Simple, Transparent and Standardised Securitisation

Business as usual?

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Abstract

The resurrection of the securitisation market lies at the heart of the EU project to build a pan-European capital markets union (CMU) and it recently flowed into the Commission proposal for a Regulation laying down a framework for Simple, Transparent and Standardised (STS) securitisation.

This article offers a critique of the EU project to create a capital markets union and in particular of the proposed framework for STS securitisation. It is firstly centred on the problematic coordination of the policy objectives that underlay the very conflicting aims in this area of financial regulation. Secondly, it points to four more specific areas of concern, namely, the definition of securitisation for the purpose of the regulation, the linkages with the shadow banking system, the reliance on external ratings, and the question of supervision and regulation.

This article contends that the persistence of these problems in the current design leads to questioning whether a revived securitisation market would still fuel the shadow banking system and create systemic risks. It points out that the difficulty to regulate complex legal relationships, typical of long intermediation chains, make the proposed framework still weak. This article submits that only a tighter approach to transaction standardisation could ensure the simplicity and transparency that the Commission is hoping to achieve. Equally, a supervisory infrastructure centred on the overseeing power of a pan-European authority is needed to prevent the recurrence of pre-crisis legal problems.

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1 – Introduction

This article critically analyses the recent initiatives aimed at restarting the EU securitisation market, which culminated with the EU Commission Proposal for a Regulation on Securitisation. This article argues that, despite offering a valuable framework to define Simple, Transparent and Standardised (STS) securitisation, the proposal lacks sufficient clarity on a number of questions, namely, the necessary degree of standardisation, the degree of standardisation, the reliance on credit rating agencies, and the regulation and supervision of the securitisation market. These problems contribute to questioning at a higher policy level whether securitisation will still fuel the shadow banking system and cause systemic risks.

In the aftermath of the global financial crisis (GFC), structured finance has been widely identified among its main causes (Turner 2009). The securitisation market suffered substantially after 2008, and it has so far remained in decline for two main reasons, commonly identified with post-crisis regulation and investors' stigma. It has been argued that this has deprived the financial sector in the Eurozone of a much needed diversified funding source, and the mechanism that allowed banks to spread the risk of their investments (Hill 2014).

A number of public consultations have been initiated, both at the EU and international level, to reprise the securitisation market without incurring the same mistakes that characterised pre-crisis practices (among which BoE, ECB 2014a; BoE, ECB 2014b; BoE, ECB 2014c; BCBS, IOSCO 2014; EBA 2015). The EU Commission started its own consultation process on a framework for STS securitisation (EU Commission Consultation 2015), which flowed into the already mentioned Proposal for a Regulation (EU Commission Proposal 2015). It needs to be noted that a differentiated treatment of securitisation that comply with STS criteria has already been introduced by two EU delegated acts, namely Solvency II (Regulation (EU) 2015/35) and Liquidity Coverage Ratio (Regulation (EU) 575/2013), which apply respectively to insurers and banks acting as investors in securitisation.

The EU initiative is part of a broader design, aimed at building a single market for capital (capital markets union (CMU), EU Commission Green Paper 2015). This is driven by a long-standing policy goal to create a pan-European securities market centred on the development of disintermediated capital markets products alongside the more traditional intermediated banking ones. It is also clear that the CMU is envisaged by the Commission as a means to strengthen the EU economy as a whole, and as a way to tackle the challenges that emerge from competitive and interconnected global markets. The project would allow innovative enterprises – and in particular SMEs – an easier access to financing channels. A well-functioning securitisation market, freed of the flaws that characterised the pre-crisis years, is conceived as the fulcrum of this project (Hill 2014).

The idea of "high-quality" securitisation is broadly conceived as encompassing simpler structures with transparent underlying assets and predictability of risks and performance. These features led to the development of STS criteria which are believed to contribute to a more robust securitisation market which could adequately perform the allocative and intermediation functions that have been missed since 2008. The next section focuses on the broad design to develop market-based channels of finance and maps the status of securitisation in Europe. Section 3 discusses the policy options

pursued through the consultations and highlights some of the responses provided by different stakeholders. Section 4 critically analyses the Commission's proposal. The main criticism of the article is developed in section 5, where the policy concerns are explained in details. Section 6 concludes.

2 – Securitisation and market-based financing channels

The structure and development of financial markets is normally assessed by looking at the balance between bank finance and capital markets finance. As far as European markets are concerned, it is commonly claimed that savings are concentrated in the banking sector, and that assets held by non-bank financial institutions in Europe are low compared to the US. This is mirrored by a lack of depth in European capital markets, where the value of equity, corporate bonds, and securitisation represent respectively 60%, 35% and 20% of the US markets (Anderson, Brooke, Hume, Kurtosiova 2015, p.6). A greater diversification of financing channels and a reduction of the alleged over-reliance on banks is one of the central goals of CMU. It is in particular claimed that capital markets can play an important role in bringing finance where it is most needed because it would allow greater access to finance for businesses across Europe. CMU would also have the effect of increasing and diversifying the sources of finance, involving investors from around the EU and worldwide, which in turn implies more efficiency because finance could be raise at lower costs (EU Commission Green Paper 2015, p.4).

Controversially, it has also been asserted that the over-reliance on the banking sector impaired the quality of European banks' balance sheet in the aftermath of the GFC, and that their limited lending capacity led to higher funding costs even for high-quality borrowers. The same did not happen in the US, where the more diversified financial system allowed alternative financing channels – capital markets-based – to meet funding demands and thus bring a quicker recovery from the crisis (Anderson, Brooke, Hume, Kurtosiova 2015, p.7). This article contends that the above analysis fails to sufficiently appreciate that the European banking system had become increasingly weakened in the pre-crisis period, because the large universal banks were over-dependant on wholesale sources of finance (Avgouleas 2009) and subject therefore to the limits and perils of the market-based financial system (Biondi 2016). This point will be expanded in section 5 of the article.

Data also suggests that capital markets across Europe remain fragmented along national lines for a number of legal, regulatory and ultimately cultural factors. These give rise to sheer differences as to the degree of development: the level of stock market capitalisation for instance varies between the 121% of GDP in the UK to the 10% in Cyprus or Lithuania (EU Commission Working Document 2015, p.11-13). Underdevelopment and fragmentation are among the problems identified by the Commission and which are thought to be halting economic growth in the Euro area in the aftermath of the GFC. Under the Commission's design, the development of market-based channels of finance would bring about a number of economic benefits, among which: diversification of funding sources and therefore better credit terms; improved allocation of capital; and more efficient distribution of risk to those better suited to bear it (EU Commission Green Paper 2015, p.5). It has also been emphasised that the development of CMU would be at the heart of a long-term investment project to improve access to finance for small and medium-sized enterprises (SME) across Europe (EU Commission Green Paper 2015, p.9).

Under the current design, the resurgence of securitisation lies at the heart of the CMU project. This is partly due to the claim that during the GFC loss rates in European securitisations remained low, compared to the US (EU Commission Green Paper, p.10). The different initiatives signposted in the previous section converge in the pursuit of a design for STS transactions which would attract a different prudential treatment and thus restart the market in a more sustainable way. In this sense, it is important to clarify the key functions that securitisation should encompass according to the EU policy design.

The investment function, firstly, would allow investing in long-term maturity assets without having to hold them on books. Securitisation can in this sense contribute to diversifying exposures and customise the relationship between cash-flow and risk, especially for long-term investors (BoE, ECB 2014b, p.7 and EU Commission Proposal 2015, p.3). Secondly, securitisation is identified as a funding tool that allows financial and non-financial institutions to support "real economy" activities, by alleviating the maturity mismatch of assets and liabilities (BoE, ECB 2014b, p.7 and EU Commission Proposal 2015, p.3). The third highlighted function of securitisation is the market-based risk-transfer mechanism that would allow banks in particular to be less dependent on the business cycle with respect to their decisions to lend. It is again observed in this context that market-based financing, as opposed to bank lending, represents a different percentage of corporate finance across the Atlantic, amounting to 14% in the US, 10% in the UK and only 5% in the EU (BoE, ECB 2014b, p.8 and EU Commission Proposal 2015, p.3). A fourth dimension of a renewed securitisation market would be its capacity, through the STS criteria, to help parties evaluate risks and avoid the recurrence of excessive levels of risk-taking experienced in pre-crisis years. This would in turn help managing systemic risks (EU Commission Proposal 2015, p.3). Finally, securitisation is critically functional to the process of generating high-quality collateral, to transform in other words illiquid loans into liquid assets, which support other transactions (BoE, ECB 2014b, p.8).

In analysing the state of securitisation in Europe post-crisis, it is useful to look at the reasons that are typically brought to explain its stagnation. It has been recognised that regulation enacted after 2008 is one of the factors that impede the securitisation market from restarting (BoE, ECB 2014c, p.2). In particular, the new regulatory capital regime in force since January 2014 brought changes to the retention rules for securitisation (Directive 2013/36/EU CRD-IV) and it is speculated that risk-retention requirements under Capital Requirement Directive (CRD-IV) will create costs for originators and their inconsistent application across jurisdictions may hinder the development of a pan-EU market. Beyond regulatory intervention, the persisting reliance on credit rating agencies (CRA) is also identified as an impediment to the securitisation market, despite efforts in the opposite direction, as will be discussed later.

3 – The Commission's policy goals and market responses

The STS framework (analysed in the next section) responds to the need to ensure financial stability and investor protection in the securitisation market. This is achieved in principle by making risks easier to assess and analyse for investors, while transactions that comply with the STS criteria would be subject to a more risk-sensitive regulatory approach (EU Commission Proposal 2015, p.7). These goals would be attained by firstly, limiting the tendency to concentrate risks in systemic institutions and the STS framework is conceived to realise an effective distribution of risks across the financial

system, where asset-backed securities would be held by less leveraged institutions. Secondly, a number of features are designed to improve the predictability of the transaction especially with respect to its performance. This would enhance investor confidence and demand for securitised products, due to the alignment of issuers' and investors' interests, and thanks to the transaction's simplicity. The idea of simplicity is also vital for the management of linkages that certain types of securitisation create with the shadow banking system (SBS; see FSB 2013. Questions on the effectiveness of the regulation of shadow banking activities will be addressed in section 5).

The EU framework laid down a modular approach centred on the key criteria of Simplicity, Transparency and Standardisation (analysed in the next section), which are complemented by additional risk features for sector-specific risks (EU Commission Consultation Document 2015). In addition, the EU Framework placed emphasis on three more aspects of STS securitisation, namely the risk-retention requirements which, it was argued, should shift from an indirect (where investors have the burden of verifying compliance) to a direct approach and which are designed to ensure the quality of underwriting standards. Secondly, there has been widespread agreement that, while the eligibility criteria should help investors to understand securitisation risks, investors should continue to perform careful due diligence. Monitoring the compliance with the eligibility criteria is therefore vital to maintain investor confidence. The Commission identified three possible strategies to this end, namely labelling, certification and licensing and the next section will discuss these options in more detail. Thirdly, the EU Framework introduced the question of how much harmonisation would be necessary to increase simplicity and certainty. In particular the standardisation of the securitisation structure has been evaluated with respect to areas such as the legal form of the SPV, the modality for transferring assets and the rights and subordinations among note-holders (EU Commission Consultation Document 2015, p.8-10).

The question of compliance with the STS eligibility criteria entails clarifying what type of authority should supervise this process. While this has not been done, the Commission has confirmed that market-driven solutions are preferred and new regulation would be considered only if necessary (EU Commission Green Paper 2015). The ambiguity of this approach echoed some controversial responses to the consultation process and the deep-seated reservations shared by most market-players on the prospect of any form of statutory regulation and intrusion into the private ordering of the originate-and-distribute model (Bavoso 2016; Stout 2011; Biondi 2011). This was reflected for instance in sharp disagreements as regards the definition of securitisation whereby some respondents stressed the potential benefit of securitising high-risk assets and the need to resort to synthetic transactions (which fall outside the scope of the STS definition) to do that (EBABSG 2015, p.7,8). More generally, most industry respondents shared concerns on the definition of simplicity. While greater analysability of the transaction for investors was welcome, a tout court ban on complex structures was considered undesirable (BoE, ECB 2014c, p.2). The question of supervision raised similar concerns among market-players who manifested during the consultation process a clear preference for private or industry bodies certifying compliance with STS criteria, rather than a public authority (EU Commission Proposal 2015, p.7).

Much controversy emerged as regards the necessary degree of transaction standardisation, which would increase transparency and facilitate due diligence. The difficulty to reconcile different tax and insolvency regimes across the EU has made some respondents favour optional regimes rather than mandatory ones (AMIC 2015, p.6,7). Interesting responses have been produced by the French

regulator, the Autorite des Marches Financiers (AMF), with respect to the standardisation of the true sale of assets to the SPV. The AMF advocated the introduction of a set of rules to regulate the transfer of assets in a robust way, and more importantly a European legal vehicle for STS securitisation that would ensure the establishment of an EU passport for SPVs (AMF 2015). Some respondents have gone further, advocating the exclusion of the practice of tranching from the STS framework (Finance Watch 2014, p.41,42): this would entail both a tighter definition of simplicity and necessarily a greater contractual standardisation.

The natural friction between market forces and regulation, which emerged very clearly from the consultations' responses, is central to the understanding of the Proposal that will be analysed in the next section. The Commission has been under substantial pressure from relevant lobbies to come up with a regulatory framework that would still allow market players to benefit from a laissez-faire environment. Weak supervisory mechanisms however, and an insufficiently robust definition of the STS criteria are likely to generate the same level of risk-taking and instability experienced before the crisis. The next section critically evaluates how the Commission's Proposal has tackled these fundamental questions.

4 – The STS framework

The first concern as regards the proposed framework is related to the responsibility that is laid on originators and sponsors for ensuring compliance with the STS criteria. Article 14 provides a regulatory mechanism that revolves around a private notification process instead of a system of public certification (much envisaged among several policy-makers and respondents such as the AMF). Investors will still need to perform due diligence before investing in STS securitisation, and this will be facilitated by the STS notification communicated to ESMA by the originator, and by information provided by originators, sponsors and SPVs. While it is acceptable that investors will have to conduct due diligence beyond relying on the STS label, the above process is not complemented by an adequate supervisory framework, due to the limited role attributed to ESMA (as will be explained later in the article). Compliance with the STS requirements in other words, will rest with originators and investors while the role of supervisors will be to monitor market developments and impose sanctions, when needed (EU Commission Proposal 2015, p.8).

The Commission has overall been reluctant to involve a public authority in the certification process. This is due to the regulatory failures associated with third party ratings (chiefly CRAs) before the GFC, and the moral hazard that this form of reliance would cause on investors. A more contextual critique of this approach will be provided in the next section, but it is worth highlighting here that the problems related to CRAs are due to their regulatory status and business model, and that a public regulator would be very unlikely to incur the same type of regulatory challenges (or conflicts of interest).

The exclusion of a public authority from standardisation efforts originates from similar motivations. The Commission argued that efforts to create more consistent market practices for the benefit of investors should be left to industry associations (EU Commission Proposal 2015, p.8). This approach however overstates the ability of market-players to recognise the systemic dimension of certain market practices and the level of risk they can create. In particular, the Commission has not elaborated on transactional problems related to tranching, and an incomplete definition of simplicity

under the STS criteria could lead in the near future to increasing risk-taking in the financial system (Finance Watch 2014).

The rest of this section provides a critical review of some specific parts of the proposal. Chapter one defines key elements of securitisation for the purpose of the Regulation. Chapter two draws the detailed due diligence requirements that investors have to carry out before becoming exposed in a securitisation and once they have invested in it. Article 3 specifies that originators, sponsors and SPVs have to make available relevant information. Article 4 confirms that the originator has to retain a net economic interest in the transaction on an ongoing basis of no less than 5%, which cannot be hedged or subject to credit risk mitigation. Unlike existing regulations, such as CRR and Solvency II, the proposal creates a direct retention requirements and related reporting obligation upon originators. This entails that it will be easier for investors to verify whether the risk has been retained. It remains controversial though whether a 5% economic interest represents a sufficient incentive to align originators' interests to investors, given that in the past similar rules already existed and also that originators often bear anyway the first loss in lower securitisation tranches. Article 5 complements the previous provision by listing the transparency requirements that originators are subject to, in particular with respect to information on the securitisation's underlying exposures.

Chapter three defines the requirements for Simple, Transparent and Standardised securitisation. In article 8 the concept of simplicity is identified through the transfer of assets to the SPV, which has to amount to a true-sale and cannot be subject of clawback provisions in the event of the originator's insolvency. This means that, despite resistance from a large section of the industry, synthetic exposure will fall outside the perimeter of STS criteria (even though the Commission is open to assess in the future whether some synthetic securitisations can be included in the STS framework; EU Commission Proposal 2015, p.15). Article 8 also excludes securitisations among the underlying assets, which essentially prohibits the practice of re-securitisation that had become common before the crisis. Article 9 defines the requirement of standardisation, which revolves around the originator's obligation to satisfy risk retention requirements. It also clarifies that the underlying exposures should not include derivatives (unless for hedging purposes – but this exception may not be consistent with the overarching goal of simplicity). Article 10 lays down the transparency requirements, whereby the originator should provide access to data and statistics related to the securitisation exposures.

While article 14 lays down the rules related to the notification process, discussed earlier in this section, chapter four deals with the critical issue of supervision. The central provision is article 15, which clarifies that the supervision of the securitisation market will be conducted by the competent authorities (CA) designated by individual member states. In particular, CAs will have the supervisory, investigatory and sanctioning powers that are necessary under the regulation (art.16). Article 17 enumerates the various administrative sanctions and remedial measures that can be enforced in connection with breaches of the regulation. It is again emphasised that the implementation of the above measures will be ensured by member states and in doing so CAs should exercise their powers directly, in collaboration with other authorities, or by application to the competent judicial authority (art.18). Articles 20 and 21 set out rules of cooperation between CAs and the ESAs and between CAs of different countries. The role of ESMA is again largely a coordination one, aimed chiefly at drafting regulatory standards to specify the cooperation obligations.

5 – Policy concerns

This article suggests that the regulatory initiatives that culminated with the Commission's proposal provide a valid framework, without however clarifying a number of fundamental issues. These relate to the possible creation of systemic risk that can be generated from certain transactions and in particular from potential spill-over into the shadow banking sector (SBS). This critique is developed in this section by discussing firstly, the problem associated with the definition of securitisation under the STS criteria; secondly, the concerns related to the inter-relation between certain transactional features and shadow banking activities; thirdly, the problem related to the role of credit ratings; and finally the broader question of the institutional and regulatory framework under which securitisation will operate.

Definition of STS

The responses to the consultations showed that different stakeholders have not agreed on what should have been included within the concept of high-quality securitisation. Much debating went into whether synthetic transactions should be excluded from the STS definition. The proposal has now clarified that simplicity will require the true-sale of the underlying receivables, and that synthetic exposures will fall outside the scope of STS (Art.8). Questions of market efficiency were raised by market-players, based chiefly on the fact that not all synthetic transactions performed badly during the GFC, and on the costs that would be incurred from the true-sale of certain classes of more risky assets (EBABSG 2015, p.8). These concerns, albeit pertinent, fail to reflect the systemic importance that securitisation can have on the financial system as a whole. The Commission's stance therefore has to be welcome, especially when considered in conjunction with other provisions that limit the complexity and riskiness of STS securitisation, namely: the exclusion of re-securitisations; the prohibition of active portfolio management (which was typical of dynamic transactions like pre-crisis CDOs; see Long 2006, p.124); the requirement that the securitised assets are homogeneous, originated in the ordinary course of business and not defaulted (Art.8).

The Commission however has failed to provide more clarity on the question of tranching. The practice of tranching seems to be accepted throughout the proposal, and the prohibition of active portfolio management per se cannot be conclusive of a willingness to restrict tranching. In light of the critical role played by this particular feature of securitisation, it is worth providing an explanation of its implications. Tranching represents a way to pool assets whereby the SPV does not issue one type of security against the asset pool, but several types, due to the slicing of the security into tranches of different credit quality and subordination (Lucas, Goodman, Fabozzi 2006). Each tranche carries a different risk and rate of return, appealing investors with different risk appetite and providing therefore a more customised product (Coval, Jurek, Stafford 2009). This practice allowed banks in particular to originate and securitise loans of poorer quality, which would anyway receive a high rating for two main reasons, namely the complex correlation formulas that underscored the way in which assets were bundled (Salmon 2009, p.79), and the credit enhancement mechanisms (Acharya, Schnabl, Suarez 2013).

Credit enhancements can become a problematic feature of the transaction when they take the shape of guarantees provided by the originator. Originators or sponsors often provide guarantees to investors so that the investors' claim is paid off even in the event of the SPV's insufficient cash-flow.

The result is that in most cases SPVs are screened from credit and liquidity problems and the relating risks are borne by the originator/sponsor, giving therefore rise to a securitisation without risk transfer. Instead of dispersing and diversifying risks, these securitisations aggregate risks in large banks that do not hold sufficient capital against these risks (Acharya, Schnabl, Suarez 2013, p.521).

The practice of tranching was also combined with the use of credit default swaps (CDS) which led large banks to have asset portfolios that were similar to one another. This is defined as correlation between banks' balance sheets, which increased dramatically in the pre-crisis years because of the use of credit enhancement mechanisms and the long transaction chains involving complex derivatives (such as CDS). Correlation in turn led to interconnectedness which aggravated problems of systemic risk, as well as risks of contagion between different tranches (Finance Watch 2014, p.35).

It has also become evident that tranching is the source of increased complexity in securitisation and more difficult assessment of risk-taking on the part of investors, something that is at odds with the Commission's overarching aims. The subordination process achieved with tranching enables the creation of senior tranches rated triple-A. These, despite being insulated from most losses, are still affected in case of extreme events. Moreover, risks related to senior tranches' correlation in the past were largely understated, that is the risk flowing from exposure to systematic or market risks, which cannot be eliminated through diversification (Coval, Jurek, Stafford 2009). The way in which risks were repackaged in tranches in other words led investors and the market as a whole to believe that, "by slicing and dicing", safe investment products could be created from risky underlying assets (Turner 2009). As a result, herding behaviour abounded among investors who relied on CRAs and on the myth that senior tranches would be risk-free securities (Coval, Jurek, Stafford 2009). Tranching in other words added uncertainty, which contributed to the difficulty to estimate risks (Finance Watch 2014). Interestingly, the Bank of International Settlements (BIS) recently stated that even when securitised assets are simple, transparent and of high quality, their risk assessment will remain uncertain, in particular with respect to certain tranches (Antoniades, Tarashev 2014).

Tranching also exacerbated the conflicts of interests between different tranche-holders, because senior tranches and equity tranches attract different attitudes to risk-taking. Moreover, these conflicts were not mitigated by asset managers who have tended to manage asset portfolios in the interest of the sponsor (investing in the equity tranche) and have therefore maintained an incentive to increase the riskiness of the asset portfolio (see Mahlmann 2012, p.13).

The pre-crisis years saw an increased appetite among investors for highly rated, low-risk securities, and in particular the demand for senior tranches to be used as collateral in the repo market. Spiralling levels of leverage and underestimation of correlation risks were among the consequences of this trend, as will be seen in the next section. The critical question then is whether the framework proposed by the Commission provides a definition of STS that will prevent the resurgence of risky market practices such as those described earlier. The idea of having simple and transparent transactions does not seem consistent with the practice of tranching, and to this extent, the Commission could have provided a tighter definition of high-quality securitisation.

Spill-overs into Shadow Banking

In the aftermath of the GFC it became increasingly evident that the SBS and the regulated financial institutions were highly interlinked, mainly because large banks had become very active both as providers of collateral and as participants in the repo market (Moe 2015; Gabor 2013).

Senior-tranche securities were before 2008 highly demanded forms of collateral in repo transactions, and were used by financial institutions to obtain short-term funding in the wholesale market. Even though securitisation was always conceived as a way to achieve diversification, the balance sheet of banks became increasingly homogeneous in the pre-crisis years, because their liabilities side was over-reliant on wholesale funding, and their assets side on securitised forms of credit (Haldane and May 2011, p.355). Excessive reliance on wholesale funding moreover exposed banks to greater levels of leverage and funding risks and it increased the linkages between banks and shadow banking (FSB 2013; Avgouleas 2009). These concerns revolve around the structure of the credit intermediation system recognised as "securitised banking" model. This refers to the practice of distributing originated assets to entities that, despite replicating some of the functions of traditional banking, are not in the regulated banking sector and are not constrained by capital and liquidity requirements. For this reason, interlinks with the SBS are said to contribute to increasing leverage at systemic level (Meeks, Nelson, Alessandri 2014, p.ii).

The linkages between the banking sector and shadow banks are attributed to some uses of securitisation and in particular the way it interplays with the repo market and money market funds (Claessens, Pozsar, Ratnovski, Singh 2013). In the securitised banking model, the best tranches, as said, are in high demands as collateral for the repo market, which over the last three decades has become a huge source of short-term finance for banks and other institutional investors (Gorton and Metrick 2012). The contagion, or correlation, is caused by the fact that collateral in repo transactions can be reused (rehypothecated) by banks, thereby increasing the correlation between banks' portfolios, the homogeneity of the financial system and the overall systemic risk (Claessens, Poszar, Ratnovski, Singh 2012, p.16; Haldane and May 2011, p.355; Moe 2015, p.12). This problem was augmented before the crisis by some credit enhancement mechanisms described in the previous section which, while ensuring triple-A ratings, increased the linkages between originators and SBS.

The complex transaction chains that had become a common feature in securitisations before 2008 have been identified as the cause of the uncontrolled level of leverage among large financial institutions (FSB 2013, p.4). The policy recommendations directed at improving transparency and disclosure are certainly a step in the right direction. However, the Commission has remained ambivalent as regards the degree of product and transaction standardisation that is necessary, because the prevailing belief is that too much standardisation would stifle innovation.

Another critical aspect of pre-crisis securitisation that the Commission has not addressed is the question of the European banks' over-reliance on the wholesale market. It was this funding base that primarily impaired European banks before the crisis, above the financial system's over-reliance on banks as funding sources. It is worth highlighting why wholesale funding poses more risks than traditional retail funding.

Wholesale funding enables banks to extend their lending capacity and grow their balance sheet beyond their core liabilities. This is so because banks access a large source of funding which is only limited by the quantity and quality of collateral that can be posted, that is the assets created through

the securitisation process (Finance Watch 2014, p.38-39). It is well known that to increase lending, banks should increase their regulatory capital or alternatively reduce their existing risks. Both of these strategies however represent constraints on banks' profitability, while there is clearly more and cheaper lending enabled through the wholesale market (the only limit on how much assets can be used as collateral being the level of haircut, namely the risk of holding those assets, Finance Watch 2014, p.39).

The extensive use of wholesale funding before 2008, combined with a general understatement of risks, enabled financial institutions to build up high levels of leverage that they could not withstand. Much of this funding channel through repo transactions became a critical factor in increasing systemic risk because banks were purchasing each other's securities with borrowed money, which again increased leverage and the concentration of risks in the financial sector (Moe 2015 p.8). This eventually triggered liquidity crises, due to the reliance on short-term assets to fund long-term liabilities and the inability to renew short-term funding (Gorton and Metrick 2012, p.426; Wray 2013, p.293,294). In essence, credit intermediation through the SBS replicated the same problems of the traditional banking system, namely maturity transformation and leverage, but they were magnified by the lack of regulation in shadow banks (particularly reserve and capital requirements; Blair 2010, p.17 and FSB 2011, p.3) and also by the complexity of transaction chains in the SBS (Turner 2014, p.5).

Some of the risks highlighted above are likely to be mitigated by the new liquidity coverage ratio introduced with CRR/CRD-IV, which create buffers designed to equip banks with necessary liquidity in the case of a run on their short-term exposures in the repo market (Clifford Chance 2012, p.21). Admittedly though, there is not much in the Commission's work that provides a clarification of the linkages between securitisation and the SBS. Regulating STS securitisation may not be sufficient in this sense, given that the repo market (referred to as securities financing transactions (SFT)) has received very limited regulatory scrutiny in the pre-crisis years, despite being much larger than the securitisation market, and used to finance securitisation products (Gabor and Vestergaard 2015, p.3 and ECB 2012)

In 2015 the Commission enacted the SFT Regulation (Regulation EU 2015/2365) with a view to reduce risks in the SBS, by mainly increasing transparency in repo-type transactions. This will occur through a twofold strategy; firstly, the Regulation set conditions on the reuse of financial instruments received as collateral (art.15, whereby both conditions revolve around counterparties' understanding of the risk entailed with the reuse); secondly, counterparties will be required to report relevant transactions to a trade repository (art.4, and 13 as regards transparency towards investors from UCITS managers). As the main thrust of the Regulation is on increased disclosure of information provided to counterparties in repo transactions, this should undoubtedly contribute to tackle problems of counterparty credit risk and systemic risk. However, it is equally pertinent to cast doubts on the effectiveness of these provisions for two reasons. Firstly, they revolve around assumptions of market discipline which have proven rather illusory in the pre-crisis years (Avgouleas 2009b). Secondly, as is discussed later in the section, the enforcement of the above provisions will depend on member states implementing relevant regimes through their national authorities, with ESMA playing largely a coordination role.

The SFT Regulation has not provided any guidelines on minimum requirements for haircuts, admitting in its preamble that these would prevent excessive leverage and concentration of risk

among large institutions. This gap is likely to be filled by the FSB through a regulatory framework with recommendations for minimum SFT haircuts (FSB 2015).

The Commission overall, while having acknowledged the risks of rehypothecation and having stated the need to appropriately regulate the flow of collateral in the financial system, has only partly addressed these problems, relying instead on an architecture still largely grounded on market-discipline mechanisms.

Reliance on external ratings

It was explained earlier in the article that the practice of tranching involves longer transaction chains which also represent more complex forms of credit intermediation. In the years before the crisis reliance on CRAs had become indispensable in the context of these transactions because of the difficult assessment of the underlying assets' risk, which investors could not supplement. The role of rating agencies went beyond the rating of structured securities. They provided a number of ancillary consulting services related to the products they would subsequently rate and advised on how to structure the transaction in order to receive a triple-A rating (Bavoso 2013, p.145; Partnoy 2006, p.61). Once again, the overarching regulatory goal to limit reliance on CRAs is at odds with the persisting complexity that generates from tranching. The question that still remains unanswered is how originators and investors will supplement the function performed (admittedly quite badly) by CRAs to mitigate the information asymmetry that derives from complex transactions.

Post-crisis regulation in the EU in the area of CRAs has followed a twofold strategy. On the one hand, EU legislation has sought to increase transparency and disclosure of credit ratings through enhanced supervision of CRAs, conducted chiefly by ESMA (Regulation 513/2011, amending Regulation 1060/2009). On the other hand, there has been a move to limit regulatory reliance on external credit ratings, to be replaced instead by either internal models (BCBS 2014, p.1) or more standardised and simplified forms of disclosure to investors. The approach endorsed by the Commission in this proposal is clearly leaning towards increased disclosure of information in a more standardised way (consistent with Regulation 462/2013, amending Regulation 1060/2009, art.8) in order to reduce reliance on third-party ratings. At the same time though, CRAs will still play a relevant role in structured finance in the foreseeable future, given the necessity to have information intermediaries between originators and investors, and the relative complexity of all securitisations, even STS.

Hence, while reduced reliance on external ratings has to be welcome given the widespread failure of CRAs before the crisis, the reliance on internal models as a way to supplement third-party ratings needs to be seen with caution. Despite introducing an improved framework and a hierarchy of approaches to assess risks in securitisations, the new approach will allow large banks to employ their internal models to establish how much capital has to be set aside against securitisation exposures (BCBS 2014, p.15-16). The concern with this policy is that it fails to address two failures that were experienced in the pre-crisis years. The first problem is that internal models rely on assumptions of market discipline which have been largely misplaced. The danger in particular would be to allow large financial institutions to devise internal risk-assessment models that enable artificially low risk measurements and as a consequence arbitrary capital relief, followed by accumulation of leverage. Secondly, the question of addressing systemic risk in financial markets is not adequately tackled through a system that remains geared to a micro-prudential approach, focusing on the risk-taking of

individual banks rather than on the accumulation of risk and leverage system-wide. There has been widespread agreement after the GFC that a lack of macro-prudential approach was at the root of the regulatory failures (Persaud 2010, p.445; Alexander 2010, p.437). This was particularly the case with respect to the reliance on market discipline that was envisaged as a means to supplement regulation (BCBS 2006). The undisputed trust in the policing function of market mechanisms has however proven misplaced (Avgouleas 2012, ch.5; Boyer 2013 p.130-132; Biondi 2013 p.163).

Admittedly, the Commission has not introduced a valid solution to the above regulatory problem. Moreover, the notification system in the proposal risks re-proposing questions of micro-prudential approach and supervisory coordination. These will be examined in the next section.

Regulation and supervision

The ambitious agenda set out with the Green Paper on CMU has left with uncertainty as regards the institutional framework under which the project would be implemented. The Green Paper stressed that the Commission supports market-driven solutions and that regulatory changes would only be considered when necessary and this is premised on the fact that the regulatory framework for capital markets has already been harmonised in the past and that supervisory convergence has been promoted since the creation of the ESAs in 2010 (EU Commission Green Paper 2015, p.22). The existence of ESAs, and in particular the development of ESMA with its regulatory and supervisory powers (see Shammo 2011, p.1890), means that on paper the CMU does not need the establishment of a SEC-type of regulator to be implemented.

However, this is only part of the picture. Questions on the effective powers of ESMA have been raised especially in relation to the budgetary constraints under which it operates and the relevant powers that have so far not been exercised, such as those related to financial products (Lannoo 2015, p.6). Concerns over ESMA's capability to face the task of supervising a fully integrated capital markets and in particular an EU-wide securitisation market are therefore well grounded, and the various consultation documents have provided little clarification in this respect. It has also been observed that while the securitisation market is cross-border in nature, capital markets remain fragmented along national borders, which means that local knowledge will probably be required in the day-to-day supervision of market practices (Lannoo 2015, p.7). As anticipated, it appears that the necessary level and type of supervision that should be necessary in a fully integrated European capital market is not yet been defined. Despite the creation of a standardised prudential treatment of securitisation across the EU (resulting from the application of the STS criteria and the Basel III framework), the risk here is that market-based channels of finance will be developed in a laissez-faire environment, reminiscent of the pre-crisis period.

At a higher policy level, the lack of a supra-national regulator makes it very difficult to envisage how the CMU project and STS securitisation more specifically would achieve some of the announced goals. Without the steering function typically associated with central authorities, the "real economy" dimension of the CMU risks being overshadowed by the profit-making priorities of financial institutions, leading in turn to more "financialisation" of the economy.

With respect to the supervision of STS securitisation, the Commission has clearly excluded the involvement of a public authority (presumably ESMA) in the certification process, and more

importantly article 15 of the proposed Regulation allocates supervisory powers to national authorities, with ESMA playing a marginal coordination role. The notification system moreover places responsibility upon originators and sponsors. This mechanism risks leaving too much power to market actors, especially if enforcement procedures are not sound and consistent across borders. The risk with this system is that it confers a private quasi-regulatory power to market-players, which may not be adequately countered by the competent authorities' enforcement capacity. If too much power is left in the industry, the boundaries of the STS certification could be easily crossed and this could lead to the same undesired practices that were common before the GFC.

Finally, post-crisis regulatory efforts at the EU level have attempted to bridge the gap between rule-making and supervision that traditionally characterised EU financial markets. The lack of synchrony between centralised regulation and local supervision and enforcement has been identified as one of the key flaws of the pre-crisis EU architecture (Ferran 2011, p.4). The allocation of supervisory powers to national authorities in the context of STS securitisation is clearly at odds with the overarching shift to centralise, and more importantly to harmonise supervisory practices across the EU, especially in a market that is intrinsically trans-national.

6 – Conclusion

The STS framework proposed by the Commission represents a promising regulatory tool to restart the securitisation market in a socially desirable way. It is not too optimistic to state that a correct implementation of the framework could lead to a sustainable securitisation market in Europe.

The recent history of securitisation however, and more broadly of innovated market-based structured product, has highlighted different applications of the transaction, most notably speculation, and excessive risk-taking. The four policy concerns raised in this article suggest that without the necessary adjustments, the proposed framework could still lead to pre-crisis levels of risk-taking and leverage, and contribute to an even more "financialised" economy. In particular, the above reservations can be broadly divided into two areas of regulatory concern: firstly, at a micro-level, the definition of what STS securitisation should encompass; and secondly, at a macro-level, the institutional infrastructure within which STS would operate. Section 5 explained how certain aspects of securitisation have not been sufficiently defined under the STS criteria. With respect to the first regulatory concern, tranching remains an accepted practice notwithstanding the level of complexity that it entails and the inconsistency with concepts of simplicity and transparency. Ultimately, the success of the Commission's proposal may depend on the degree of transaction standardisation that will be implemented (and accepted by market-players), even though it appears that efforts in this sense will be left to industry initiatives. This article contends that plain non-tranched securitisation may be the only way to ensure certain functions of the transaction, without creating pre-crisis systemic risk.

As regards the second area of concern, this article emphasises that the Commission has not attempted to redefine the institutional structure of debt capital markets. In spite of recent efforts to harmonise the supervision of EU capital markets with the inception of ESAs (and in particular of ESMA), the monitoring of STS securitisation will be chiefly conducted by national authorities and this could give rise to problems of inconsistent implementation and ensuing regulatory arbitrage. It should be noted that while the CMU project and the STS framework should have represented the

natural opportunity to fully empower ESMA as a pan-European supervisory authority, this remains a collective actor (Schammo 2011 p.1905), largely constrained in its supervisory and intervention powers. This article submits that without an adequate institutional structure in place, and a public regulator to oversee capital markets activities, the industry's creativity will pose risks to the robustness of the market.

An indication of the above regulatory concern is represented by the notification system. This mechanism risks reinforcing the private ordering that has traditionally permeated this area of financial markets. Excessive reliance on the originating parties for the certification of STS criteria may not achieve the necessary degree of macro-prudential control over the transaction's dynamics. The shortcomings of the private certification mechanism may become apparent when faced with the industry's creativity and the bounded rationality of market-players. Complex regulatory challenges will also stem from the persisting risks of interconnectedness and spill-overs into the shadow banking system. It is not clear how the industry, without the overseeing of a public authority, will be able to forecast and mitigate these problems (Bavoso 2016). These concerns need to also factor the prudential treatment that securitisation will receive under the revised Basel Framework (BCBS 2014). This will change the regulatory capital requirements for securitisation in order to address pre-crisis shortcomings and recognise the features of the STS criteria. The proposed amendment of prudential requirements will provide for a minimum 15% risk weight floor for all securitisation positions (EU Proposal 2015b). At the same time though EBA proposed a more appropriate risk calibration of STS securitisation that would involve a risk weight floor of 10% for senior positions (EBA 2015). It remains to be seen whether these new capital requirements will make off-balance sheet transactions less attractive for banks. In this case, other forms of market-based finance that do not involve off-balance sheet positions – such as covered bonds – may prove a valid alternative, despite the CMU project having given only marginal scope to them.

As a final consideration, the Liikanen Report has proposed structural reforms of the banking industry as a means to deal with Too-Big-To-Fail institutions (EU Proposal 2015c). The proposal seeks to shield activities that entail an implicit public safety net (commercial and retail) from the losses incurred as a consequence of risky activities (investment). It is understood that this separation is likely to prevent commercial banks from engaging with wholesale funding sources, which entails a reduced reliance on securitisation, at least on the liabilities side (EU Proposal 2015c).

Notwithstanding the above final considerations, this article suggests that the current framework to restart securitisation suffers from two fundamental weaknesses – one related to the definition of securitisation, the other to the institutional arrangements in place – and that currently this could lead to securitisation being employed beyond its announced functions.

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