 Ibid article 13 para 12. See also PCS (n 20) 35.

105 EBA, 'Report on appropriate uniform definitions of extremely high quality liquid assets (extremely HQLA) and high quality liquid assets (HQLA) and on operational requirements for liquid assets under Article 509(3) and (5) CRR' (December 2013).

106 Bill Thornhill, 'Covered Bond Lobbyists 1, ABS Market 0' *Global Capital* (25 October 2013).

107 William Perraudin, 'Covered Bond versus ABS Liquidity: A Comment on the EBA's Proposed HQLA Definition' (Risk Control, January 2014), at 21 (fig 8), 24 (fig 11).

108 Ibid 4, 18 (fig 6 for the UK, and fig 7 for Spain).

In the same vein, ever since 2016, and including the period of the Covid-19 pandemic, senior RMBS and auto loan securitizations appear to have been consistently more liquid than covered bonds.[109] Crucially, this observation is not limited to highly-rated securitizations, but also applies to senior securitizations of all ratings.[110]

However, this robust liquidity performance of securitization vis-à-vis covered bonds (and other financial instruments) is not reflected on the current LCR framework. Covered bonds are eligible for inclusion not just in Level 2B, but rather in every LCR Level (1, 2A, and 2B), and they are subject to considerably more lenient rating requirements[111] and haircuts.[112]

In a similar fashion, securitization structures receive an adverse treatment vis-à-vis corporate bonds in the context of the LCR: Corporate bonds are eligible for inclusion in both Level 2A and Level 2B of the LCR, provided they meet certain requirements, eg regarding their size and tenor.[113] The minimum rating they must have is BBB,[114] and the minimum haircut for Level 2A is 15%,[115] which is significantly lower than the respective haircut for Level 2A securitization (25% or 35%).

To close the gap between securitization transactions and the aforementioned financial instruments, market participants have suggested including senior STS tranches backed by residential loans and auto loans and leases in Level 1 of the LCR, subject to a minimum AA− rating, a minimum 7% haircut, and a minimum issue size of €500mn (similar to Level 1 covered bonds). Senior STS tranches backed by SME-heavy loans and consumer loans would then become eligible for Level 2A, subject to the same requirements as covered bonds eligible for the same level (minimum A− rating, minimum 15% haircut, a minimum issue size of €250mn). Senior STS tranches not meeting the issue size criteria for inclusion in either Level 1 or Level 2A would be eligible for Level 2B, but the minimum rating would be BBB− (instead of AAA/AA, as it currently stands), and the minimum haircut would be 30%.[116]

## 4. Regulatory capital requirements under Solvency II

Both in its response to the European Commission's 2021 Consultation and elsewhere, the securitization industry has made it abundantly clear that, in its view, the Solvency II framework for securitization is in dire need of review, in order to reinvigorate interest in securitization amongst insurers.[117] As market participants explain, it is imperative that (re)insurance undertakings become once again active investors in securitization, not only for the sake of the insurance industry, but even more importantly for the sake of the wider European economy.[118]

Despite the European regulator's explicit goal to incentivize (re)insurance undertakings to return to the European securitization market, where they once played a significant role,[119] the results so far have been described by market participants as 'nothing short of catastrophic'.[120] Indicatively, as revealed in the May 2021 Report of the European Supervisory Authorities' (ESAs) Joint Committee (JC), by end-2019 the share of securitization positions in the investment portfolios of European (re)insurance undertakings was equal to 2.3%. The investment of

109 William Perraudin and Yixin Qiu, 'Comparing ABS and Covered Bond Liquidity' (AFME and Risk Control, 25 February 2022) (hereinafter 'Perraudin Liquidity 2022'), at 8.
110 Ibid 7, Fig 3.
111 Regulation 2015/61, article 10 para 1(f), article 11 para 1(c) and (d), and article 12 para 1(e).
112 Ibid articles 10 para 2, 11 para 2, and 12 para 2(d).
113 Ibid article 11 para 1(e) and article 12 para 1(b).
114 Ibid article 12 para 1(b).
115 Ibid article 12 para 2.
116 EBF Relaunching (n 27) 47–48, Appendix 2.
117 Ibid 23.
118 PCS (n 20) 39.
119 Cf ECB and BoE, 'The Case for a Better Functioning Securitisation Market in the European Union' (May 2014), at 14.
120 PCS (n 20) 7–8.

insurers in STS securitization represented 2% of that amount, making the total investment in STS securitization by insurers equal to a mere 0.046%.[121]

In the industry's view, these truly disheartening data are inextricably linked to the prudential treatment of securitization under Solvency II. Indeed, the consensus amongst market participants seems to be that, even after the incorporation of the STS regime in Solvency II, the regulatory capital requirements imposed by the current framework are the main factor hindering the increase of investment in securitization by insurers.[122] This holds true not just for more complex transactions, but also for STS tranches, senior and non-senior (mezzanine).[123]

Focusing on STS securitizations, their treatment under the currently applicable provisions of Solvency II is admittedly better, compared to the treatment that an equivalent tranche would have received under the previous 'punitive' regime.

That said, the industry has expressed a number of concerns in that regard. In order to illustrate how adverse the treatment of STS securitization is under Solvency II, the industry refers to recent studies that analyse the relative risk of European securitization structures vis-à-vis other 'neighbouring' financial instruments during the Covid-19 pandemic.

To elaborate, despite findings that the risk of senior and non-senior STS tranches is 5% and 3% lower respectively, compared to the risk that a (re)insurance undertaking assumes when investing in a covered bond,[124] the latter is treated in a clearly favourable fashion under Solvency II. The same holds true when securitization is compared to corporate bonds.

By way of example, a one-year AAA rated senior STS tranche has a spread risk of 1%, whereas an equivalent corporate bond is assigned a spread risk of 0.9%, and an equivalent covered bond has a spread risk of 0.7%.[125] As tenor increases, the gap becomes more visible: a five-year AAA rated senior STS tranche has a spread risk of 5%, whereas the spread risk for an equivalent corporate bond and covered bond is 4.5% and 3.5% respectively.[126]

The biggest difference however lies between non-senior STS tranches and other financial instruments. Indicatively, a five-year AAA rated non-senior STS tranche is assigned a spread risk of 14%. Compared to the 4.5% and 3.5% spread risk assigned to equivalent corporate bonds and covered bonds respectively, the difference is astonishing. In the same vein, a five-year AA rated non-senior STS tranche is assigned a spread risk of 17%. Again, compared to the 5.5% and 4.5% spread risk assigned to equivalent corporate bonds and covered bonds respectively, the treatment that securitization receives is without a doubt adverse.[127]

Furthermore, under Solvency II, securitization tranches are also treated unfavourably vis-à-vis whole loan pools. This is the case not just for non-STS tranches, eg when the capital charge of investing in a CLO tranche is compared to investing in a pool of leveraged loans, but also for STS tranches, senior and non-senior.[128]

Remarkably, as one market participant explains, Solvency II effectively requires an (re)insurance undertaking to allocate more capital to the purchase of an AAA rated senior

[121] Joint Committee of the ESAs, 'Joint Committee Report on the Implementation and Functioning of the Securitisation Regulation (Article 44)' (17 May 2021), at 43–44.

[122] EC Targeted Consultation Summary (n 26) 57. That said, according to the ESAs' Questionnaire, included in Joint Committee of the ESAs, 'Joint Committee Advice on the Review of the Securitisation Prudential Framework (Insurance) JC-2022/67' (12 December 2022) (hereinafter 'ESA Joint Advice Insurance'), at 65ff, Annex I, a significant number of stakeholders are of the opinion that the current calibration for capital requirements on securitization under Solvency II is proportionate and commensurate with securitization's risk.

[123] EC Targeted Consultation Summary (n 26) 57–59.

[124] William Perraudin and Yixin Qiu, 'ABS and Covered Bond Risk and Solvency II Capital Charges' (AFME and Risk Control, 25 February 2022), at 3.

[125] See Regulation 2015/35, article 176 for corporate bonds, article 178 for securitization, and article 180 for covered bonds.

[126] Cf Raines (n 51) 547; Insurance Europe (n 77) 20.

[127] Cf Deutsche Bank, 'Deutsche Bank Response to the European Commission Targeted Consultation on the Functioning of the EU Securitisation Framework' (28 September 2021), at 44.

[128] Ibid 41, 42; Insurance Europe (n 77) 20.

STS RMBS tranche, than to the purchase of a pool of the same residential mortgages that would collateralize that RMBS. This is despite the fact that such an RMBS tranche will have a credit enhancement equivalent to 20 times the worst credit loss that has been recorded historically for this asset class, and also notwithstanding the fact that such RMBS tranches suffered no credit losses during the GFC.[129]

Given the inability, so far, of the Solvency II framework to incentivize insurers to return to the European securitization market, even after the amendments introduced via Regulation 2018/1221, the industry is pushing for a further fundamental review that will finally allow securitization to compete with other 'neighbouring' financial instruments on an equal footing.

Thus, market participants are arguing that capital charges for senior STS tranches (but also potentially for senior non-STS tranches) should be more closely aligned to the charges applicable to covered bonds and corporate bonds of equivalent rating and maturity.[130] This could be achieved by aligning capital charges for senior STS and non-STS tranches to equivalent covered bonds, when the securitization is backed by granular mortgage loans or consumer loans. When the securitization is backed by corporate loans, capital charges for senior STS and non-STS tranches could be aligned to charges applicable to corporate bonds.[131]

Finally, in order to close the gap between securitization and whole loan pools, market participants are suggesting that the capital charge for senior securitization tranches should in principle become lower than the charge applied to the respective whole loan pools on a standalone basis[132] or, at the very least, the capital charge for senior tranches should be capped at the capital charge of the underlying asset pool.[133]

## IV. THE EUROPEAN REGULATOR'S RESPONSE

Following the publication of the October 2022 EC Report on the functioning of the SECR, and the December 2022 Joint Advice of the ESAs on the prudential treatment of securitization, the direction of travel for the regulatory treatment of European securitization vis-à-vis other 'neighbouring' financial instruments has become much clearer. This direction, however, is hardly what the industry had been hoping for.

### 1. The current regulatory playing field is justified

Before delving into an analysis of the specific points raised by the European Commission and the ESAs, concerning each area in which the securitization industry is claiming there is an uneven regulatory playing field, it is pertinent to bear in mind that, despite its acknowledgement that securitization is indeed treated adversely vis-à-vis other financial instruments, the European regulator does not agree that the regulatory playing field surrounding securitization and other 'neighbouring' financial instruments is uneven, or that the adverse treatment that securitization receives should be a source of concern.

In all fairness, in their responses, the European Commission and the ESAs do acknowledge the industry's concerns. It is thus noted that the industry considers disclosure and due diligence obligations imposed under the SECR on sell-side and buy-side entities respectively as 'too prescriptive and strict', compared to the obligations imposed on institutions involved in covered bond transactions.[134] In a similar fashion, it is recognized that, according to market participants, STS securitizations (and asset-backed commercial paper (ABCP) structures) should be treated

[129] PCS (n 20) 40.
[130] High Level Forum (n 27) 53.
[131] Insurance Europe (n 77) 20.
[132] High Level Forum (n 27) 53.
[133] Deutsche Bank (n 127) 43; EBF Relaunching (n 27) 23.
[134] EC Report (n 10) 9.

in the same way as covered bonds under the LCR,[135] and that capital charges imposed on securitization structures, particularly non-STS and non-senior STS, under Solvency II are too high, relative to capital charges for corporate bonds and covered bonds.[136] This acknowledgement however, on behalf of the regulator, does not translate into an endorsement of the securitization industry's concerns.

On the contrary, as the ESAs point out, the claim about an uneven regulatory playing field is probably an exaggeration, at least in the context of Solvency II. On the one hand, regulatory capital requirements imposed on senior STS securitization tranches are 'approximately of the same magnitude' as those imposed on corporate bonds and covered bonds.[137] To the extent that there is any actual disparity in treatment, eg between non-STS/non-senior STS tranches and other 'neighbouring' financial instruments, such disparity is in fact justified.

This is due, not only to the 'nature of securitization and its added risk', ie the fact that, in the ESAs' view, securitization is inherently riskier, or that other instruments are inherently safer,[138] but also due to the limited interest that (re)insurance undertakings exhibit in investing in securitization, compared to covered bonds and corporate bonds.[139] Focusing on the latter argument, the regulator interprets the fact that (re)insurance undertakings have been marginal investors in securitization for a fairly long time—a phenomenon that even the STS amendment of Solvency II, via Regulation 2018/1221, failed to reverse—as an indication that such institutions do not consider prudential regulation as an important driver in their investment activity.[140]

After all, as the ESAs argue, capital requirements for senior STS tranches are 'broadly comparable' to those for covered bonds and corporate bonds. Nevertheless, the share of senior STS tranches in the portfolios of (re)insurance undertakings is only a fraction of the share that covered bonds and corporate bonds, but also—remarkably—non-STS tranches have, proving that incentives related to the prudential treatment of securitization is not what keeps (re)insurance undertakings away from securitization structures.[141]

Based on those findings, the ESAs conclude that, even assuming that the regulatory playing field was indeed uneven, any kind of levelling for senior STS tranches and other 'neighbouring' financial instruments (or for STS tranches vis-à-vis non-STS tranches) would be unwarranted, because its effectiveness, as a means of incentivizing (re)insurance undertakings to return to securitization, is far from certain, whereas the cost of amending the existing framework is potentially too high.[142]

In a similar fashion, the evident disparity in treatment between securitization and covered bonds in the context of the LCR[143] is justified because, contrary to the findings of research commissioned by the securitization industry,[144] covered bonds are in fact much more liquid than securitization, at least when the repo market is taken into consideration.[145]

135 ESA Joint Advice Banking (n 10) 90.
136 ESA Joint Advice Insurance (n 122) 36.
137 Ibid 9, 24–25.
138 Ibid 63. See also ibid 31, where the ESAs point to the 'dual recourse' (to the issuer, as well as to underlying pool of assets) that covered bonds offer to investors, as a justification for the preferential regulatory treatment that covered bonds receive vis-à-vis securitization.
139 Ibid 23, figs 17, 18.
140 Ibid 5.
141 Ibid 25–26.
142 Ibid 6.
143 Where, as explained above, securitization (STS) tranches are eligible only for inclusion in Level 2B, subject to a number of stringent requirements, regarding haircuts, maturity caps, ratings etc, whereas covered bonds are eligible for inclusion in all LCR Levels.
144 Perraudin Liquidity 2022 (n 109).
145 ESA Joint Advice Banking (n 10) 93.

In addition, the ESAs note that, ever since the introduction of the LCR, the share of securitizations (including STS tranches) in credit institutions' liquidity buffers has been practically negligible, unlike covered bonds that have been used extensively by banks as 'high quality liquid assets' (HQLA).[146]

This 'indifference' towards securitization, on behalf of credit institutions, is particularly noteworthy according to the ESAs if one takes into account that, overall, the LCR levels of European banks are considerably above minimum regulatory standards.[147] On top of that, while developing the European liquidity framework, the European regulator deviated from Basel rules, and expanded the category of securitization products that could qualify for the LCR, exactly so as to incentivize credit institutions to use securitization as a means of improving their liquidity profile.[148] Not even that, however, was sufficient to convince banks to include more securitization tranches in their buffers.

The conclusion reached by the ESAs is that credit institutions do not consider securitization as an effective means of coping with liquidity stress periods, because they deem securitization structures to be ineffectively marketable during periods of stress. An alternative explanation they provide is that banks do not find securitization attractive enough to diversify into.[149]

In view of the above, upgrading securitization in the LCR would make little sense, and is certainly not a priority, because banks already have considerable incentives to invest, yet they steer clear of securitization. Further incentivizing them would do very little to change that situation.

### 2. No need for a fundamental recalibration of the regulatory framework

The European regulator's stance, regarding the regulatory playing field for securitization vis-à-vis other 'neighbouring' financial instruments, is indicative of its wider perception of the European securitization framework. More precisely, according to the European Commission and the ESAs, the regulatory framework of securitization in Europe, ie the SECR and the prudential rules stemming from the CRR, LCR, and Solvency II, is overall fit for purpose.

So far as the securitization market is concerned, the regulator considers it to be fairing relatively well, and to have improved in terms of quality, having stabilized after years of decline.[150] That 'success' can partly be attributed to the new regulatory framework, since the latter has already contributed significantly to the achievement of the EU's core goal of establishing a safe and sound European securitization market that works to the benefit of the wider economy.[151] Even more remarkably, and without providing any relevant evidence, the European Commission suggests that market participants are 'generally supportive' of the new securitization framework.[152]

Bearing in mind those conclusions reached by the regulator, it should come as no real surprise that, unlike market participants, the European Commission and the ESAs consider any substantial reform to the SECR or the securitization prudential framework as unwarranted for the time being.[153] Instead, they suggest that all that is needed is a targeted, technical, fine-tuning of the existing framework for consistency.

146 Ibid 87–88, see especially fig 31.
147 Ibid 87.
148 Ibid 87–88.
149 Ibid 8–9, 14, 87.
150 EC Report (n 10) 4–5, 25.
151 Ibid 25.
152 Ibid 5.
153 See ibid 7 for the SECR; ESA Joint Advice Banking (n 10) 7 for the CRR and the LCR; and ESA Joint Advice Insurance (n 122) 4 for Solvency II.

*a. Some positive developments*

In all fairness, despite its explicit disagreement with the industry, some of the targeted amendments that the European regulator has proposed do have the potential indirectly to ameliorate the position of securitization vis-à-vis other financial instruments, deemed 'neighbouring' by the industry.

The plan put forth by the European Commission in its October 2022 Report, to streamline disclosure obligations imposed on sell-side entities under the SECR, is a characteristic example of such a potentially beneficial targeted amendment.

To elaborate, in an acknowledgement that, ever since it was introduced, article 7 of the SECR has been a source of considerable concern for market participants, the European Commission recognized that, in some areas, templated disclosure has been functioning inefficiently, forcing sell-side entities to produce and report information that is often useless to investors. This inefficiency has been the source of unnecessary compliance costs.[154] It also took into account the industry feedback that ESMA templates were inappropriate in their current form, so far as private deals are concerned, acknowledging that 'because of the bespoke nature of private securitization, investors in such transactions need more tailor-made information than the ESMA templates might be able to provide'.[155]

In response, the regulator suggested that templated disclosure should be further streamlined and simplified, and to that end, it mandated ESMA to review the existing templates for underlying assets in securitization. More specifically, ESMA was invited to address certain technical difficulties faced by sell-side entities when completing the relevant templates; to remove fields from the templates that are deemed unnecessary; and to align disclosure obligations more closely with investors' needs. Furthermore, ESMA was asked to assess the extent to which disclosing loan-by-loan data is helpful to investors, regardless of the type of securitization.[156]

To the extent that they are implemented, those suggestions by the European Commission have the potential significantly to ease the burden currently assumed by sell-side entities in securitization deals, and to align the SECR more closely to Directive 2019/2162, which imposes disclosure obligations on credit institutions that issue covered bonds. It is for such reasons that the European Commission's plan has been warmly received by market participants,[157] who have praised ESMA's proactive engagement with the industry,[158] and have committed to work closely with the regulator in the context of the formal public consultation that ESMA launched in December 2023, which was expected to run until 15 March 2024.[159]

Another example of a potentially beneficial proposal, from a regulatory playing field-perspective, is the ESAs' recommendation to recalibrate capital non-neutrality rules in the CRR. Specifically, the ESAs have recommended that, subject to a number of requirements (concerning amortization, granularity, and the thickness of non-senior tranches that are sold to third parties),[160] the risk weight floor for retained senior STS tranches, risk weighted under

154 EC Report (n 10) 10.

155 Ibid 11–12.

156 Ibid 10.

157 AFME and others, 'Securitisation can Provide Significant Support to Europe's Economy in the Testing Times Ahead—Targeted Measures are Needed to Unlock its Potential' (3 November 2022) (hereinafter 'AFME November 2022'), at 2, 8; AFME and others, 'Request for Guidance to National Competent Authorities to Use Enforcement Powers in a Proportionate and Risk-Based Manner' (9 December 2022), at 1–2. Cf Jennifer Aubry and others, 'EU Securitisation Review: Two Months on' (Clifford Chance, December 2022), at 2–3.

158 ESMA quickly began working towards the implementation of its mandate, by launching an informal 'pre-consultation' in December 2022, through which the industry had the opportunity to provide feedback, see AFME, 'Securitisation Data Report Q4 2022' <https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Report%20Q4%202022%20and%202022%20Full%20Year-2.pdf> accessed 2 January 2024, at 6.

159 ESMA, 'ESMA Consults on Possible Changes to the Securitisation Disclosure Templates' (December 2023) <https://www.esma.europa.eu/press-news/esma-news/esma-consults-possible-changes-securitisation-disclosure-templates> accessed 2 January 2024.

the SEC-IRBA (as the most sophisticated approach), should be reduced from 10% to 7%. For retained senior non-STS tranches risk weighted under all the approaches, the floor should be reduced from 15% to 12%.[161] If accepted by the European Commission, this recommendation will achieve a closer alignment between risk weights imposed on securitization structures, and risk weights imposed on covered bonds.

At the same time however, by limiting the risk weight floor recalibration to retained tranches, the ESAs' recommendation aims exclusively at facilitating the SRT market, and those originating credit institutions involved in 'balance sheet' synthetic securitization (SRT) deals. On the contrary, risk weights for securitization tranches sold to the market will remain unchanged. The ESAs justify this decision by arguing that a recalibration of capital non-neutrality rules aimed at investors would not be particularly helpful in the effort to revitalize the European securitization market, in view of other factors that keep investor demand subdued.[162]

Even regarding SRT deals, market participants point to the risk that any potentially positive effect of the recommendation to recalibrate the risk weight floor might be negated, as a result of the Basel III output floor, that will drastically increase regulatory capital requirements, particularly for retained securitization tranches.[163] To avoid that risk, the risk weight floor recalibration needs to be coupled with a recalibration of the capital surcharge also known as a the 'p' factor.

In that context, it is pertinent to note that, in early 2023, the European Parliament's Committee on Economic and Monetary Affairs (ECON) approved an amendment to the third iteration of the Capital Requirements Regulation (CRR3) (the draft legislation, which along with the sixth iteration of the Capital Requirements Directive (CRD6) will implement the remaining Basel III reforms in the EU) that is expected to facilitate credit institutions that engage in synthetic SRT securitization deals.[164]

More specifically, the amendment, tabled in August 2022 as 'Amendment 1388' to CRR3,[165] adopts an earlier proposal put forward by the High Level Forum and the European Banking Federation (EBF) to reduce the 'p' factor by half for the purpose of calculating the output floor, when risk weights for securitization positions are calculated using the SEC-SA.[166] Thus, for STS securitizations, the 'p' factor should be reduced from 0.5 (the current calibration) to 0.25, whereas for non-STS securitizations, it should be reduced from 1 to 0.5.[167]

This amendment, which survived the trilogue negotiations between the European Commission, the Council, and the Parliament,[168] is merely a temporary measure, since it will be effective until 31 December 2032,[169] pending a comprehensive review of the European securitization framework in the context of the Capital Markets Union (CMU), which EBA has been mandated

160 ESA Joint Advice Banking (n 10) 70, table 4.

161 Ibid 69, table 3.

162 Ibid 7–8.

163 AFME, 'AFME Disappointed by ESAs' Inaction on Securitisation—EU Legislators Should Provide Leadership to Address Regulatory Imbalances' (13 December 2022), at 1.

164 European Parliament, 'Report on the Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 575/2013 as Regards Requirements for Credit Risk, Credit Valuation Adjustment Risk, Operational Risk, Market Risk and the Output Floor (COM(2021)0664 – C9-0397/2021 – 2021/0342(COD))' (9 February 2023).

165 Committee on Economic and Monetary Affairs of the European Parliament, 'Amendment 1198-1561: Draft report Jonás Fernández (PE731.818v01-00): Amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor: Proposal for a regulation (COM(2021)0664 – C9-0397/2021 – 2021/0342(COD))' (18 August 2022), at 109–10.

166 High Level Forum (n 27) 61–62; EBF Relaunching (n 27) 15.

167 European Parliament (n 164) article 465 para 5a.

168 AFME Q3 2023 (n 14) 7.

169 Council of the European Union, 'Note to Permanent Representatives Committee—Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 575/2013 as Regards Requirements for Credit Risk, Credit Valuation Adjustment Risk, Operational Risk, Market Risk and the Output Floor' (2021/0342 (COD) (4 December 2023), article 465 para 7.

to conduct by 31 December 2026, as per CRR3.[170] The industry's hope of course is that, by the time of that review, the European regulator will have reconsidered its stance, and will render the reduction in the 'p' factor permanent.

Nevertheless, the halving of the 'p' factor was welcomed by market participants, because it is expected to mitigate the adverse effects that the output floor, calibrated on the standardized approach, is expected to have, particularly on retained tranches in balance sheet synthetic SRT deals, due to the effectively double layer of conservatism that it would introduce when coupled with capital non-neutrality rules.[171]

In that sense, the (temporary) reduction in half of the 'p' factor, coupled with the lowering of the risk weight floor, as proposed by the ESAs in their December 2022 Joint Advice, can indirectly benefit securitization vis-à-vis other financial instruments, by substantially alleviating the burden of capital non-neutrality rules that apply to securitization, and thus align more closely the regulatory capital requirements that the CRR imposes on securitization structures and covered bonds respectively.

### *b. Keeping securitization at bay*

Notwithstanding the potentially beneficial effects of the proposed targeted amendments, the October 2022 EC Report and the December 2022 ESA Joint Advice offer overall very little in respect of the securitization industry's push for a levelling of the regulatory playing field for securitization vis-à-vis other 'neighbouring' financial instruments.

For instance, despite admitting that due diligence obligations imposed on buy-side entities under the SECR are complex and disproportionate, creating an assessment premium in the form of high due diligence costs that does not exist when investing in covered bonds,[172] the regulator does not purport to ease that burden.

So far as the LCR and Solvency II frameworks are concerned, it was explained above that the regulator considers the current calibration of the regulatory playing field for securitization vis-à-vis financial instruments like covered bonds and corporate bonds as appropriate and justified. Therefore, the October 2022 EC Report and the December 2022 ESA Joint Advice contain no substantive proposals for amending either framework in the foreseeable future.[173]

On a more general note, as market commentators point out, even if the mood in regulatory circles vis-à-vis securitization was about to change at some point, and become more accommodative, this will certainly not happen in the near future. Elections for the European Parliament are scheduled for June 2024, and until then there is no realistic prospect of any amendments to the primary (level one) text of the currently applicable framework for securitization. Thus, no tangible progress is expected before the end of 2025.[174]

170 Ibid article 506ca.

171 DLA Piper, 'The European Parliament Offers the Prospect of Relief Regarding the Upcoming Output Floor' (27 January 2023).

172 ESA Joint Advice Banking (n 10) 7–8, 12. See also Precious Ivongbe and Kevin Ingram, 'A False Dawn for the European Securitisation Prudential Framework?' in Clifford Chance, 'Securitisation Markets and Regulation: Choosing Different Paths?' (June 2023), at 6.

173 That said, according to Ivongbe and Ingram (n 172) 8–9, the European Commission is understood to be sympathetic to the need for recalibrating the Solvency II rules that apply to securitization. However, the opposing view of the ESAs in that regard is expected to make any such attempt for recalibration more difficult, because the European Commission will have to carry out any relevant technical analysis on its own. Moreover, a recital proposing a review that could lead to potential changes in the capital requirements for securitization positions under Solvency II was tabled for discussion in late 2023, in the context of trilogue negotiations on the Solvency II Directive that have been ongoing since September 2023, see AFME Q3 2023 (n 14) 8.

174 George Smith, 'Praise the PRA for Leaving Carve-out Culture to the EU' *Global Capital* (7 November 2023); Tom Lemmon and George Smith, 'European Securitization Dancing Slow as "Mood Music" Turns Upbeat' *Global Capital* (15 December 2023).

## V. EFFECTS OF AN UNEVEN REGULATORY PLAYING FIELD: THE QUESTION OF COMPETITION

Based on the analysis conducted in the previous sections, it is suggested that the European securitization industry's claim about securitization structures receiving an adverse regulatory treatment vis-à-vis other financial instruments is valid.

Despite the validity of its claim, however, and the forcefulness with which the industry has expressed its concerns and frustration, and notwithstanding any potentially beneficial effect that the proposed targeted amendments of the regulatory framework might have, the European regulator appears unwilling to engage in any fundamental recalibration of the existing framework that would result in a substantially more favourable regulatory treatment of securitization.

That is due to the fact that, unlike market participants, the European regulator is not of the opinion that the adverse treatment of securitization vis-à-vis whole loan pools, corporate bonds, and covered bonds signifies an uneven regulatory playing field. On the contrary, in its view the adverse treatment of securitization is more or less justified.

Deciding which of the two sides is correct about the existence of an uneven regulatory playing field presupposes, first of all, a comprehensive understanding as to *why*, in the industry's view, it is crucial that securitization stops being treated in such an adverse regulatory fashion.

### 1. The industry's main argument for a levelling of the playing field

The thrust of the securitization industry's argument has been that the preferential regulatory treatment reserved for other financial instruments that the industry considers 'neighbouring' to securitization is negatively affecting the European securitization market, because it is discouraging potential issuers and investors from engaging in securitization transactions. In parallel, market participants claim that the adverse treatment of securitization is causing a migration, both from a sell-side and a buy-side perspective, away from securitization and towards other financial instruments that the regulator is treating more favourably.[175]

Therefore, the hope is that treating securitization more favourably vis-à-vis those other financial instruments would help reverse that trend, by incentivizing potential issuers and investors to engage with securitization, while alleviating the effects of the aforementioned migration. Ultimately, this would help the European securitization market to flourish.

### 2. Assessing the industry's argument

In order to assess whether a more favourable regulatory treatment of securitization could have the beneficial effects suggested by the securitization industry and, consequently, whether the current stance of the regulator amounts to an uneven regulatory playing field, it is necessary, first, to examine if the adverse treatment that securitization receives is actually pushing market participants towards other financial instruments.

This brings us to the questions of comparability and competition. Indeed, the industry's argument presupposes, first, that specific securitization structures are comparable to other financial instruments (making the latter 'neighbouring' to securitization) and, second, that a competitive dynamic exists those specific securitization structures and their 'neighbouring' financial instruments, which allows supply-side entities and/or buy-side entities to use those financial instruments interchangeably.

Otherwise, absent such a comparability and competitive dynamic, the preferential treatment that the European regulator offers to other financial instruments would not affect the European securitization market or, viewed from a different angle, the adverse treatment of securitization would not amount to an uneven playing field. That would be the case because regulation would

175 Cf PCS (n 20) 11; AFME November 2022 (n 157) 2.

not be functioning as a (dis)incentive for market participants, so far as securitization vis-à-vis other financial instruments is concerned.

Consequently, a more favourable treatment of securitization that would align it more closely to the treatment of whole loan pools, corporate bonds, or covered bonds would not be successful in incentivizing potential issuers and investors to engage with securitization *instead* of a 'neighbouring' financial instrument, nor would it reverse the trend away from securitization.

That is not to say of course that, if no competitive dynamic exists, a regulatory easing vis-à-vis securitization would be totally worthless from a market revival perspective. Without this dynamic however, the securitization industry's argument that the regulatory playing field is uneven would be stripped of a significant part of its power. Perhaps it could still be useful to draw a comparison between securitization and covered bonds and/or other financial instruments, just to illustrate how adverse the regulatory treatment of securitization is. In all other respects however, such an exercise would be akin to comparing apples to oranges.

## 3. Identifying comparable structures

At the outset, it is pertinent to reiterate that a valid comparison can only be drawn between *specific* securitization structures and other financial instruments. After all, securitization is not a single financial instrument. Rather, the term 'securitization' should properly be used to describe a technique via which a multitude of different financial instruments can be created, each of which is unique in its structure, and the objectives its serves.[176] In other words, securitization is a spectrum.

Therefore, it is important to identify those specific securitization structures that *can* be compared to other 'neighbouring' financial instruments. Having identified those structures, it then becomes possible to examine if a competitive dynamic exists between them—in other words, whether those securitization structures and their 'neighbouring' financial instruments can be perceived as substitutes of one another. The three financial instruments usually put forward by the securitization industry, as 'neighbouring', ie comparable, to securitization in this context, are corporate bonds, whole loan pools, and covered bonds.

Beginning with corporate bonds and whole loan pools, it is doubtful whether/how those financial instruments can truly be deemed as 'neighbouring' to any specific securitization structure, either from a structural or from an economic perspective. In any event, a scarcity of relevant data and lack of previous research in that regard would render any such comparison inevitably speculative. In light of the above, no such comparison is drawn in this article.

That leaves us with covered bonds. And in their case, a comparison with specific securitization structures is both meaningful and feasible.

## 4. Comparing RMBS to covered bonds

From a sell-side perspective, covered bonds are used by credit institutions as a cost-efficient funding tool, ie as a means for banks to finance their low-profit businesses.[177] Although, historically, covered bond issuance financed both mortgage lending and public sector lending—hence the distinction between 'mortgage covered bonds' and 'public sector covered bonds'—the latter's importance has declined significantly during the last 20 years,[178] to the extent that it would be accurate to suggest that covered bonds today are, first and foremost, a tool for funding



176 Penn and Papadogiannis (n 32) 225–26.

177 Giuseppina Chesini and Monica Tamisari, 'The Regulatory and Market Developments of Covered Bonds in Europe' in Luisa Anderloni, David T Llewellyn and Reinhard H Schmidt (eds), *Financial Innovation in Retail and Corporate Banking* (New Horizons in Money and Finance 2009) 199.

178 EBA, 'Report on EU Covered Bond Frameworks and Capital Treatment: Response to the Commission's Call for Advice of December 2013 Related to Article 503 of the Regulation (EU) No 575/2013 and to the ESRB Recommendation E on the Funding of Credit Institutions of December 2012 (ESRB/12/2)' (July 2014), at 14–15, figs 1, 2.

mortgage loans, and particularly 'high quality' residential mortgage loans.[179] From an investor perspective, credit institutions and assets managers/funds are the biggest (private) investors in covered bonds today,[180] and have been so since the early 2000s.[181]

Regarding securitization, it is important to distinguish at the outset between 'true sale' structures, used primarily for funding purposes, and synthetic structures, that are mostly used for risk management purposes (transfer of credit risk), and for achieving regulatory capital relief.[182] Based on that distinction, it is much more appropriate, at least from a sell-side perspective, to compare covered bonds to 'true sale' securitization structures.

Specifically, it is meaningful to compare covered bonds to RMBS, a financial instrument that is typically structured as a 'true sale',[183] and is used as a means of financing residential mortgage loans, just like 'mortgage covered bonds'. Indeed, historically, both covered bonds and RMBS have been used extensively by European credit institutions as a source of mortgage funding.[184]

It is also important to note that, historically, there has been considerable overlap in terms of the assets used to collateralize both covered bonds and European RMBS, that is, 'prime', highly-rated, residential mortgage loans with a loan-to-value (LTV) ratio between 50% and 80%.[185]

From an investor perspective, credit institutions and funds form the bulk of the investor base, so far as European RMBS is concerned.[186]

In view of this significant overlap between covered bonds and RMBS in terms of sell-side entity objectives, underlying assets, and investor bases, it is suggested that the two financial instruments are indeed 'neighbouring', ie comparable.

The next crucial issue is whether this comparability also means that RMBS and covered bonds function as competitors, or substitutes of one another.

## 5. Competition between RMBS and covered bonds

### *a. Theoretical and empirical findings*

The proposition that RMBS and covered bonds compete with one another is supported by existing market analysis and academic literature, which suggest that, notwithstanding certain differences, covered bonds and RMBS structures can be considered 'close substitutes' or 'workable alternatives', and confirm that some sort of competition can be expected between the two financial instruments, both from a supply, and from a demand perspective.[187]

179 Cf issuance and outstanding amounts of 'mortgage covered bonds' vis-à-vis 'public sector covered bonds' in 2021, in ECBC, 'Statistics' in *ECBC Covered Bond Fact Book* (2022), at 561. As mentioned in Elisa Coletti, Intesa Sanpaolo and Karsten Rühlmann, 'Covered Bonds in the Environment of Rapidly Changing Interest Rates and Real Estate Markets' in *ECBC European Covered Bond Fact Book* (2023), at 45, 'in practice ... with the exception of a few countries, most cover pools are purely residential'.

180 Leaving central banks aside, see Florian Eichert, Frederik Kunze and Niek Allon, 'Covered Bond Investor View: Private Buyers Return as the ECB Steps Back' in *ECBC Covered Bond Fact Book* (2022), at 97, fig 2.

181 European Commission, 'Report of the Mortgage Funding Expert Group' (22 December 2006) (hereinafter the 'EC Expert Group'), at 51, graph 6.

182 This refers primarily to 'balance sheet' synthetic securitization structures (see analysis above).

183 EC SynthSec July 2020 (n 38) 4.

184 EC Expert Group (n 181) 3.

185 Cf Phillip Moore, 'Covered bonds: Picking up Tacks in Front of the Steamroller' *Euromoney* (5 November 2009); ECB and BoE (n 119) 11. That said, current average LTV levels are higher for RMBS (approx 75%, according to ESRB (n 19) 49, chart 13), than for covered bonds (around 50%, according to Coletti (n 179) 47).

186 ECB, 'Recent Developments in Securitisation' (February 2011), at 16. For more recent data see ESRB (n 19) 22, chart 2a (referring to all types of securitization structures).

187 ECB and BoE (n 119) 16, 26; Global Capital, 'When RMBS are Safer than Covered Bonds' *Global Capital* (27 March 2015); Mafalda C Correia and João M Pinto, 'Are Covered Bonds Different from Securitization Bonds? A Comparative Analysis of Credit Spreads' (2023) 29(3) European Financial Management 841, at 843; Santiago Carbó-Valverde, Richard J Rosen and Francisco Rodríguez-Fernández, 'Are Covered Bonds a Substitute for Mortgage-backed Securities?' (2017) 20(3) Journal of Economic Policy Reform 238, at 251. See also Nils Boesel, Clemens Kool and Stefano Lugo, 'Do European Banks with a Covered Bond Program Issue Asset-backed Securities for Funding?' (2018) 81 Journal of International Money and Finance 76, at 77, who argue that covered bonds and 'asset-backed securities' (ABS) can be considered substitutes of one another, without however drawing any further distinction between the various securitization structures.

It is very pertinent to note that this competition between RMBS and covered bonds is not a mere theoretical possibility, but is also corroborated by empirical findings. Indeed, by analysing data from the period of the GFC, ie between 2007 and 2012, existing academic literature has observed a substitution effect in the relationship between covered bonds and RMBS.

More precisely, during the GFC, credit institutions that had a covered bond programme were observed to securitize less of their assets; they became in other words more dependent on covered bonds, while reducing their engagement with RMBS, as a means of financing their mortgage loans.[188] As a result of this 'crowding out', the European covered market experienced significant growth, in terms of issuance, seemingly at the expense of the European RMBS market, which contracted considerably during the crisis.[189]

Indicatively, European RMBS issuance in 2007 was equal to €259bn.[190] Although volume increased sharply in 2008 (€585bn),[191] the market then experienced a dramatic contraction, and by 2012 issuance was equal to €119bn.[192] In contrast, European mortgage covered bond issuance in 2007 was equal to €283bn;[193] in the following years issuance increased considerably and in 2012 European mortgage covered bond issuance had a value of €612bn.[194]

From the perspective of buy-side entities, a migration of buy-to-hold investors away from RMBS and towards other financial instruments, including covered bonds, was observed from 2009 onwards.[195]

Various suggestions have been put forward, to explain this substitution effect, including an (alleged) superiority of covered bonds vis-à-vis RMBS from an agency cost perspective, which became obvious to market participants during the crisis, and rendered covered bonds cheaper, as a funding tool for credit institutions, because of the lower risk premia required by investors.[196]

A similar, yet distinct, explanation points to the 'higher protection level' that covered bonds are thought to offer, ie the structural features that covered bonds deploy to protect investors from issuer-related and cover pool-related risks. Those features are deemed to have created, in the context of the crisis, an additional incentive for investors to invest in covered bonds, and, conversely, to have reduced the demand for RMBS.[197]

It is at least debatable whether covered bonds actually offer a higher level of structural protection to investors, vis-à-vis 'true sale' RMBS. In fact, so far as senior RMBS investors are concerned, the protection they enjoy is arguably more comprehensive, primarily thanks to the use of debt tranching, a credit enhancement mechanism deployed in RMBS transactions (but not in covered bonds)[198] which results in a 'buffer' comprising junior RMBS investors. The presence of junior investors effectively means that any credit events and/or liquidity deficits occurring at the collateral level leave senior investors unscathed (at least until all other investors are completely wiped out).

188 Boesel, Kool and Lugo (n 187) 77. See also Correia and Pinto (n 187) 879, who uses data from 2000 to 2020, and reaches the same conclusion as Boesel, Kool, and Lugo. It is important to note that the aforementioned authors refer to mortgage-backed securities (MBS) more generally. Nevertheless, their findings are equally relevant for RMBS.

189 ECB and BoE (n 119) 26.

190 AFME/ESF, 'Securitisation Data Report, 2008 Q4' <https://www.sifma.org/resources/research/afme-esf-securitisation-data-report-2008-q4/> accessed 2 January 2024, at 3.

191 Ibid.

192 AFME, 'Securitisation Data Report, Q4 2012' <https://www.sifma.org/resources/research/afme-securitisation-data-report-q4-2012/> accessed 2 January 2024, at 3.

193 ECBC, 'Statistics' in *ECBC Covered Bond Fact Book* (2011), at 456.

194 ECBC, 'Statistics' in *ECBC Covered Bond Fact Book* (2013), at 545.

195 EBA, 'Report on Qualifying Securitisation: Response to the Commission's Call for Advice of January 2014 on Long-Term Financing' (July 2015) (hereinafter 'EBA Qualifying'), at 26.

196 Boesel, Kool and Lugo (n 187) 79, 86. For a comprehensive critique of the supposed 'agency problems' that plagued European securitization (including RMBS) during the GFC see Penn and Papadogiannis (n 32) 231–33.

197 ECB and BoE (n 119) 8.

198 Silviu Eduard Dincă, 'Covered Bonds vs. Assets Securitization' (2014) XXI(11)(600) Theoretical and Applied Economics 71, at 80.

Provided that collateral suffices for the payment of principal and interest to senior RMBS investors (and no other event of default has materialized), no need to liquidate the assets in the pool will arise, and of course the securitized bonds will not accelerate.

In contrast, absent a debt tranching mechanism, covered bond structures contemplate a quite different allocation of risk to investors. Investors are not divided into different ranks with different priorities, and instead have recourse against the cover pool on a pari passu basis. Consequently, losses at the cover pool level affect all investors equally, and a single interest payment that is missed can have catastrophic results, since it can cause the outstanding covered bonds to default and the entire covered bond programme to accelerate.[199]

### *b. The role of regulation in crowding out RMBS during the GFC*

A third, very interesting, suggestion put forward by market commentators is that the growth the covered bond market experienced during the GFC, by crowding out securitization structures, may be attributed to the preferential regulatory treatment that covered bonds received at the time vis-à-vis securitization (including RMBS).[200]

According to this argument, it was the incentives that the regulator created for issuing and investing in covered bonds, combined with its 'punitive' treatment of securitization, that allowed the covered bond market to flourish, while preventing the European RMBS market from bouncing back from the standstill it had been in ever since 2007.[201]

Focusing on this final suggestion, it is important to bear in mind that the adverse regulatory treatment of securitization vis-à-vis covered bonds is not a recent phenomenon. Far from it, even before the GFC, investing in covered bonds implied lower regulatory requirements than securitization, including RMBS.[202] Indicatively, under the original Capital Requirements Directive (CRD), the risk weight floor for top-rated RMBS positions was 20% when the SA was applied, compared to 10% for covered bonds.[203]

As the crisis unfolded, the divergence in regulatory treatment between RMBS and covered bonds intensified, as securitization was stigmatized for the ongoing debacle, prompting the regulator to introduce, as explained earlier, a set of punitive rules that aimed at curbing securitization's (supposedly) 'perverse' incentives and complexity.[204] Covered bonds on the other hand, were able to maintain, and even extend, their regulatory privileges.

199 For a more detailed analysis as to why covered bonds are arguably riskier than 'true sale' RMBS, see Thomas Papadogiannis Varouchakis, 'Risks for Investors at the Post-Insolvency Stage of the Covered Bond Issuer' (2023) 38(4) Journal of International Banking and Financial Law 227 (this article refers to UK covered bonds and RMBS structures, but otherwise it is equally relevant for European financial instruments). As argued therein, in addition to a lack of debt tranching, covered bonds are arguably riskier than 'true sale' RMBS, due to the significant residual risks that arise at the post-insolvency stage of the covered bond issuer. For a more sceptical view in that regard, see Clarissa Jones, 'Revisiting the Transaction at an Undervalue Risk to UK Covered Bondholders' (2023) 38(7) Journal of International Banking and Financial Law 476.

200 Cf Jaime Caruana and Adrian Van Rixtel, 'International Financial Markets and Bank Funding in the Euro Area: Dynamics and Participants' (2011) Bank for International Settlements, at 11; International Organization of Securities Commissions, 'Global Developments in Securitisation Regulation: Final Report' (November 2012), at 47. See also Lawton M Camp and others, 'Covered Bonds Regulatory Update: The Good, the Bad, and the United States' (2013) 19(2) Journal of Structured Finance 16, at 21; EBA Qualifying (n 195) 21. Finally, see European Commission, 'Consultation Document: Covered Bonds in the European Union' (2015), at 10–11, where the argument is presented, without being endorsed by the author.

201 Louise Bowman, 'Can ABS Rescue Europe's Bank-Funding Market?' *Euromoney* (6 March 2012); Euromoney, 'Schizophrenic Regulators Killing Securitization' *Euromoney* (12 April 2013).

202 Rebeca Anguren Martín, José Manuel Marqués Sevillano and Luna Romo González, 'Covered bonds: The Renaissance of an Old Acquaintance' (2014) 9(1) Banks and Bank Systems 46, at 55.

203 See 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, Annex IX, Part 4, Point 6, table 1 for securitization, and Annex VI, Point 71 for covered bonds. When the IRBA was applied, covered bonds could attract a risk weight as low as 2.1%, see EC Expert Group (n 181) 68.

204 See Penn and Papadogiannis (n 32) 236–38.

In the same vein, it is worth noting that the crowding out of RMBS by covered bonds during the GFC might also have been fuelled by the covered bond purchase programmes (CBPPs) that the ECB introduced at the time.

More specifically, CBPP1, which ran from July 2009 until June 2010, is thought to have been very successful in supporting the covered bond market, by lowering covered bond spreads; easing funding conditions for banks and corporates; supporting credit institutions in their lending capacity; and improving liquidity in the private debt securities market.[205]

At the same time however, spread analysis has shown that the covered bond purchases by the Eurosystem in the context of CBPP1 fed into RMBS prices, causing RMBS spreads to widen.[206] Although the effects of CBPP2 (which run from November 2011 until roughly mid-2012) on the covered bond market are less straightforward,[207] it, too, has been observed to have had a negative effect on the European RMBS market, by leading to a credit spread increase.[208]

### *c. Parallels between the GFC period and today*

To recapitulate, there is sufficient evidence to suggest that, during the GFC, the adverse regulatory treatment of securitization, coupled with the monetary policies implemented by the ECB, negatively affected the European securitization market, by contributing to the substitution of 'true sale' RMBS with covered bonds.

In light of that, and also taking into account that, as explained above, 'true sale' RMBS structures are not particularly riskier than covered bonds, especially at the post-insolvency stage of the issuing institution, it can be argued that, during the GFC, the regulatory playing field was indeed uneven for RMBS vis-à-vis covered bonds.

To assess whether the adverse regulatory treatment of RMBS continues negatively to affect the securitization market, and whether the regulatory playing field is still uneven, it is worth having a look at the post-GFC state of the RMBS market in Europe, vis-à-vis the market for covered bonds.

From an issuance perspective, average annual RMBS issuance for the period 2013–2022 was equal to €101bn, which signifies a 65% decrease, compared to annual RMBS issuance during the GFC period (€283bn).[209] On the other hand, average annual mortgage covered bond issuance was equal to €422bn in the post-GFC period, compared to an average of €485 in the GFC period (this translates into a 13% decrease).[210]

It is also worth observing that average annual RMBS issuance in the post-GFC period was roughly 25% of the average annual mortgage covered bond issuance. During the GFC period, average annual RMBS issuance was equal to 58% of the average annual mortgage covered bond issuance. This signifies that, since 2007, the gap between the RMBS market and the mortgage covered bond market has increased sharply, at least in terms of annual average issuance.

The same conclusion is reached when outstanding amounts in the two markets are compared: In the period 2013–2022, the European mortgage covered bond market exhibited remarkable growth, from €1.97tn to €2.41tn. In contrast, the European RMBS market contracted from

[205] Holger Markmann and Joachim Zietz, 'Medium-term Impact on the Secondary Market' in Holger Markmann (author), *Covered Bonds under Unconventional Monetary Policy* (Nico B Rottke and Jan Mutl (eds), Essays in Real Estate Research: Band 14, Springer Gabler 2017), at 49–50; Maureen Schuller, 'ECB Policy Toolkit and Covered Bond Supply' in *ECBC European Covered Bond Fact Book* (2013), at 52–53, figs 2, 3; John Beirne and others, 'The Impact of the Eurosystem's Covered Bond Purchase Programme on the Primary and Secondary Markets' (January 2011) 122 ECB Occasional Paper Series, at 5.

[206] Correia and Pinto (n 187) 877.

[207] Cf Schuller (n 205) 53.

[208] Correia and Pinto (n 187) 877.

[209] For RMBS issuance and outstanding amounts, data was collected from the sections titled 'European Issuance by Collateral' and 'European Outstandings by Collateral' respectively, included in the 'Securitisation Report' issued quarterly by the Association for Financial Markets in Europe (AFME).

[210] Data on covered bond issuance and outstanding amounts were collected from the 'Statistics' section included in the 'European Covered Bond Fact Book' published annually by the ECBC.

€879bn in 2013 to €529bn in 2022. It is therefore evident that the covered bond market has been continuously expanding during the last decade, whereas the European RMBS market has sharply shrunk.

This analysis illustrates a clear parallel between the GFC period and today, regarding the regulatory treatment that covered bonds and RMBS receive, as well as the state (and interrelationship) of the market for each of the two financial instruments. Although other historic factors and their economic repercussions (the Covid-19 pandemic being a prime example) are without a doubt also important in explaining the continuous contraction of the European RMBS market, covered bonds are in all probability continuing to crowd out RMBS, thanks to the preferential regulatory treatment they receive in Europe.

In light of that analysis, it is submitted that the claim put forward by market participants about the existence of an uneven regulatory playing field, and the effects of this uneven playing field on the European securitization market, continues to be valid, so far as 'true sale' RMBS vis-à-vis covered bonds is concerned.

By treating covered bonds in a clearly preferential fashion, the European regulator appears consistently to be discouraging potential issuers and investors from engaging in RMBS transactions, and could even be fuelling a migration away from RMBS and towards covered bonds. The continuous contraction of the European RMBS market could very well be a reflection of the negative effects that the uneven regulatory playing field has had on securitization.

In that sense, it is submitted that the securitization industry has good reasons to be pushing for a more favourable regulatory treatment of 'true sale' RMBS structures, since there is enough evidence to suggest that, by aligning the treatment that RMBS receives vis-à-vis covered bonds, the regulator can incentivize issuers and investors to migrate back to RMBS, resulting in a slowdown (or even a reversal) of the European RMBS market's continuous contraction.

Even more importantly, the significance of the RMBS segment for the wider European securitization market (indicatively, in 2022, more than half of total European issuance was RMBS),[211] means that by jump-starting RMBS, through a more favourable regulatory treatment, the regulator could also potentially provide a boost to other securitization segments that remain subdued or underdeveloped.

## VI. CONCLUDING REMARKS

The analysis conducted in this article confirms the existence of an uneven regulatory playing field for 'true sale' RMBS structures vis-à-vis covered bonds. It achieves that by illustrating that, so far as RMBS vis-à-vis covered bonds is concerned, the adverse regulatory treatment of securitization is negatively affecting the European securitization market, by incentivizing issuers and investors to migrate elsewhere.

It follows that, by treating RMBS more favourably, the European regulator can assist the RMBS market and, consequently, the wider European securitization market, to escape from the subdued state it has been ever since the GFC.

Whether the regulator will (and should) pursue this course of action is a different question. After all, favouring securitization at the expense of covered bonds would signify going against a political economy in Europe which seems almost inescapable.[212]

Indeed, covered bonds have a track record of 250 years in Europe, without any defaults in their modern history. They are deeply ingrained in the financial system of multiple European countries such as France, Denmark, and especially Germany, where no strong tradition of using RMBS exists as of yet. Because of their long history and importance, and their 'pristine

211 AFME Q4 2022 (n 158) 17.

212 The author wishes to thank Professor Niamh Moloney for making this insightful remark.

creditworthiness', covered bonds have been treated as the European regulator's 'darling' ever since the 1980s.[213] For all those reasons, if helping the European securitization market to flourish would risk unsettling the market for covered bonds, the regulator would, in all probability, consider this simply too high a price to pay.

This does not mean that the European securitization industry should cease arguing for a more favourable regulatory framework, and a level playing field between RMBS and covered bonds. It does mean however that this is not a purely 'technocratic' or legal question, but rather a political one. Any technical analysis that illustrates how RMBS is not inherently riskier than covered bonds and should therefore be allowed to compete with them on an equal footing, can only take the securitization industry so far. Convincing officials that securitization is a powerful tool that can be leveraged for the benefit of the wider European economy is equally important if the European securitization market is to experience its long-awaited revival any time soon.



[213] Cf the preferential treatment of covered bonds when undertakings for the collective investment in transferable securities ('UCITS') invest in them, introduced in 1988, via Council Directive 88/220/EEC of 22 March 1988 amending, as regards the investment policies of certain UCITS, Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS) [1988] OJ L100/31.