Regulations for Securitisation and Covered Bonds: Too Much or Too Little

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Abstract

This study analyses the most important regulations for asset-backed securities and covered bonds devised after the global financial crisis in Europe. The study presents three perspectives of these regulations. It discusses the premises and context of these regulations and highlights the asymmetric treatment of these two instruments. The premises of the regulations are inspired by the market criticism and are not in line with the theoretical understandings of securitisation. Moreover, most of these regulations are influenced by the situation in the US market and there is a need to recalibrate these regulations on European realities. The asymmetric treatment given to these instruments is also a matter of concern as it may harm the funding-base diversification. The study emphasises that regulations must be reconsidered and aligned with the European realities creating a level playing field for all the market players and instruments.

Keywords: Securitisation, Covered Bonds, Regulations, European Banks
Review Paper

1. Introduction

Regulating securitisation – a process generating asset-backed securities (ABS) – has always been a challenging task for policy makers because of its complex nature. Many attempts to regulate this market have been made after the global financial crisis (GFC), but regulatory authorities on both sides of Atlantic are still struggling to devise an efficient and effective regulatory framework for it. However, covered bonds (CB) are governed by well-defined regulations in most of the European countries with some differences in the legal framework of each country[1]. Despite some structural differences between ABS and CBs, it is argued that they can be regulated in a similar way as they are expected to provide similar economic benefits[2,3].

After the collapse of securitisation market, it was generally perceived that CBs might replace ABS and different market stakeholders including banks, investors and regulators started showing

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[1] A single definition of existing CBs is hard to present because of structural differences in countries across Europe. Every country has a different structure and a set of regulations for CBs. Federal Deposit Insurance Corporation (FDIC) defines a covered bond as a "non-deposit, recourse debt obligation of an Insured Depository Institution (IDI) with a term greater than one year and no more than thirty years, that is secured directly or indirectly by perfected security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages, or AAA-rated mortgage-backed securities secured by eligible mortgages if for no more than ten percent of the collateral for any covered bond issuance or series" (FDIC, 'Covered Bonds: FDIC Policy Statement on Covered Bonds', vol FIL-73-200 (2008) <https://www.fdic.gov/news/news/financial/2008/fil08073.pdf>.).

[2] See e.g. IOSCO, 'Global Developments in Securitisation: Regulation Final Report' International Organization of Securities Commissions (2012) <http://www.eifr.eu/files/file2248388.pdf>.

[3] This argument lacks an empirical support. However, both instruments are used for generating liquidity and controlling the funding cost.

a deeper interest in them. Their stable performance during the GFC was the main cause of this interest. Many countries devised new regulations for CBs and others updated their existing ones. CBs also made their entry into the US market during this period. Keeping in view the higher interest of market stakeholders and stable performance during the GFC, CBs were given a favourable treatment in post-crisis regulations that further incited the interest in this asset class. However, CBs might not be the actual replacement of securitised products, rather it is another security in the arsenal of the giant financial market[4].

According to Keys[5], seeds of bad regulations are sown during the crisis period and a reflexive reaction is usually seen after the crisis. Such a reaction was seen in the regulations immediately devised after the GFC. The resulting criticism on these regulations led to several revisions. Nevertheless, these regulations are still stringent, and they are hampering the efforts to revive the securitisation market. The efforts are being made to revive securitisation as it is considered to play a positive role in the economic growth by increasing the funding availability[6].

This study identifies and reviews the most recent and key regulations of securitisation and CBs in Europe. It develops three perspectives of these regulations. Firstly, the study finds that premises of these regulations are in contradiction with the theoretical underpinnings of the securitisation process. Secondly, this study highlights that the current regulatory treatment provided to securitisation is not based on the European realities but heavily influenced by the US market. The key differences existing in both markets are unfortunately ignored. Finally, the study performs a comparison between the regulatory treatment of CBs with ABS. This comparison helps understand how CBs are getting a favourable treatment in regulations and what can be the possible implications of this asymmetric treatment.

Rest of the paper is structured as follows. Section 2 reviews the post-crisis regulations for securitisation. The premises of different regulations have been highlighted and regulations have been analysed in the light of these premises. A critique of regulations for securitisation has been provided at the end of this section. This section also highlights that the current regulatory treatment of securitisation is not based on the European realities. Section 3 reviews the regulations for CBs. This section provides an overview of the recent developments in the regulations for CBs. At the end of this section, a critique of regulations for CBs has been provided. Section 4makes a comparison of regulations for securitisation and CBs. This section highlights that how CBs are getting a favourable treatment as compared to ABS. Section 5 concludes and provides some recommendations for the future research.

2. Regulations for Securitisation

In response to the criticism on securitisation and role of regulations, regulators on both sides of the Atlantic developed stringent regulations for securitisation. The reaction to the criticism on securitisation is visible in the new regulations, mainly Dod-Frank Act in the USA, and Capital Requirement Directive (CRD) IV, Capital Requirement Regulations (CRR), Solvency II and Basel III in Europe. These regulations became a subject of widespread criticism from the market analysts, academicians, and other market stakeholders. The regulations devised after the GFC have been

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[4] Edward Harrison, 'Are Covered Bonds Really the Solution?' (*Credit Writedowns*, 2008) <https://www.creditwritedowns.com/2008/08/are-covered-bonds-really-solution.html>.

[5] Benjamin J Keys and others, 'Financial Regulation and Securitization: Evidence from Subprime Loans' (2009) 56 Journal of Monetary Economics 700 <http://www.sciencedirect.com/science/article/pii/S0304393209000592>.

[6] Securitisation increases the lending capacity of banks and a wider population in the economy can access funding through banks.

repeatedly revised in response to this criticism. A fourth (revised) draft of Basel III was issued by Basel Committee on Banking Supervision (BCBS) in July 2016, followed by three initial drafts in 2013, 2012 and 2014. European Commission (EC) also issued a proposal on September 30, 2015 (hereinafter referred as 'STS framework') to promote Simple, Transparent and Standardised (STS) securitisation[7,8]. This proposal is analogous to BCBS Proposal for Simple, Transparent and Comparable (STC) Securitisation, but the former is proposed as the EU law. A delegated Act Supporting the Solvency II directive was also issued in 2014 and amendments were introduced in 2015[9]. This highlights the intensity of the challenge faced by the regulators while devising regulations for securitisation

2.1. Post-Crisis Regulations for Securitisation in Europe

The post-crisis regulations for securitisation are focused on four key areas: (i) addressing conflicts of interest by aligning incentives; (ii) transparency of securitisation by removing the information asymmetry; (iii) dealing with inappropriate incentives and (iv) reduction in reliance on rating agencies. In line with these targeted objectives, the post-crisis regulations for the securitisation in Europe can be classified into six categories i.e. risk retention requirements, high disclosure requirements, due diligence requirements, reforms for credit rating agencies, capital requirements and liquidity requirements. These regulations are discussed below.

2.1.1. Risk Retention

The risk retention regulations (RRR) have been introduced because of the alleged moral hazard associated with the so-called originate-to-distribute (OTD) model. US regulatory authorities introduced the risk retention requirements in Dod-Frank Act and European regulators also introduced similar requirements. According to RRR, originators are required to retain an unhedged portion of the credit risk while securitising their assets[10]. The minimum requirement is 5% of the securitisation transaction[11].

RRR are premised on the general perception about securitisation that banks do not maintain a 'skin in the game' while securitising that results in a misalignment of incentives between investors

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[7] European Commission, 'Proposal for a Regulation of the European Parliament and of the Council Laying down Common Rules on Securitisation and Creating a European Framework for Simple, Transparent and Standardised Securitisation and Amending Directives 2009/65/EC, 2009/138/EC, 2' (2015) COM(2015) 472 final <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015PC0472&from=EN>.

[8] A final proposal No. COM(2015) 472 has been issued by the EC on 30.09.2015 that provides a set of common rules to develop a European framework for STS securitisation. According to the Article 294 of Treaty on the Functioning of European Union (TFEU), European Parliament was meant to communicate its position to European Council after reviewing the proposal submitted by the EC. An initial draft report has been issued by the European Parliament in response to this proposal that suggest many amendments in the original proposal (Paul Tang, 'Draft Report on the Proposal for a Regulation of the European Parliament and of the Council Laying down Common Rules on Securitisation and Creating a European Framework for Simple, Transparent and Standardised Securitisation and Amending Directives 2009/6', vol 2015/0226((The European Parliament 2016) <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+COMPARL+PE-583.961+01+DOC+PDF+V0//EN&language=EN>).

[9] Solvency II deals with insurance companies. However, this act occupies a core importance in the securitisation market as insurance industry has been significantly investing in this market. The current provisions in the Solvency II are likely to reduce the interest of insurance industry in this market, thereby marginalizing the investor base of the securitisation market.

[10] The originators are not allowed to use any hedging technique for this retained portion of the risk as hedging will trounce the (desired) objective of RRR.

[11] Article 405, Regulation (EU) No. 575/2013

and originators. As a result, quality of the originated assets deteriorates. It is believed that this requirement will help to ensure the incentive alignment and quality of the underlying assets will improve. However, this premise is questionable, and it may not be the reason behind the astronomical losses emanating during the GFC. The risk retention was mandated by the market before the debacle of securitisation during the GFC. Originators and sponsors of the securitisation transactions were already having a strong `skin in the game' as the securitisation might be difficult unless the lower tranches are not retained by the originator[12].

Schwarcz[13] argues that risk retention regulation may lead to the `mutual misinformation' problem. The originator may exhibit a fake confidence in the issued securities by retaining a portion of the risk in the securitisation transactions. The investors may get misinformed and reliance may also shift on the signal generated by the originator. This may become in conflict with the due diligence requirements. The securitisation carried out by many originators with retention of lower tranches also contributed to the financial crisis as it buttressed the false confidence of investors in these securities. BCBS[14] has attempted to control this situation by incorporating the size of the tranches in risk weighting mechanism.

2.1.2. Disclosure Requirement

The securitisation transactions are considered highly complicated and opaque. Most of the problems related to securitisation are attributed to this opaqueness and complexity[15]. Therefore, regulatory authorities are largely focused on promoting transparency of these transactions through higher disclosure requirements. Chapter 3 of the STS framework provides the requirements for transparency. The originator is responsible for providing the historical data related to default and delinquencies of the underlying exposure. A sample of the underlying exposures should be subject to verification by an external party[16]. The investors should be provided with a liability cash flow model by originator before the investment decision has been taken. The compliance with all these requirements is the joint responsibility of originator, sponsor and Securitisation Special Purpose Entity (SSPE). The securitisation transaction showing compliance with chapter 3 of the STS framework will be regarded as STS securitisation.

The disclosure requirements may not prove to be effective as the risks associated with complex securitisation and especially sub-prime mortgage loans were fully disclosed, but such

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[12] See e.g. Gary B Gorton and George G Pennacchi, 'Banks and Loan Sales Marketing Nonmarketable Assets' (1995) 35 Journal of Monetary Economics 389 <http://www.sciencedirect.com/science/article/pii/030439329501199X>; Barney Hartman-Glaser, Tomasz Piskorski and Alexei Tchistyi, 'Optimal Securitization with Moral Hazard' (2012) 104 Journal of Financial Economics 186 <http://www.sciencedirect.com/science/article/pii/S0304405X11002832>; Henri Pagès, 'Bank Monitoring Incentives and Optimal ABS' (2013) 22 Journal of Financial Intermediation 30 <http://linkinghub.elsevier.com/retrieve/pii/S1042957312000265>.

[13] Steven L Schwarcz, 'Securitisation and Post-Crisis Financial Regulation' 1 <http://scholarship.law.duke.edu/faculty_scholarship/3558/>.

[14] BCBS, 'Revision to the Secuitisation Framework' (Bank for International Settlements 2016) <http://www.bis.org/bcbs/publ/d374.pdf>.

[15] See e.g. EBA, 'EBA Report on Qualifying Securitisation: Response to the Commission's Call for Advice of Juanuary 2014 on Long-Term Financing' (2014) <https://www.eba.europa.eu/documents/10180/950548/EBA+report+on+qualifying+securitisation.pdf>; BCBS, 'Credit Risk Transfer; Developments from 2005-2007' (Bank for International Settlements 2008); Bonnie Buchanan, 'Back to the Future: 900 Years of Securitization' (2014) 15 The Journal of Risk Finance 316 <http://www.emeraldinsight.com/doi/abs/10.1108/JRF-04-2014-0040>.

[16] This requirement seems akin to cover pool monitoring in case of CBs. However, the regulations do not clarify that who will appoint this external agency and who will bear the cost. The eligibility criteria for the designated external party is also not given in this proposal.

disclosure could not prevent the cataclysmic collapse of the securitisation market. Moreover, the information required to be disclosed by an originator is substantial and it is an arduous task to evaluate the long documents with complex legal and technical terminologies. The investor will require a fair amount of knowledge about financial modelling to understand STS securitisation transactions as well. Therefore, even the most sophisticated institutional investors may continue to rely on rating agencies while taking the investment decision. The granular disclosure requirements are likely to place a burden on securitising institutions without providing a proportionate benefit to investors. Hence, these requirements may serve as a disincentive to securitisers.

2.1.3. Due Diligence

It is believed by regulators and other market participants, that the massive losses faced by investors in the securitisation market can be ascribed to the heavy reliance on rating agencies. The investors were not showing due diligence while taking the investment decisions. The decline in the mechanistic reliance on rating agencies[17] and thereby promoting due diligence have been high on the regulatory agenda after the crisis[18]. Per these requirements, an investor must show due diligence while making the investment decision[19]. These regulations require investors to evaluate various risks involved in securitisation transactions that clearly lie in originators' ambit[20]. The compliance with the granular and detailed due diligence requirements envisaged by the EC may cause a decline in investors' interest in the securitised instruments. The investors breaching the due diligence requirements will be subject to higher risk weights (RWs) (as a penalty) on their securitisation exposures in compliance with other sectoral regulations (Basel III and Article 407 of CRR).[21]

These requirements are laid out to avoid feeding-frenzy atmosphere in the financial markets[22]. However, these requirements may be unnecessary and considered too paternalistic in nature. They seem to shout at investors: 'Do a better job!'. Given that investors will suffer the losses in case of poor investment decision, they are already expected to conduct some due diligence before making their investment decisions. The reliance on the STS notification by the originator may not be enough and investors need to evaluate other accompanying information. These due diligence requirements may prove to be burdensome for the investors. They are required to outlay high level of due diligence before investing in securitisation and evaluating if a securitisation transaction can be regarded as STS.

One may argue that investor in this market are institutional investors who are investing others' money. Therefore, they must perform due diligence. However, the due diligence is not confined to securitisation exposures only, but investors are expected to show this due diligence in almost

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[17] BCBS, 'Basel III: The Net Stable Funding Ratio' (Bank for International Settlements 2014) <http://www.bis.org/bcbs/publ/d295.pdf>.

[18] The European Commission, 'An EU Framework for Simple, Transparent and Standardised Securitisation' (2015) <http://ec.europa.eu/finance/consultations/2015/securitisation/docs/consultation-document_en.pdf>.

[19] The due diligence requirements are provided in Article 406 of CRR and Chapter 2 (Article 3) of the STS framework.

[20] Keith Mullin, 'STS Self-Certification? Barking up the Wrong Tree' (*International Financing Review*, 2015) <http://www.ifre.com/sts-self-certification-barking-up-the-wrong-tree/21213725.fullarticle>.

[21] Regulation (EU) No. 575/2013

[22] Paul Stevenson, Managing Director of Moody's Investor Service Inc. said, "When everybody wants to securitise, and everyone is willing to buy, and everyone thinks nothing will go wrong, there gets to be a feeding-frenzy atmosphere, and you have to remain cautious" (Suzanne Woolley, 'What's Next, Securitized Bridge Tolls' (*Businessweek Archives*, 1996) <http://www.bloomberg.com/bw/stories/1996-09-01/whats-next-securitized-bridge-tolls>.)

all forms of investment decisions, as other market instruments like unsecured bonds, equities and CBs are not inherently less risky than securitised products. Hence, granular due diligence requirements for a single market segment may serve an impediment to the revival of that market. The empirical investigation performed by Fabozzi[23], on the data before 2007, shows that European investors were already looking beyond the credit rating. They were already performing some sort of due diligence while making their investment in ABS. Hence, these requirements seem redundant.

2.1.4. Reforms for Credit Rating Agencies

Credit Rating Agencies (CRAs) were largely blamed for their contribution in the debacle of the securitisation market. They were not able to pierce the fog of information asymmetry. There are two key views about CRAs. First, the ratings assigned by CRAs were upwardly biased and second, these ratings were based on flawed methodologies adopted by CRAs[24]. The 'issuer-pays' model of CRAs was also a subject of widespread criticism as it is supposed to create conflicts of interest resulting into upwardly biased ratings[25,26]. Because of this situation, investors were hoodwinked by the higher ratings assigned to the issued securities. There were political calls for strictly regulating CRAs to ameliorate the rating mechanism and remove the conflicts of interest[27].

The European regulations are focusing on increasing the accountability and transparency of rating agencies. Rating agencies are required to disclose the fee that they charge from their clients[28]. This requirement is inspired by the criticism on `issuer-pays' model. Moreover, new regulations for CRAs stipulate that an issuer should appoint two credit rating agencies to get ratings of its structured finance instruments[29]. This double rating requirement is perceived to increase the credibility of the rating assigned to the issued securities. This requirement is meant to deal with the problem of poor-quality rating of securities because of flawed methodologies being followed by CRAs.

The proposed reforms for CRAs are focused on increasing the transparency because of doubts arising from the 'issuer-pays' model and credibility of ratings. However, it is noteworthy that ratings are not inflated in the interest of sellers only. The (institutional) investors also have the incentive to get inflated ratings to enjoy the flexibility and reduce the amount of capital against

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[23] Frank J Fabozzi and Dennis Vink, 'Looking beyond Credit Ratings: Factors Investors Consider in Pricing European Asset-Backed Securities' (2012) 18 European Financial Management 515 <http://onlinelibrary.wiley.com/doi/10.1111/j.1468-036X.2010.00577.x/epdf>.

[24] Charles W Calomiris, 'The Debasement of Ratings: What's Wrong and How We Can Fix It' 1 <https://www0.gsb.columbia.edu/faculty/ccalomiris/RatingAgenciesE21.pdf>.

[25] BCBS, 'Report on Asset Securitisation Incentives' (Basel Committee on Banking Supervision 2011) <http://www.bis.org/publ/joint26.pdf>.

[26] The issuers of the securities pay CRAs for getting the rating of their issued securities. The issuers may "shop around" to get a better rating for their securities. This is likely to create pressure on rating agencies to follow a pliant rating criterion, otherwise they might lose the business. However, such pressure can be dismissed in the presence of many issues and issuers in the market and CRAs may not succumb to such pressures because of reputation risk stemming from the possibility of detection of poor practices by market analysts, competitors and investors. Conversely, these latter considerations may become inapplicable in the case of complex securities like collateralised debt obligations (CDOs) as there are few issuers of these securities in the market and these securities are too complex to be quickly evaluated by third parties.

[27] Lawrence J White, 'Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs Is a Better Response' (2010) 25 Journal of International Banking Law and Regulation 170 <http://w4.stern.nyu.edu/economics/docs/workingpapers/2010/White_Credit Rating Agencies for JIBLR.pdf>.

[28] Article 3(1) of the EC delegated regulation (EU) 2015/1

[29] Article 8c (1) of CRA Regulation (EU) No. 462/2013

their holdings of highly-rated securities[30]. Therefore, it becomes irrelevant who pays to rating agencies[31]. The dual rating requirements puts an extra cost on issuers that is likely to stultify the securitisation by putting an additional barrier to entry into this market.

2.1.5. Capital Requirements

Stringent capital regulations have been introduced after the observations related to the thin capitalization of banks before the GFC and sudden downgrades of securitised instruments. The capital requirements are higher for ABS holdings in the new Basel III Framework. The investors are required to hold high capital against their ABS exposures as compared to their exposures in other similar types of investment.

The minimum RW floor given to a securitisation exposure is 15% and unrated securitisation exposure receive RWs of 1,250%[32]. The capital requirements against the securitisation exposures have been widely criticized in the industry. Some have dubbed them as a punitive treatment of securitisation[33]. The investors are required to hold higher capital against the ABS than the capital required against the assets backing these ABS. Therefore, the notion of capital neutrality is supported in the industry[34,35]. The notion of capital neutrality sounds reasonable as banks were playing around the capital requirements before the GFC because of different standards for the securities and assets underlying them.

It is also argued that the proposed approaches for calculating RWs should be calibrated with historical loss statistics of different classes of securitisation[36]. However, such calibration is not provided in the revised securitisation framework. The capital treatment of securitisation exposure in the light of revised securitisation framework does not consider the legal form of securitisation but it is based on the economic substance of relevant exposure[37]. The RW penalty of 1,250% is too strict. Thus, many participants are likely to make an exit from the securitisation market and such a conservative approach will act as a barrier for the smaller banks to enter this market. The additional RWs as proposed in Article 407 of CRR reflect a more suitable approach.

The Proposed STS framework of EC and STC Proposal of BCBS have been introduced in response to this criticism. The securitisation transactions making a compliance with these frameworks will be subject to 25% reduction in the capital requirements as compared to non-STS

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[30] Calomiris (n 24).

[31] The inflations in ratings were mainly demand driven. The race to bottom in ratings was welcomed by investors. Similar problems would have occurred even if the issuers had paid to CRAs. Hence, `issuer-pays' model cannot be blamed for the problems arising because of inflated ratings

[32] Only STS securitisation is subject to a risk floor of 10%.

[33] Federation Bancaire Francaise, 'French Banking Federation Response to the BCBS 269 Consultative Document Relative of the Revision of the Securitization Framework' (BNP Paribas 2014) <http://www.bnpparibas.com/sites/default/files/ckeditor-upload/files/PDF/Positions DAI/REGULATION PRUDENTIELLE/Consultations BCBS/Securitization framework - FBF - BCBS Consultation - March 2014.pdf>; GFMA, 'GFMA Response to the Consultative Document on Revisions to the Basel Securitisation Framework' (Global Financial Markets Association 2013) <http://www.gfma.org/correspondence/item.aspx?id=450>; IOSCO (n 2).

[34] Federation Bancaire Francaise (n 33).

[35] The amount of required capital for holding ABS should be decided on the basis of the capital required for the underlying assets.

[36] Mayer Brown, 'Revisions to Basel Securitisation Framework - Final Rules' <https://www.mayerbrown.com/files/Publication/b3b4c676-fcfc-48ea-b7e5-20362b0097ac/Presentation/PublicationAttachment/b283e009-6dc1-496a-ac28-3e113d133165/UPDATE_Basel_Securitization_1214.pdf>.

[37] European Commission (n 7) p. 6, § 1.

securitisation. However, the compliance with these proposals itself is too costly and tedious that this benefit of reduction in capital may not be attractive for investors.

2.1.6. Liquidity Requirements

BCBS introduced Liquidity Coverage Ratio (LCR) in 2013 to promote resilience of banks against the liquidity risk in the short-run[38]. A delegated act was also issued by the EC for the LCR[39]. According to LCR, a bank must hold enough high-quality liquid assets (HQLA for covering the differences in cash inflows and outflows over a period of 30 days to avoid the stress scenario. LCR divides HQLA into 3 distinct levels. Securitised instruments are placed in the last category of high-quality liquid assets i.e. level 2B[40]. The treatment of securitisation is overly zealous here. In the prior LCR framework, securitised instruments were not classified as HQLA. However, residential mortgage backed securities (RMBS) were included in the list of HQLA after the market criticism. The recent delegated act also included ABS issued against auto and Small and Medium Enterprises (SME) loans.

ABS included in the LCR must meet a list of requirements outlined in Article 13 (§ 2 to 14) of the above-referred EU delegated Act. This article applies high-RWs and haircuts to ABS and delineates the assets backing these instruments that are eligible for placement in level 2B assets. Given the criteria outlined in this Article, many of ABS will not be able to qualify as HQLA. RMBS have been given preferential treatment over all other classes of ABS. However, Perraudin[41] provides the empirical evidence that some of the non-residential mortgage-backed securities have remained more liquid than RMBS and many of these securities have been either excluded from the LCR framework or are subject to higher haircuts. Therefore, securitisation is significantly disfavoured in the LCR.

2.2. Critique of Post-Crisis Regulations for Securitisation}

The securitisation market is still crippled by the legacy of the financial crisis. The revival of securitisation is a prime agenda of regulators in Europe as now it is considered a panacea for the ailing European economy. However, the regulations devised for securitised instruments are hindering the revival of this market. The new STS framework highlights that the EC has realized the importance of securitisation in the financial market. The proposal for STS securitisation is considered a good development and it has been welcomed by many of the market participants. However, many of the regulations are still administratively cumbersome for issuers and investors. The complexity and onerous nature of these regulations are still disincentivizing for the market participants.

Self-certification is a potential problem that may arise out of the STS proposal. Banks may paint a rosy picture of their securitised instruments unless some deterrence mechanism is in place. The self-certification may not help to revive investors' confidence in the securitisation market as investors may be sceptical about the credibility of this self-certification. Many market stakeholders

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[38] BCBS, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' (Bank for International Settlements 2013) <http://www.bis.org/publ/bcbs238.pdf>.

[39] European Union, 'Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to Supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with Regard to Liquidity Coverage Requirement for Credit Institutions' (2014) 11 Official Journal of the European Union <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN>.

[40] Article 13 of The EC Delegated Act No. C (2014)7232 Dated 10.10.2014

[41] William Perraudin, 'Covered Bond versus ABS Liquidity : A Comment on the EBA's Proposed HQLA Definition' <www.afme.eu/WorkArea/DownloadAsset.aspx?id=10360>.

and organization are in favour of giving labelling to securitisation. For this purpose, prime collateralised securities (PCS) labelling has been introduced in Europe.[42] The purpose of this labelling is to ensure that issued securities follow the STS criteria. However, I believe that this labelling mechanism may not be very different from ratings and that the similar blames that are placed on CRAs can be placed on PCS in the case of next crisis. This is especially so when CRAs are mainly criticized for the `issuer-pays' model and the same model is followed in getting PCS label.[43]

Regulatory treatment of securitisation after the GFC is not based on the European realities but it is highly influenced by the situation in the US market. Unlike the USA, the failure of securitisation market is not linked to the credit deterioration in Europe, but market became illiquid and prices fell that led to the accumulation of marked-to-market losses[44]. Mario Draghi, president of European Central Bank (ECB), said in a press conference on March 6, 2014:

> "If we consider just the revitalization of the ABS market, there are many things that need to change in regulation and in legislation. Today, the capital charges for ABS discriminate them unfavourably with respect to other instruments with similar degrees of riskiness. The current capital regulation of ABS was calibrated on a reality which is not the European one"[45].

The OTD model and development of complex securities like Collateralised Loan Obligations (CLO) are two key elements for which securitisation was immensely criticized and strict regulations were demanded. However, it is pertinent to note that both are largely the US phenomena. Many of residential mortgages in the US were issued with a view to securitise them. Many non-banking companies and mortgage brokers in the USA also started issuing mortgage loans with a view to securities them. However, in Europe, with an exception of Netherlands and Spain, residential mortgages were never securitised on a large-scale[46]. The OTD culture never flourished in Europe like the US market. Mainly, loan origination was taking place within the banking system.

The development of complex securities was also very limited in Europe. CDO became the second biggest segment of ABS market in the US in 2006. These CDOs were backed by sub-prime bonds as collaterals. Although some European banks invested in US securitised instruments including CDOs, but the existence of CDOs in Europe was not ubiquitous. Therefore, the securitisation in Europe cannot be alleged for the problems that were pervasive in the US market. Moreover, the European securitisation market operates under the private market forces but Government Sponsored Entities (GSEs) have largely influenced the securitisation market in USA. Therefore, evaluating the impact of securitisation on the credit market is more difficult as it is hard to disentangle its impact in the presence of concurrent impact of GSEs.

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[42] It is akin to European Covered Bond Council (ECBC) labelling system for CBs.

[43] See http://pcsmarket.org/about-pcs/

[44] Hans J Blommestein, Ahmet Keskinler and Carrick Lucas, 'Outlook for the Securitisation Market' (2011) 2011 OECD Journal: Financial Market Trends <http://www.mdpi.com/1996-1073/2/3/556/>.

[45] Mario Draghi, 'Introductory Statement to the Press Conference (with Q&A)' (*Press Conference*, 6 March 2014) <http://www.ecb.europa.eu/press/pressconf/2012/html/is120802.en.html>.

[46] Dutch RMBS were mainly issued for the funding purpose and risk transfer was not the main motive behind their issuance (Max Bronzwaer, 'Dutch RMBS' (2012) 17 The Journal of Structured Finance 134.)

The above discussion explicates that most of the premises for the new regulations for securitisation are questionable and so are the regulations. Pacces[47] highlighted that these financial regulations are likely to increase distortions in the banking system instead of correcting them. Most of the regulations concerning ABS are based on controlling moral hazard and maintaining `skin in the game'. However, many studies have documented that these problems did not play a major role in the unfolding of the financial crisis [48]. Therefore, it is unlikely that these regulations can help to rectify the actual problems in the securitisation market.

3. Regulations for Covered Bonds

A regulatory framework for covered bond is currently non-existent in the US market. Therefore, investors are still hesitant to invest in CBs in the US market. On the contrary, the CB market is well-established in Europe and CBs are issued and traded under a well-defined legal framework. According to ECBC, there were 19 countries with defined regulations for CBs before the GFC, but this figure has reached to 28 now. The financial crisis increased the dependency of banking system across Europe on CBs to access non-depository funding from the market. Therefore, regulatory authorities defined regulations for CB market or countries already having a regulatory framework for CBs updated their regulations to meet the challenges posed by changes in market conditions after the crisis.

Although most of national regulations across various European countries follow a similar pattern, some structural differences do exist. For instance, issuer of CB can be originator of underlying assets. However, national regulations of France do not allow the French banks to be the issuers of CBs and originators of the assets at the same time. Moreover, CB specific disclosure requirement is mandatory to public in many countries. These requirements are meant to control the problem of asymmetric information that is supposed to help control the moral hazard. Over-collateralisation limits vary from 0% in Portugal to 25% in France and Spain. Most of the countries have licensing requirements for the CB issuers that is meant to ensure that CB issuers meet all the necessary requirements to issue CBs. In essence, most of differences in national regulations are nominal and they are mostly related to reporting requirements.

The basic regulations for CBs were outlined in Undertakings for Collective Investment in Transferable Securities (UCITS) directive of 1988. CBs making a compliance with the Article 52(4) of UCITS directive, are considered as a safe investment and get a favourable treatment in regulations. The Article 129 of the CRR provides the guidelines to get a favourable treatment in case of CB exposures. This article defines the eligibility criteria of the assets used in the cover pool. LCR also has central position in the set of regulations for CBs in Europe. CBs are placed in all categories of HQLA and are subject to a haircut of 15%[49].

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[47] Alessio M Pacces, 'The Role and the Future of Regulation in the Financial Crisis: The Uncertainty Perspective' 1 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1551266>.

[48] See e.g. Gabriella Chiesa, 'Optimal Credit Risk Transfer, Monitored Finance, and Banks' (2008) 17 Journal of Financial Intermediation 464 <http://www.sciencedirect.com/science/article/pii/S1042957308000351>; Gabriella Chiesa, 'Bankruptcy Remoteness and Incentive-Compatible Securitization' (2015) 24 Financial Markets, Institutions & Instruments 241 <http://onlinelibrary.wiley.com/doi/10.1111/fmii.12029/abstract>; Pacces (n 47); GB Gorton, 'Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007' 53 <http://ssrn.com/abstract=1401882>; Christophe Chamley, Laurence J Kotlikoff and Herakles Polemarchakis, 'Limited Purpose Banking - Moving from Trust Me to Show Me Banking' (2012) 102 American Economic Review: Papers & Proceedings 1 <https://www.aeaweb.org/conference/2012/retrieve.php?pdfid=568>.

[49] See Articles 10 1(f), 11 1(c & d) and 12 1(e) of the LCR Delegated Regulations

CBs can only be issued against high-quality assets meeting a certain criterion of loan-to-value (LTV) Ratio. According to CRD IV, a bank must calculate the LTV for each loan individually. Therefore, a loan with higher LTV cannot be part of the cover pool because other loans in the cover pool have lower LTV. Notwithstanding, there can be loans with higher LTV in a cover pool because of other factors e.g. property devaluation. These loans are replaced by other loans with lower LTV. This is highly protective for investors but onerous for the issuers. During the economic downturns, a small increase in the LTV may create several challenges for the issuing institutions when LTV is close to the ceiling. The LTV requirements currently vary from country to country, but each CB issuance must have a compliance with a certain LTV threshold[50].

3.1. Critique of Regulations for Covered Bonds

The new regulations devised after the GFC, mainly liquidity, capital, funding and investment related regulations, incentivise the CB issuance (in lieu of ABS issuance)[51]. The purpose is to strengthen the funding profile of the issuing banks and providing extensive legal protection to investors in the CB market. However, a large-scale issuance of CBs may result into a high level of asset encumbrance that results into subordination of the unsecured creditors and depositors[52,53].The increase in the issuance of CBs for securing cheaper funding may give rise to a tension between the rights of the CB holders and that of Deposit Guarantee Schemes (DGS). A higher CB issuance implies a downside to the DGS, as it may create an asset shortfall for satisfying the claims of depositors.

Because of the large-scale CB issuance, banks may curtail their lending to the economic sectors who meets the eligibility requirements for the cover pools backing the issuance of CBs[54]. Because of their subordination, unsecured creditor may increase the risk premia. Thus, the unsecured funding via issuance of unsecured bonds may become costlier in this situation. CBs also result into ring-fencing of the underlying assets on the balance sheet of the issuers unlike securitisation. The issuer cannot use these assets at the time of distress to generate liquidity. Moreover, this ring-fencing also results in the subordination of unsecured depositors and general unsecured creditors in the event of bankruptcy.

Most of market participants in the United States and Europe are iffy if CBs could truly replace ABS. These concerns are linked with the balance sheet capacity constraints of the issuers and size of the domestic housing market. Therefore, promoting securitisation is inevitable to boost the economic activity by ensuring the continuous supply of credit in the financial system that is dominated by banks[55]. Hence, the regulatory authorities and policy makers must consider the merits of a reformed securitisation market. The issuance of CBs and ABS should be balanced and a tilt towards any single security needs to be discouraged.

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[50] ECB, 'Covered Bonds in the EU Financial System' (2008) <http://www.ecb.europa.eu/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf>.

[51] CBs are subject to lower haircuts in the LCR and risk weights given to CBs are lower than ABS of similar rating.

[52] EBA, 'EBA Final Draft Regulatory Technical Standards' (2013) <https://www.eba.europa.eu/documents/10180/423258/EBA+RTS+2013+05+(Final+draft+RTS+on+covered+bonds+close+correspondence).pdf>.

[53] According to the definition of asset encumbrance provided by the European Banking Authority (EBA) "An asset shall be treated as encumbered if it has been pledged or if it is subject to any form of arrangement to secure, collateralise or credit enhance any transaction from which it cannot be freely with-drawn".

[54] CBs can only be issued against certain loans. The large issuance of CBs will not let the bank to issue loan to other sectors and only CBs eligible loans will be issued.

[55] The issuance of ABS will decrease bank reliance on unsecured funding and CBs. This will not help them to control their funding cost but credit supply to economy will also increase.

The favourable regulatory treatment of CBs is based on the historical default statistics as explained by EBA[56]. Nonetheless, there is no incident of a CB default and none of the CB holders has been asked to take the losses (not during the GFC and sovereign debt crisis in Europe, not in Greece and not even in Cyprus), there are some CB issuing institutions that faced a bail-out after the GFC,[57] and liquidity in this market was adversely affected. The ECB introduced the Covered Bond Purchase Programme (CBPP) at that time to maintain liquidity in this market. Conversely, the fact that an instrument did not default in the past does not make it immune from the risk and the probability of default in future cannot be ruled out completely.

4. Asymmetric Regulatory Treatment

The regulations after the GFC provide a discriminative treatment to ABS as compared to CBs that is visible in the CRR, Solvency II, Basel III and LCR Framework. There are many concerns that a less rigorous regulatory scrutiny received by CBs relative to ABS may eventually lead to an under-appreciation of risk in the CB market. The asymmetric regulatory treatment of securitised instruments vis-a-vis other instruments of similar risks such as CBs may result into unintended consequences. CBs provide a dual recourse to the investors, but this is onerous for CB issuers.[58]

The most important discrimination is visible in the capital regulations as CBs have been given the lowest RW of 10% in the CRR,[59] whereas, the RW given to securitisation exposures with Credit Quality Step (CQS) 1 is 20%[60,61]. As a result, banks taking exposures in ABS are required to hold higher capital as compared to the ones taking exposures in CBs. Moreover, the competent authorities have been given the authority to partially or fully exempt CBs[62] against the limits on large exposures.[63] Therefore, a bank may take large exposures in CBs if it is allowed by the local authorities, whereas such exemption is not given in case of ABS and investors can take limited exposures in this market.

Solvency II proposal also provides a highly discriminative treatment to securitisation as compared to CBs[64]. For instance, spread risk factors[65] under Solvency II Directive are 2.1% (Type

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[56] EBA (n 15).

[57] These banks include Düsseldorf Hypothekenbank (April 2008), Hypo Real Estate AG (October 2008), Eurohypo AG (May 2009) and Valovis Bank (December 2011).

[58] The investors in the securitisation have only recourse to the underlying pool of collateral. If the pool is not enough to meet their claims, they do not have a recourse to the originator. However, CB holders do not have the recourse to the underlying cover pool only. Their first claim is against the underlying cover pool but if this cover pool is not enough to meet their claims then they have an unsecured claim against other assets of the issuing institution *pari passu* to its other creditors and in some cases, they have a preferential claim against other assets.

[59] Article 129(4) of Regulation (EU) No. 575/2013 (CRR)

[60] Article 251 of Regulation (EU) No. 575/2013 (CRR)

[61] The credit quality of a security informs about its default risk. The securities with CQS 1 are highly rated securities usually having a AAA rating.

[62] Article 400(2a) of Regulation (EU) No. 575/2013 (CRR)

[63] An institution shall not incur any exposure that is higher than 25% of its eligible capital or Euro 150 million, whichever is higher. However, CBs can be exempted from such limits. See Article 395 of Regulation (EU) No. 575/2013 (CRR).

[64] Spread Risk Sub Module of the EC Delegated Act Supplementing Directive 2009/138/EC (Solvency II)

[65] The value of a bond may decrease because of some financial mistakes made by the issuing institutions. These mistakes may result in downgrade of issuer's rating thereby causing a drop in the value of issued securities. The spread risk factor is assigned to various classes of bonds to account for this spread risk. The holding institutions must hold some capital against these exposures. The amount of required capital against the holding of a security is determined on the basis of its assigned spread risk factor.

1) and 12% (Type 2)[66] for AAA-rated ABS[67] and 0.7% for CBs of same rating.[68] The same factor for re-securitisation transactions range from 33% to 100%.[69] These differences in spread risk factor result into higher capital requirements for ABS as compared to CBs.[70] The potential size of the investor base of securitised instruments may reduce significantly because of these regulations[71].

LCR framework also provides a favourable treatment to CBs as compared to the securitised products of similar rating and maturity profiles. ABS were altogether excluded from the initial proposal of the LCR. Although some classes of ABS are now included in the LCR framework after the market criticism, asymmetric treatment of ABS continues. The qualifying ABS are required to meet several conditions. These conditions are explicitly outlined in the Article 13 of the LCR regulations[72]. Mainly, these conditions include the compliance with CQS requirements,[73] class of tranches,[74] LTV requirements,[75] and full recourse for mortgages[76]. This may not be possible for all the ABS transactions to meet these requirements. Despite all these strict requirements, all classes of qualifying ABS are placed in level 2B assets i.e. last category of the LCR framework. The total amount of level 2B assets must not exceed 15% of the total liquidity buffer, whereas this limit is 60% and 30% for level 1 and level 2A assets of the LCR respectively and CBs are placed in these first two categories[77]. Consequently, many of ABS virtually remain excluded from the LCR framework.

The favourable treatment of CBs is also visible in Net Stable Funding Ratio (NSFR) of Basel III[78]. NSFR is meant to ensure that a bank maintains a stable funding profile in relation to the composition of its assets and off-balance sheet activities. Among all the securitised instruments, only RMBS are part of the NSFR[79]. The amount required to fund a specific class of assets is determined on the basis of the RSF factor assigned to each class of assets. The RSF factor[80]

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[66] Securitisation is classified as Type 1 and Type 2 Securitisation. Type I Securitisation refers to high-quality STS Securitisation.

[67] Article 178(1b & 2b) of the EC Delegated Act Supplementing Solvency II Directive

[68] Article 180(1) of the EC Delegated Act Supplementing Solvency II Directive

[69] Article 178(3b) of the EC Delegated Act Supplementing Solvency II Directive

[70] The spread risk factor of an instrument is directly proportional to the risk weight assigned to that instrument.

[71] Before the eruption of GFC, approximately 15% of securitised instruments were placed with insurance companies. Therefore, the strict regulations provided in Solvency II might cause a remarkable decline in the inclination of insurers to buy these securities, as it will be uneconomical for them to hold these securities because of high capital charges associated with them.

[72] Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions. *Official Journal of the European Union*, 11.

[73] The securitised instruments with a credit assessment of at least CQS 1 are allowed in the LCR.

[74] The securitised instruments must belong to the most senior tranche.

[75] All securitised instruments must be subject to the LTV requirements laid down in the point 1 of the Article 129(1)(d) of the Regulation (EU) No 575/2013 (CRR).

[76] The mortgage owner remains responsible for the shortfall in sale proceeds from the property.

[77] Article 17(1c) of Regulation (EU) 2015/61 (LCR)

[78] NSFR is the amount of available stable funding divided by the required stable funding. This ratio should be equal to or greater than 100%. Available Stable Funding (ASF) is the amount of liabilities and capital that is expected to be stable over the period considered by the NSFR, i.e. one year, and the Required Stable Funding (RSF) is a function of liquidity profile and maturities of the assets held by an institution. NSFR will be applicable from January 01, 2018

[79] The earlier version of LCR also included RMBS only. However, ABS backed by auto loans and SME loans are also included in the recent LCR framework, but no changes have been made in the NSFR.

[80] RSF factor is assigned to different classes of assets to approximate the amount of funding required for the holding of a particular class of assets. The assets are required to be funded either because of their roll-over or because of their

assigned to CBs (with a minimum credit rating of AA-) is merely 15% but for the qualifying RMBS (with a minimum credit rating of AA) the same factor is 50%[81]. Other types of securitised products receive RSF factor of 100%. A bank taking exposure in securitised instruments will be required to maintain large number of funds against its securitisation exposure because of higher RSF factors.

Table 1: Asymmetric Regulations for Asset-Backed Securities and Covered Bonds

Regulations	ABS	CBs
LCR (Basel III)	Placed in level 2B category of HQLA (the lowest category) Lowest Haircut is 25% Maximum allowed limit is 15% of HQLA Only RMBS, Commercial ABS and Auto ABS are included in HQLA (with restrictions)	Placed in all categories of HQLA (even in the top category) Lowest Haircut is 7% Maximum allowed limit is 40% of HQLA
NSFR (Basel III)	RSF Factor is 50% Minimum required rating AA Only RMBS are included	RSF Factor is 15% Minimum required rating AA-
Risk Weights (CRR)	RW floor for rated securitised instruments is 20% for CQS 1	RW floor for rated CBs is 10% for CQS 1
Risk Weights for Unrated Securities (CRR)	1,250% RW for unrated ABS	RW assignment is based on RW assigned to senior unsecured exposures
Spread Risk Factor (Solvency II)	Ranges from 2.1% to 100% for different securitised instrument depending on credit quality and maturity structure	Ranges from 0.7% to 0.9% depending on credit quality and maturity structure
Haircuts (ECB)	Placed in the last category of eligible assets Applicable haircut is flat 10% irrespective of maturity Securities with CQS 1 and CQS 2 are eligible only	Placed in category II and III Applicable haircut starts from 1% and varies with the maturity CBs with CQS 3 are also included

CBs are also getting favourable treatment in the form of lower haircuts on the discount window. There are five categories of the eligible assets that can be used as collateral[82]. CBs are

monetisation inability. RSF is somewhat akin to the haircut applicable to liquid assets for the purpose of LCR calculations.

[81] BCBS, 'Basel III: The Net Stable Funding Ratio' (n 17).

[82] Annexure of Guideline (EU) No. 2016/65 of 18 November 2015

placed in the Category II (Jumbo CBs) and III (All other CBs). The applicable haircuts to CBs with the CQS 1 and 2 start from 1% and vary with the maturity of CBs. However, ABS with CQS 1 and 2 are placed in the last category of eligible assets and the applicable haircut is flat 10% irrespective of the maturity. Moreover, CBs with the CQS 3 are still eligible for collateral but ABS with CQS 3 are not. As a result of higher haircuts, CBs overtook ABS as collateral in the repo market[83]. The asymmetric treatment of securitisation and CBs is summarised in Table 1.

5. Conclusion

The review of regulations performed in this study provides with three perspectives of regulations for securitisation and CBs. Firstly, the premises for the current regulations are not aligned with the theoretical understanding of securitisation transactions. This raises the questions on the credibility of the regulations. Although regulations are extensive, but they may fail to target the actual problems lying in the securitisation market. The regulators need to reconsider these premises and recalibrate the regulations accordingly.

Secondly, the regulatory treatment of securitisation is not based on the European realities, but it is highly influenced by the situation in the US market. The European securitisation market had different dynamics and the problems that were pervasive in the US securitisation market were not ubiquitous in the European market. The differences in both markets must be understood and problems on the other side of Atlantic should not be generalized. The treatment of European securitisation should be aligned with its own dynamics.

Thirdly, an asymmetric treatment is provided to ABS and CBs in the current regulations. The consequences of this asymmetric treatment need to be evaluated. The favourable treatment given to a specific instrument may generate system-wide instability as it might promote over-reliance on it. This may adversely affect the funding diversification of issuers and investment diversification of the investors. A financial system flooded with a certain instrument may become fragile to the economic shocks of that specific market. A situation akin to the securitisation crisis may arise in future. Therefore, there is a need to develop a level playing field for the securities with similar risk characteristics and maturity structures.

The discussion in this paper has highlighted the need to reconsider the regulatory framework for ABS and CBs. The regulators should revisit the premises for the regulations and consider the European realities while recalibrating the regulations. The future research should be focused on empirical investigation of the European securitisation and CBs market. The findings of such empirical investigations can be used as foundation for recalibrating the regulations in Europe. The structure of securitised products and CBs can also be compared and evaluated if the differences in structuring various transactions are affecting the performance of various financial instruments.

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[83] Carlo Altomento and Patrizia Bussoli, 'Asset-Backed Securities: The Key to Unlocking Europe's Credit Markets?' <http://bruegel.org/2014/07/asset-backed-securities-the-key-to-unlocking-europes-credit-markets/>.