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European Securitisation Law: between a sustainable banking sector and the mitigation of emerging risks during the Covid-19 crisis

Droit Européen de la Titrisation : Entre un Secteur Bancaire Durable et L'atténuation des Risques Émergents Pendant la Crise du Covid-19

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Abstract: Regulation of the securitisation process is an essential part of ensuring the stability of financial markets in the EU. Securitisation allows financial assets, such as individual loans, to be bundled into a tradable financial instrument - a security. In recent decades, securitisation of financial assets has taken on an increasingly important role in European and global financial markets. By creating instruments that can be collectively valued and transferred, financial institutions are better able to adjust their risk exposure to counter external and internal threats. However, during the financial crisis, market shortcomings, particularly in the area of mortgage-backed securities, led to a decline in the volume of securitised financial assets and caused turmoil in global financial markets. It is a central role of the acquis communautaire to protect the functioning of the internal market and thus the financial sector as an integral part of it. To this end, the EU legislative bodies are authorized to adopt measures for the approximation of provisions laid down by law, regulation or administrative action in Member States. As the securitisation process is an integral aspect of this sector, it is not surprising that the EU has established a strict regulatory framework. During the financial crisis, numerous weaknesses in this framework were revealed. This in turn led to continuous efforts by European legislative and regulatory authorities to improve the process, notably through Regulation (EU) 2017/2402, which introduced new principles for the securitisation market and expanded the obligations of market participants. However, this new regulation is put to the test, as new developments related to the Covid 19 pandemic and the associated rise in public and private debt are once again highlighting the need for an effective and transparent securitisation process. Based on these developments, the aim of this paper is to analyse the securitisation process from a European financial law and regulatory perspective and to assess whether the changes to the regulatory framework for the securitisation market have indeed contributed to more transparency and better regulatory oversight.

Keywords: Securitization, Financial regulation, Financial crisis, Risk management.

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1. Introduction

Securitisation regulation is an integral part of ensuring the stability of financial markets in the EU. The term securitisation describes the process of converting homogeneous financial assets into transferable financial instruments. This process essentially allows the bundling of claims arising from individual loan contracts into a tradable financial instrument - a security. In recent decades, securitization of financial assets has become popular among financial institutions for the purpose of managing structural and credit risks. By creating instruments that can be collectively valued and transferred, financial institutions are better able to enter into contracts that allow them to adjust their risk exposures in order to counter external and internal threats. Consequently, as the financial system in general expanded, the volume of securitised financial instruments issued also grew. However, during the financial crisis, market shortcomings particularly in the area of mortgage-backed securities, led to a downward trend in the volume of securitised financial assets and caused turmoil in global financial markets.

It is a central task of the European Union to protect the functioning of the internal market and thus the financial sector as an essential part of it. To this end, the EU legislative bodies are authorized to adopt measures for the approximation of provisions laid down by law, regulation or administrative action in Member States. [1] As the securitisation process is an integral segment of this sector, it is not surprising that the EU has established a strict regulatory framework for it. During the financial crisis, several weaknesses in this framework were revealed. This in turn led to continuous efforts by European legislative and regulatory authorities to improve the process in order to restore confidence in securitised financial instruments. Regulation (EU) 2017/2402 of the European Parliament and Council of 12 December 2017 introduced new principles for the securitisation market and expanded the obligations of market participants.

The revision of Basel III by the Banking Committee of the Banking Supervision requires changes in bank capitalization and more efficient credit and structural risk management. In this respect, securitisation of bank assets can be a valuable tool. However, recent developments related to the Covid 19 pandemic and the associated increase in public and private debt again highlight the need for an effective and transparent securitisation process. The aim of this paper is therefore to analyse the securitisation process from a

European financial law and regulatory perspective and to assess whether the changes to the legal framework of the securitisation market have indeed contributed to more transparency and better regulatory oversight in the EU.

2. Securitization in Perspective of European Banking Industry

2.1 The development of the securitization industry and its role in the modern banking system

The securitization industry was established in the United States in 1970 with the creation of the process of converting non-liquid assets (mortgage loans) into liquid financial instruments (Buchanan, 2016). Today, the securitization process is regularly used in the banking industry to manage liquidity, interest rate and credit risk. By pooling homogeneous assets and issuing securitization products, banks can optimize their asset and liability structure according to management objectives (Casu et al, 2013). Securitization allows lenders to refinance their loan portfolios by packaging different types of loans into tradable securities with different risk profiles that are available to investors. These bundled assets are then transferred by entering into definitive transaction agreements (securitization contracts).

The organized financial market for securitization products allows non-bank financial institutions to participate in the lending process and financial market risk management. Financial institutions with non-deposit and long-term funding structures, such as investment funds, hedge funds or insurance companies, can provide liquidity and shorten the maturity of credit institutions' assets. They convert illiquid loans into tradable and transferable debt securities. In robust and efficient securitisation markets, credit institutions can manage risk preferences and optimize liquidity management and the interest rate structure of assets and liabilities, and reduce the credit risk of the loan portfolio. Securitization can increase the lending capacity of the banking sector and improve key performance indicators of banks (Casu et al, 2013).

The various forms of Mortgage-Backed Securities (MBS), Assets Back Securities (ABS), Collateralized Debt Obligations (CDO) or Collateralized Loans Obligations (CLO) were intensively developed until the financial crisis of 2007.[2] Since the role of securitization processes in causing the financial crisis became evident, the positive effects of securitization of financial assets have been questioned (Peicuti, 2013). Before the crisis, rating agencies systematically underestimated the risks of financial instruments created originated in the securitization process (Krall, 2016). Many financial institutions made a loss on the position of securitized financial products, and the market became illiquid (Shanuka, 2017).

However, as many authors correctly note, securitization has an important role in the market. It ensures the sustainability of credit channels due to the continuing demands for liquidity and maturity transformation of commercial banks' assets (Yener et al, 2009). Securitization enables commercial banks to modify loan portfolio risk and term structure. Moreover, it can be associated with monetary easing policies and the ability of banks to share risks with other financial institutions (Zang and Xu, 2019). It is therefore evident that securitisation supports the financial system and provides financial institutions with a wide range of alternative tools in risk management.

2.2 The impact of the financial crisis and reform of the regulation on securitization

During the financial crisis, confidence in the efficiency of financial markets was lost. This subsequently led to a decline in the volume of outstanding transactions in the European financial market.[3] During the financial crisis, European authorities realized that systemically important banks in the European Union banking system had more than €1 trillion in long-term loans available for refinancing (European Central

Bank, 2009). Cumulative losses and the lack of transparency of the quality of the underlying assets discouraged market makers from participating in the market for securitised financial products (Davidson, 2008). The impact of these developments was more intense in the financial market within the euro area than in the financial market in the United States (Bank of England, 2014).

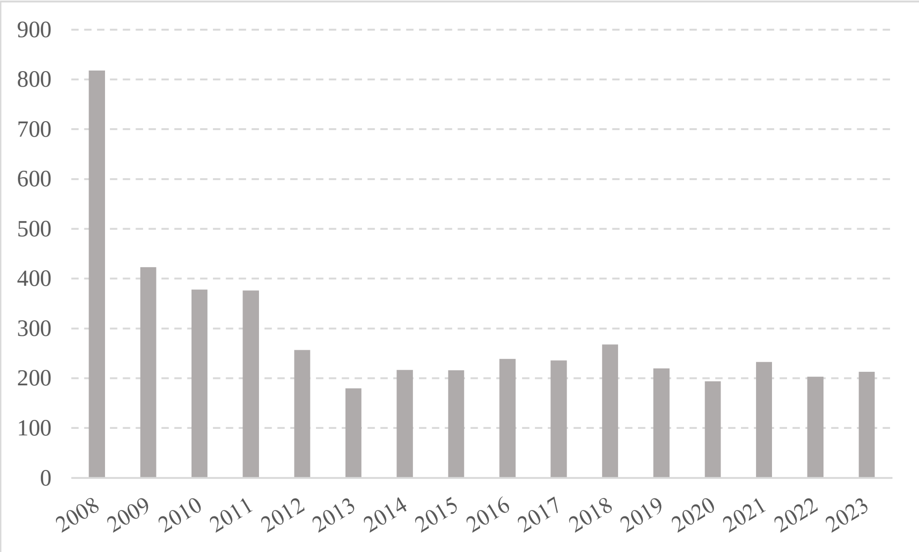

Figure 1 : Europe Securitization Issue (in billion EUR)

Source: Authors calculation based on data available at AFME (https://www.afme.eu).

Financial authorities recognized as a weakness of the securitization market the asymmetric access to information between issuers of securities and investors in the primary and secondary markets. Exotic financial instruments created by underwriters lost liquidity and market value (Davidson, 2008). During the financial crisis, most issuers of securitized securities switched from the "originate-to-distribute" concept to the "originate-to-repo" concept and abused collateral opportunities with central banks. They used the nonconventional monetary policy to manipulate corporate structures and exploit additional profit opportunities (Braun, 2020).

2.3 Increasing capital standards necessitating an evolution of existing securitization law

Due to the importance of the securitisation market, European authorities extended financial market regulation to financial instruments created through the securitisation process. However, it is also essential for the banking sector itself, to rely on a well-regulated securitisation market before the new Basel Accord solicitation. The new capital and liquidity requirements will lead to European banks being non-compliant without including other financial institutions, financial mechanisms and financial instruments in liability and risk management. They will also contribute to low market-to-book ratios (Ercegovac et al, 2020).

The great financial crisis of 2008 had a devastating impact at a global level, particularly on the banking sector. Both the depth and severity of the crisis were fuelled by deficiencies in legal regulation that led to weaknesses in the banking sector, such as excessive leverage, insufficient and low-quality capital, and inadequate liquidity buffers. In response, the Basel Committee launched several reforms aimed at making banks more resilient, i.e., improving the banking sector's ability to absorb shocks from various sources (financial or economic stress). In addition, the objective was to support international banking activities and reduce the risk of spill overs from the financial sector to the real economy. This was particularly important for the European Union, where the crisis turned into a sovereign debt crisis, showing which problems can arise from doom loops between banks and sovereigns.

The Basel reforms began in 2009 and the final part of Basel III was agreed upon at the end of 2017[4]. Including phase-in periods, the implementation of final Basel III (often referred to as Basel IV) standards is expected to be achieved till 2033[5], completing a process of nearly two decades of regulatory reform. The final part of the standards remains to be implemented in the European Union based on the regulatory proposal presented by European Commission in the second half of 2021. The proposal is currently under discussion in the Council of the EU and the European Parliament still has to confirm its position on the proposal. It is important to note that Basel III is a large and complex set of standards that will result in an equally complex regulatory framework. The main changes introduced by Basel IV focus on limiting the reduction in capital (i.e., capital requirements) that can result from banks' use of internal models under the Internal Ratings-Based approach.

Since the publication of Basel II, banks can generally use two methods to determine minimum capital requirements, the SA and the IRBA approach. The Standardized Approach (SA), is permitted by default for all banks and prescribes risk weights for all categories of risk-weighted assets. Alternatively, a more complex but risk-adequate internal ratings-based approach (IRBA) can be used, which takes into account a bank's actual risk situation by modelling credit risk based on internal and external customer-specific data (Basel Committee on Banking Supervision, 2019). While the application of the IRBA requires constant investment in model development as well as validation, it allows a great deal of leeway in determining and, if necessary, reducing a bank's minimum capital requirements. Due to these positive effects, most major European banks implemented the IRBA years ago with the introduction of the Basel II requirements.

The European Central Bank performed a Targeted Review of Internal Models[6] , which showed that risk-weighted assets (RWA) calculated using internal models, as opposed to assets calculated using the SA model, were in some cases highly inconsistent and therefore unreliable. At different banks, the risk quantification of the same loan portfolio led to different RWA results due to critical shortcomings in the development of Probability of Default (PD) and Loss given default (LGD) models as well as in the assessment of data quality.

The Basel Committee on Banking Supervision presented revisions to the original Basel III Accord to make the banking system more resilient to an impending crisis (Basel Committee on Banking Supervision, 2017). In this regard, the main revisions concern: the standardised approach of credit risk, the internal rating methodology, the credit value adjustment for the inclusion of counterparty risk, the assessment of operational risk and the definition of the output floor, which sets a floor for the capital requirement calculated under the internal model relative to the total capital required under the standardised approaches.

Table 1 Basel III revision contest and implementation period

Basel III Accord Revision	Implementation Date
Standardized approach in credit risk	January 1st 2023
Internal rating base approach	January 1st 2023
Credit value adjustment	January 1st 2023
Operation risk approach	January 1st 2023
Leverage ratio – Exposure definition	January 1st 2023

Leverage ratio – Global System Important Banks buffer	January 1st 2023
Output floor: 50%	January 1st 2023
55%	January 1st 2024
60%	January 1st 2025
65%	January 1st 2026
70%	January 1st 2027
72,5%	January 1st 2028

Source: Basel Committee on Banking Supervision (2017). High-level summary of Basel III reforms, p. 12. [7]

The numerous shortcomings of the internal models, are to be remedied by the introduction of the output floor with the implementation of Basel IV. From 2023, an RWA result calculated under the IRBA is expected to be at least 50% of the RWA calculated using SA. Subsequently, the output floor will increase by five percentage points annually until it reaches its final value of 72.5% in 2028. As a result of these changes, financial institutions will require additional capital and, consequently, the cost of capital is likely to increase due to rising demand. In addition, with increasing competition and low profitability exacerbated by the COVID -19 pandemic, opportunities for rapid capital increases are very limited, so different approaches should be explored to enable capital requirements to be met.

In analysing the upcoming capital requirements, the European Banking Authority indicated the issue of a significant capital shortfall during the implementation period (European Banking Authority, 2020).

Table 2 Total capital shortfall scenario (in billion EUR) [8]

Description	CET 1	T1	TC
All Banks	74.6	106.8	109.5
Large Banks	74.6	106.2	108.9
Medium Banks	0.0	0.5	0.6
Small Banks	0.0	0.0	0.0

Source: European Banking Authority (2020). Basel III reforms: impact study and key recommendations, December 2019, p. 66.

The challenge for the European Regulatory Authorities is to provide the regulatory framework, tools and institutional support for commercial banks to adapt to the new capital requirements. In the first phase of the implementation of Basel III, most banks reduced lending, reduced the volume of their loan portfolios, and allocated lending capacity to government securities and liquidity funds (Klinac and Ercegovac, 2018). In an analysis of European Banking System, some research concluded that low price-to-book ratios of banking firms made it difficult to raise new capital (Ercegovac et al, 2020). Securitization should assist banking firms in complying with the new regulation in:

- Reducing the risk weighting of assets by transforming the risk structure of assets,
- managing the bank's loan portfolio,
- managing the bank's liquidity assets, and improving the bank's liquidity profile.

The interest of the financial authorities is to make the financial system more efficient and provide more opportunities in bank performance and risk management. Securitization could be a mechanism to increase the financial stability of commercial banks and overcome the regulatory gaps. Regulation of the securitization process is therefore an essential prerequisite for the integration of financial institutions, including in the bank-based financial system.

3. Regulatory changes in the securitization market

The last financial crisis highlighted the weakness of the regulatory architecture of the European financial system. Over the past decade, the European Union has responded with radical changes to its financial regulatory framework to prevent a repeat of scenarios like 2008 and 2009.[9] To make the European Single Financial Market more efficient, the European Union had to find ways to improve the legal framework for securitisation. The European Commission was particularly concerned about the over-reliance of market participants on the risk assessment of credit rating agencies. Most credit rating agencies lost credibility during the financial crisis due to their overly lenient evaluation processes, which in turn led to a loss of confidence in ratings and destabilized financial markets (Ryan, 2013).

3.1. The regulation of rating agencies

To prevent potential conflicts of interest and return confidence in available benchmarks, the European Commission has expanded its regulation of credit rating agencies. Regulation (EC) 1060/2009 on credit rating agencies was introduced with the aim of increasing the transparency of the rating process, a sine qua non for the existence of efficient financial markets.[10] One focus of the regulation was to establish criteria for a transparent and efficient rating methodology . Key aspects of the Regulation were based on the concepts of transparency and oversight . In this context, the Regulation required that "a credit rating agency disclose to the public the methodologies, models and key rating assumptions it uses in its credit rating activities" . In addition, the credit rating agencies had to "disclose any credit rating, as well as any decision to discontinue a credit rating, on a non-selective basis and in a timely manner".[11] Finally, it established a clear national supervisory regime across the member states under which each agency must be registered .However, while the Regulation clearly aimed to ensure that methodologies were rigorous, systematic, continuous and subject to validation based on historical experience, it largely did not aim to intervene in the rating process itself. Neither competent authorities nor other public authorities of a Member State were allowed to interfere in any way with the content of credit ratings or methodologies, leaving agencies a wide range of autonomy in their core processes under this Regulation.[12]

3.2. Amendments to the regulation of rating agencies and the introduction of a common rating approach

Regulation (EU) 462/2013 extended the mechanisms of integrity, responsibility, governance and independence of rating agencies[13]. Unlike Regulation (EC) No 1060/2009, this Regulation introduced a common regulatory approach to improve the quality of credit ratings issued in the European Union. Such a common approach aimed at creating a high level of consumer and investor protection and thus falls within the core competences of European legislation[14]. Among the main innovations of the Regulation were rules requiring the targeted financial institutions15 to use credit ratings for regulatory purposes only if they were issued by credit rating agencies established in the Union and registered in accordance with the Regulation[16]. In addition, the Regulation also addressed the overreliance on external credit ratings by requiring the targeted institutions to perform their own credit risk assessment[17]. Together with the rules on the involvement of sectoral competent authorities in the supervisory process[18] and the rules on the civil liability of rating agencies[19], these innovations formed the bulk of the new legal framework for securitisation after the financial crisis.

4. The current regulatory landscape for securitization in EU

To date, work has continued to regulate the securitisation process. Securitisation in the EU is mainly regulated by the Securitization Regulation 20 and the Capital Requirements Regulation[21]. These regulations replaced the previous regulatory framework, which consisted of a multitude of provisions in different regulations instead of a single piece of legislation. In particular, the Securitisation Regulation set out a comprehensive framework for securitisation. It came into force on 1 January 2019. At that date, the rating structure of rating agencies in the European financial market is as follows:

Table 3 European securitization by rating structure (as per 31th December 2023)

Rating	Ratio
Aaa\AAA	57,60%
Aa\AA	29,20%
A\A	6,40%
Baa\BBB	3,50%
Ba\BB	1,50%
B\B	1,30%
Caa\CCC and Below	0,50%
Non-Rated	0,00%

Source: Authors calculation based on data available at AFME (https://www.afme.eu).

4.1. The simple, transparent and standardised securitization framework

With these legal acts, the EU established a general framework for securitisation and created a specific framework for simple, transparent, and standardised (STS) securitisation[22]. A large aspect of the general framework was the definition of the actual parameters that allow STS securitization. In this context:

Simple securitisation' means that:

- Assets packaged in securitisation must be homogeneous loans/receivables.[23]
- No securitisation of securitisations is allowed.
- Loans must have a credit history long enough to allow reliable estimates of default risk.
- The ownership of a loan must have been transferred to the securitisation issuer (i.e. they must be sold by the creator of the loans to the entity that will issue the securitisation).

'Transparent and standardised securitisation' means that:

- Loans packaged in securitisation must have been created using the same lending standards as any other loan[24]..
- At least 5% of the loan portfolio must be retained by the originator[25].
- Documents must provide details of the structure used and the payment cascade (i.e. the sequence and amount of payments to each tranche).
- Data on packaged loans must be published on an ongoing basis.
- The contractual obligations, duties, and responsibilities of all key parties to the securitisation must be clearly defined.

4.2. Key objectives and main challenges of STS securitization

The objective of the framework is to promote a safe, deep, liquid, and robust market for securitisation, which is able to attract a broad and stable investor base to help allocate finance to where it is most needed in the economy. The new securitisation regime is a part of the European Commission's project to establish a capital market Union. This framework promoted STS securitisation with the aim to increase investor confidence and restore market activity. But at the same time, it also included amendments to the treatment of regulatory capital requirements for credit institutions that originate, sponsor, or invest in securitisation. Such a harmonization effort has increasingly become necessary to ensure a stable securitization market in the EU.

4.3. The implications of Basel IV standards and economic measures mitigating the effects of the Covid-19 pandemic

Given that the new Basel IV standards will have a significant impact on capital requirements, it is clear that banks will be increasingly interested in exploring securitisation as an alternative approach to raising additional capital. A further incentive to increase the use of securitisation will certainly be provided by the changes to the regulatory framework proposed by the European Commission in 2020 as part of the so-called Capital Markets Recovery Package.

The package essentially contains targeted adjustments to the Prospectus Regulation[26], MiFID II[27] and securitisation rules. It proposes targeted changes to the capital markets rules to encourage more investment in the economy, enable rapid recapitalisation of companies and increase the capacity of banks to finance the recovery. The proposed amendments expand the scope of SLS securitization from traditional securitization to on-balance sheet synthetic securitization. They also permit the securitization of non-performing loans (NPLs). Although the primary intent of the proposed amendments is to enable banks (as the most important financial institutions) to finance a stronger economic recovery needed in the aftermath of the COVID -19 pandemic, the proposed amendments will certainly contribute to a significant increase in the volume of securitization transactions in the European Union.

4.4. Synthetic securitization

The new regulation allows synthetic securitisations to become an important part of the overall securitisation market. In this context, it is important to understand the legal and technical differences between regular and synthetic securitisations. While the practical purpose of both types is similar[28], the actual legal rules that govern them differ considerably. While regular securitisation requires a transfer of assets, synthetic securitisation, which is based on the individual obligations of the counterparties, does not necessarily require this. To understand the differences between these two categories, it is important to situate them within the existing legal framework. As securitisation processes regularly take place in an international environment, local regulations increasingly play a minor role in their design[29]. However, there are still significant national legal differences, particularly between common law jurisdictions, under which regular securitisation processes were originally invented, and civil law jurisdictions, which often lack certain legal concepts that are necessary or useful to the process[30]. Therefore, a distinction between the legal classifications of regular and synthetic securitisation still depends to some extent on key aspects of national legal systems.

A key part of the regular securitization process play so-called Securitization Special Purpose Entities (SPEs or SSPEs)[31]. These entities are created to hold the securitized assets, which in most cases they have obtained through assignment agreements, and usually take the form of trusts (in common law jurisdictions) or corporations (in civil law jurisdictions). The loans are transferred to the SPE, which then issues securitizations to investors, collects payments from the borrowers, and then services their expenses and distributes the proceeds to the investors[32]. When the original borrowers transfer the rights under the issued loans to an SSPE, they surrender them entirely, or at least to the extent that third parties, such as their creditors, cannot access them in enforcement or bankruptcy proceedings[33]. In contrast, synthetic securitisation does not require an actual transfer of the assets.

In synthetic securitisation, ownership of the securitised receivables remains with the originator (the receivables remain on the balance sheet). In this type of securitisation, credit risk is transferred through the use of credit derivatives or financial guarantees, so neither the SSPE nor the issuance of securities is necessary. This means that on-balance sheet synthetic securitisation is easier and quicker to execute than traditional true sale securitisations. In particular, this allows for easier securitisation of assets such as large corporate loans or SME loans. These securitisations are also a much easier way of executing portfolios from different Member States, as they remove the legal complexities associated with the true sale of underlying exposures subject to different legal regimes. However, they also involve certain risks.

The transfer of risk in synthetic securitisations depends not only on the capital structure of the transaction (i.e. tranching[34]) and possible mechanisms of support by the originator (as is the case with true sale securitisations), but also on the features of the credit protection agreement entered into by the parties and the creditworthiness of the investor. As explained above, synthetic securitisation contracts are inter-partes contracts where the exposures are not transferred to third parties but a two-tier structure is created where the original holder of the exposures retains control over them but must transfer economic rights to the counterparty under the synthetic securitisation contract. This leaves the counterparty exposed to the risk of the original holder of the exposure becoming insolvent or bankrupt. In other words, the use of credit protection, particularly when it is unfunded and provided by non-public protection providers, exposes individual banks to counterparty risk and, in the case of a high concentration of protection providers, can lead to interconnectedness in the financial system that can have systemic effects (as demonstrated in the 2008/9 financial crisis). Notwithstanding, if both parties enter into the transaction with full knowledge of the underlying risks, the risk of misalignment of interests between originators and investors is reduced, as risk management is equally important for the protection seller and the protection buyer. [35]

However, it is necessary to distinguish between balance sheet synthetic securitisations and so-called synthetic arbitrage securitisations, which do not fall into the category of STS securitisations. Synthetic arbitrage securitisations are those where the originator of the securitisation does not necessarily have the relevant exposures and seeks to benefit from the possibility of actual or perceived arbitrage in determining the prices of different tranches of loan portfolios[36]. Synthetic arbitrage securitisations are problematic for several reasons, as they are neither a transfer of exposure to third party obligors nor a hedge against credit risk. Given the negative role that such securitisations played in exacerbating the effects of the great financial crisis of 2008/2009, the proposed changes to the regulatory framework aim to exclude synthetic arbitrage securitisations.

4.5. The role of changing capital requirements under European law and increases in non-performing loans due to Covid-19

In addition to the amendments to the Securitization Regulation, further motivation for banks to make greater use of on-balance sheet synthetic securitization will be the changes to the Capital Requirements Regulation providing for targeted differentiated prudential treatment of STS on-balance sheet securitization exposures (in relation to non STS on-balance sheet synthetic securitization exposures and arbitrage synthetic securitisation). This would be justified by the good performance of STS on-balance sheet securitization compared to traditional securitisation and arbitrage synthetic securitisation, within particular low default and loss rates. Moreover, the extension of the STS label would stimulate simpler, more standardised and more transparent synthetic securitisations, with reduced agency and modelling risks.

Given the current situation with the COVID-19 disease pandemic, it is realistic to expect banks to face an increase in non-performing loans (NPLs) what will generate additional pressure on banks' balance sheets as well as its capital requirements. In the first step, NPLs have a negative effect on the profitability of banks because they increase the number of required provisions and, at the same time, reduce interest income and increase costs associated with monitoring and managing NPLs. The management of large NPLs stocks requires serious resources making the management then unable to deal with other, profitable activities. And most importantly (in the context of the changes brought by upon Basel IV), high levels of NPLs require higher levels of capital given that higher risk weights are applied to such placements, which then results in capital consumption.

Therefore, changes in the securitization framework are of great importance for banks. By adapting the legal framework the legislator enables the implementation of securitization transactions even on non-performing loans. The current securitisation framework is designed for performing loans. In its “Opinion on the Regulatory Treatment of Non-Performing Exposure Securitisations” from 23 October 2019, the European Banking Authority (European Banking Authority, 2019) pointed out that the current prudential framework for securitisation set out in Regulation (EU) No 575/2013, when applied to securitisations of NPEs, leads to disproportionate capital requirements because the Securitisation Internal Ratings Based Approach (SEC-IRBA) and the Securitisation Standardised Approach (SEC-SA), is not consistent with the specific risk drivers of NPLs. A specific treatment for the securitisation of NPEs should therefore be introduced building upon the EBA Opinion as well as internationally agreed standards.

Also, the final elements of the Basel III framework published on 7 December 2017 impose that, in case of securitisation exposures, a minimum credit rating requirement only upon a limited set of protection providers, namely to entities that are not sovereign entities, public sector entities, institutions or other prudentially regulated financial institutions. It is therefore necessary to amend Article 249(3) of Regulation (EU) No 575/2013 to align it with the Basel III framework in order to enhance the effectiveness of national public guarantee schemes assisting institutions’ strategies to securitise NPLs.

Finally, given the importance of securitization for banking operations as well as its future role as essential tool in the compliance with Basel IV regulatory requirements, it should be noted that in accordance with the provisions of the Securitization Regulation, review of the whole securitisation framework should be performed. Also, on 18th October 2021, the European Commission sent a Call for Advice1 (CfA) to the Joint Committee (JC) of the European supervisory authorities (ESAs) for the purposes of the securitisation prudential framework review. The CfA seeks the JC’s assistance to assess the recent performance of the rules on capital requirements (for banks and (re)insurance undertakings) and liquidity requirements (for banks) relative to the framework’s original objective of contributing to the sound revival of the EU securitisation market on a prudent basis. For the purpose of the review of the framework, the Commission would need to receive the JC’s advice no later than by 1 September 2022. Additionally, it is necessary to consider the Action Plan for the Capital Markets Union, published by the European Commission on 24 September 2020[37] which highlights this issue in *Action 6: Helping banks to lend more to the real economy.* It is a key aim of the review to strengthen the role of securitisation as an instrument available to banks to help them provide sustainable and stable funding to the real economy in a post-COVID-19 environment. This should especially apply to better access for SMEs and the green transition. As is stated in the action plan, particular attention shall be paid to the capacity of the current framework to adequately reflect the effective riskiness of both STS and non-STS securitisation instruments. This in turn will require the inclusion of standards regarding the appropriateness of disclosure requirements, a clear process for recognising significant risk transfers and the prudential treatment of cash and synthetic securitisation, while preserving the financial stability of the European Union. In addition to strengthening the securitisation market, the Commission will continue to assess the possibility of introducing a dual-recourse instrument named European Secured Notes.[38]

Notwithstanding the planned comprehensive review of the securitization framework, the European Commission has proposed targeted amendments to the regulatory framework due to the expected benefits that these changes should have for the economic recovery. However, these targeted changes do not in any way diminish the scope of the planned comprehensive review and should focus on the broader impact of the new regime, including issues such as risk retention modalities, use of private securitisations, and the impact of the disclosure regime. The forthcoming revision will also be an opportunity to look at the recommendations of the High Level Forum for the Capital Markets Union on increasing the European Union securitization market (European Commission, 2020 c).

5. Conclusion

Securitization is a very important and powerful tool for banks to transfer credit risk to other parties while providing sufficient lending capacity to their customers. To facilitate securitisation, particularly in relation to the post-Covid-19 recovery, the European Commission has proposed targeted changes to the securitisation framework that will extend the existing EU framework for simple, transparent and standardized (STS) securitisation to synthetic securitisation. This is a significant change, not only in the area of financial regulation, but more importantly in the legal dimension of securitisation, as securitisation contracts form diametrically opposed legal relationships with respect to regular and synthetic securitisations. While regular securitisation contracts transfer actual claims against third parties, synthetic securitisations are primarily a transfer of risk through contracts containing guarantees provided by the seller of a synthetic securitisation.

For banks, synthetic securitisations are an important credit risk management tool as they allow them to transfer the credit risk of a set of loans, typically large corporate loans or loans to SMEs, to investors. The label "synthetic STS" should not be understood to mean that the securitisation is risk-free, but that legal criteria are established by European law that allow for a diligent protection of both the seller and the buyer. Furthermore, in member states, a national competent authority will be able to analyse the risk involved in order to establish external supervision. As a result of these changes, an enhanced STS framework that includes on-balance sheet synthetic securitisations will certainly provide additional incentives for securitisations within the robust EU framework and help banks find ways to share risk with capital market participants. However, it remains important for both regulators and the parties involved to manage synthetic securitisations within legitimate risk standards that take into account not only the asset pool in question but also the legal implications of the respective securitisation contracts.

The proposed European regulatory changes also remove regulatory barriers to the securitisation of non-performing loans in a way that aligns the rules with international standards, ensures their regulatory stability and allows start-up banks to adopt risk-sensitive modelling practices. These changes will help banks in the European Union to better manage their balance sheets, especially with respect to meeting current and future capital requirements (e.g., increasing RWAs through the finalized Basel III standards), secure their lending capacity over the medium term, and share risks more widely with the non-bank financial sector. Finally, the upcoming review of the securitisation framework during 2022 should provide an opportunity to introduce more fundamental changes (e.g. green securitisation).

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Endnotes

[1] Art. 114 para. 1 i.r.t. art. 26 Treaty on European Union (TEU).

[2] The usual underlying assets in financial securitization are mortgage loans, housing loans, consumer loans, student loans, car loans and other homogenous assets with long term maturity structure or sensible credit risk profile. See more in: Saleuddin R. (2015). Securitization, the Global Financial Crisis, and the New Regulatory World. In: Regulating Securitized Products. Palgrave Macmillan, London, p. 17-41.

[3] Base on the SIMFA data the additional issue with importance of securitization market in total European Union financial system will be in post Brexit period due to the volume of 385 billion EUR of the total 1.510 billion EUR owned by Great Britain financial institutions.

[4] The overview of the main reform is available at: Basel Committee on Banking Supervision (2017). High-level summary of Basel III reforms, December 2017, p. 1-12.

[5] Based on the current proposal of the so called „Banking Package 2021“, the implementation of Basel III in the EU would be completed when the last transitional arrangements expire, i.e., in 2033. This is five years after the deadline agreed by the BCBS member jurisdictions (which includes EU) expires. Moreover, this means that full implementation of the Basel III package will not be completed in the more than ten years.

[6] The targeted review of internal models (TRIM) is a large-scale project conducted by the ECB in close cooperation with the NCAs over 2016-2020. Its aim is to reduce inconsistencies and unwarranted variability when banks use internal models to calculate their risk-weighted assets. Available at https://www.bankingsupervision.europa.eu/banking/tasks/internal_models/trim/html/index.en.html

[7] Due to the pandemic crisis the implementation dates have been postponed for one year. For more details, see: Bank for International Settlements (2020). Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19, March 2020, p.1.

[8] Where are: T 1 - Tier 1 Capital, CET 1 - Common Equity Tier 1 Capital, and TC – Total Capital. More details on capital structure see in Regulation (EU) 575/2013, p. 37-40.

[9] In founding of new regulatory institutions framework European Union upgraded regulatory agencies: European Banking Authority (EBA) for regulation of banking system, European Insurance and Occupational Pensions Authority (EIOPA) for insurance regulation, and European Securities and Markets Authority (ESMA) for regulation of securities markets.

[10] Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, Article 12.

[11] Art. 10 para 1 Regulation (EC) No 1060/2009.

[12] Art. 23 para 1 Regulation (EC) No 1060/2009.

[13] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies, Art. 1 para 1.

[14] Regulation (EU) No 462/2013 art. 1 para 1.

[15] Namely: credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, alternative investment fund managers and central counterparties.

[16] Regulation (EU) No 462/2013 art. 1 para 4.

[17] Regulation (EU) No 462/2013 art. 5a para. 1.

[18] Regulation (EU) No 462/2013 art. 5a para. 2.

[19] Regulation (EU) No 462/2013 art. 35a.

[20] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitization and creating a specific framework for simple, transparent and standardized securitization, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 – (OJ L 347/35, 28.12.2017)

[21] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions

[22] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitization and creating a specific framework for simple, transparent and standardized securitization, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 – (OJ L 347/35, 28.12.2017) Chapter 4, articles 18-26

[23] E.g. car loans with car loans, residential mortgages with residential mortgages).

[24] In other words, it is not allow to pick specific lending standards or aspects of lending standards that would make a security seem more attractive as an investment.

[25] Regulation (EU) 2017/2402 Art. 6 para 1.

[26] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC

[27] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

[28] It is however not identical: Synthetic securitisation is mainly used as an efficient tool by many banks in their credit risk and capital management activities, as it enables them to transfer credit risk to the private capital markets efficiently. In this way, capital and lending limits becoming free and available for new lending activities. Contrary, traditional securitisation is not used as credit risk management tool, but mainly as an instrument to raise funds from the sale of assets. In addition, this type of securitisation is a particular efficient means to reduce risk and thus capital requirements when obtaining liquidity from the sale of exposures.

[29] Jan Job de Vries Robbe: Securitization Law and Practice: In the Face of the Credit Crunch, Kluwer Law International B.V., 2008, p. 252.

[30] Frankel, Tamar, Cross-Border Securitization: Without Law, But Not Lawless, Duke Journal of Comparative and International Law, 1998, Vol. 8, 225, p. 274 f.

[31]GW Law Faculty Publications & Other Works Faculty Scholarship 2009 The Dark Side of Universal Banking: Financial Conglomerates and The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis the Origins of the Subprime Financial Crisis Arthur E. Wilmarth Jr. George Washington University Law School, awilmarth@law.gwu.edu p. 986.

[32] Frankel, Tamar, Cross-Border Securitization: Without Law, But Not Lawless, Duke Journal of Comparative and International Law, 1998, Vol. 8, 225, p. 260 f.

[33] See for the standards of a contract for the transfer of assets under common law for example, alredy Re George Inglefield Ltd, 1932 All ER Rep 244; 1933 Ch 1.

[34] Tranches are a collection of securities that are separated and grouped based on various characteristics and sold to investors. Tranches can have different maturities, credit ratings, and yields or interest rates. A credit rating is an assessment of the creditworthiness of the borrower or issuer of a particular debt or financial obligation. The financial instruments that can be broken up into tranches include loans, bonds, mortgages, and insurance policies. Tranches are typically used in securitization process in which various types of debt instruments are divided and packaged into funds to be sold to investors who want to earn the interest rate on the debt. Investment bankers can create a single basket of loans that have similar characteristics that appeal to specific investors., Investopedia (www.investopedia.com)

[35] Report from the Commission to the European Parliament and the Council on the creation of the specific framework for simple, standardized and transparent synthetic securitisation, limited to the balance sheet synthetic securitisation COM (2020) 284 final, p. 2

[36] The main objective of arbitrage synthetic securitisation (mainly CDOs – also called Collateralised Synthetic Obligations or CSOs) is one of arbitraging between the (higher) spread received on underlying lower credit quality debt or products indices (such as ITRX CMBX, ABX) and the (lower) spread paid on the resulting structured and credit enhanced CDO note and usually embeds extra features such as leverage or foreign currency pay-outs. Arbitrage synthetic securitisations are usually investor- and/or asset manager-driven and are structured to achieve a desired portfolio profile in terms of seniority, rating and return desired by investors. In addition, arbitrage synthetic transactions can be managed transactions, i.e. transactions where a portfolio manager is appointed to 'actively' manage the collateral underlying the synthetic CDO (Moor and Rimarchi, 2015).

[37] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions (2020). A Capital Markets Union for the people and business new action plan, September 2020, Annex 1, page 3.

[38] As set out in 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, it will submit a report to the European Parliament and the Council by 8 July 2024, Article 31