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"Simple, Transparent and Standardized": Narratives, Law and the Interest Coalitions behind the European Commission's Capital Markets Union

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Abstract

In this paper we take a closer look at those parts of the European Commission's Capital Market Union (CMU) that bear upon the attempt to set up a new market for securitized mortgages, called "simple, transparent, standardized", or STS-securitization. The "puzzle" at the heart of the paper is the discrepancy between the "frontstage" narratives told by the Commission and the actual content of law making taking place "backstage". The paper comes in four sections. After the Introduction there are two sections, which look at the construction of what is meant to become a "new" European market in securitized assets which is distinguished from pre-crisis securitization by the markers "simple", "transparent" and "standardized". The second section looks at the narratives, the third at the legal details. The fourth section discusses the interest coalition behind it.

Keywords: securitization ; European Union ; law ; politics of finance ; sovereignty ; regulatory capitalism

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The "When the proposals for STS came along, I was a bit bemused as to how a set of such complex proposals could be labelled "simple"."


1. Introduction

Europe’s "Capital Markets Union" (henceforth: CMU) is rapidly gaining traction. Announced in November 2014, the new European Commission (EC) under Jean-Claude Juncker has quickly capitalized on the more buoyant post-crisis mood among the member states of the European Union (EU) to kick-start a series of "public" consultations on what it deems to be the key priorities of the panoply of proposals included in the original Green Paper, written under the supervision of the former British Commissioner, and former professional lobbyist, Jonathan Hill (EC 2015a).

The premise underlying the CMU is that the striking economic performance difference between the US and the Eurozone (well over 11 percentage points lower growth in the Eurozone compared to the US over the period of 2008 to 2015) is caused by the overreliance of European economies on bank lending rather than market lending, as is the case in the US. An insight that the Commission took straight from a private industry report, titled "Bridging the Growth Gap", that Boston Consultancy Group produced for the main Brussels-based financial lobbyist (BCG 2014), the Association for Financial Markets in Europe (AFME). Since European banks were still slowly rebuilding their balance sheets after the shock of 2008, their ability to finance the real economy was widely perceived to be impaired. Hence the presumed need to open up an alternative financing channel, which is what the CMU formally is about. Here is what the Commission writes on the webpage dedicated to the CMU. Under the heading "Unlocking funding for Europe’s growth" it states:

"The Capital Markets Union (CMU) is a plan of the European Commission to mobilise capital in Europe. It will channel it to all companies, including SMEs, and infrastructure projects that need it to expand and create jobs. By linking savings with growth, it will offer new opportunities for savers and investors. Deeper and more integrated capital markets will lower the cost of funding and make the financial system more resilient. All 28 Member States of the EU will benefit from building a true single market for capital" (http://ec.europa.eu/finance/capitalmarkets-union/index_en.htm).

To do so the Commission aims to further integrate European capital markets, diminish administrative burdens, introduce harmonized rule book for prospectuses, share emissions and peer-to-peer lenders, and, most notably, restart European securitization markets to increase the accessibility of new/old funding markets for European banks. The official legitimisation of the latter is that it would serve the credit needs of Small and Medium Sized Enterprises (SMEs). This abbreviation appears no less than 49 times in the Green Paper, surpassing by far any other term, illustrating its importance (EC 2015a).
The thing to note is that since the launch of the CMU, the Commission has concentrated its efforts mainly at the securitization part of the proposal, which appears only at page 11 of the original Green Paper and is formally not about constructing an alternative credit intermediation channel to bank finance at all since it serves mainly as a funding tool for banks and as such only reinforces the dependence on bank finance which the CMU sets out to correct in the first place. Securitisation helps banks to find alternative sources of funding but is not in and of itself an alternative to bank lending (Hardie et al. 2013).

Nevertheless, the results of the "public" consultation on this part of the CMU have already been worked into a revised proposal by the European Commission, including two proposals for legal directives and an explanatory and legitimating Memorandum laying out the rationale behind the draft, and was accepted by the Council of Ministers in December 2015 – "at record speed" as Commissioner Hill tweeted proudly 15 minutes later. The aim is to get it through European Parliament as quickly as possible, although increasing doubts among Members of European Parliament (see Engelen 2016a; 2016b). Brexit and the resulting stepping down of Jonathan Hill as Commissioner are sure to delay the passing and ultimate implementation of the proposal.

In this paper we don't discuss and assess the CMU as such but look at those parts that bear upon the attempt to set up a new market for securitized mortgages, called "simple, transparent, standardized", or STS-securitization. The documents dealing with this are revealing in that they betray the extent to which the Commission feels itself obliged post-crisis to respond rhetorically to one of the main lessons of the crisis, namely that securitization created complex, opaque and idiosyncratically risky financial products that caused the meltdown of 2008. On the basis of a critical reading of a number of key passages of those documents we show that the proposal is "framed" as being about enhancing the access to credit of SME whereas it is actually about lowering capital requirements for securitized mortgages. Moreover, the legal details suggest that the securitizations endorsed by the Commission are the spitting image of pre-crisis industry practices and as such are anything but "simple", "transparent" and "standardized". The "puzzle" at the heart of this paper is the striking discrepancy between the "frontstage" narratives told by the Commission and the actual content of law making taking place "backstage".

The next two sections look in more detail at the construction of what is meant to become a "new" European market in securitized assets which is distinguished from pre-crisis securitization by the markers of "simple", "transparent" and "standardized" (STS). In the first section we focus on the discrepancy between the official storyline of the CMU being all about facilitating nonbank finance in Europe and simultaneously prioritising the construction of a European market of STS securitizations, which is mainly a funding tool for banks and as such has nothing much to do with "non-bank finance" or "market-based finance" (see Hardie et al. 2013; Aalbers & Engelen 2015; Engelen 2015; 2016). In the second empirical section we delve deeper into the legal documents themselves to demonstrate that once you enter the details of the securitization framework nothing "simple", "standardized" or "transparent" remains. Obviously, this raises urgent questions about what could explain the discrepancy between walk and talk, policy narrative and policy content, "narratives" and "law", "frontstage" and "backstage". Those questions are addressed in the subsequent section, through a discussion of the interest coalition behind the STS securitization initiative and what is behind the

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1 See Pesendorfer 2015 for an excellent analysis of the extant criticisms of the CMU, its origins, as well as the mismatch between narrative and actual content of the CMU.
remarkable speed and force with which the Commission is pushing it through the European institutions.

2. "Building" a Market for STS securitizations (I)

The official story is that securitization is good for the economy. That is what the first sentence of the Memorandum confidently states:

"The development of a simple, transparent and standardized securitisation market constitutes a building block of the Capital Markets Union and contributes to the Commission’s priority objective to support job creation and a return to sustainable growth" (EC 2015a: 2).

It is a frame that is reiterated on the website of the Commission dedicated to the CMU, where securitisation is presented as:

"[A]n additional source of finance, particularly for SMEs and start-ups... that would encourage integration of EU financial markets and by (sic!) make it easier to lend to households and businesses."

The same website also contains a crude video explaining the aims of the CMU in similar terms through the fictional storyline of Anna, a promising entrepreneur looking for funding, and Paul, a wealthy saver looking to invest his money. In between them stand borders, rules and regulation, depicted in the video as distopian walls. In comes the CMU, to breakdown the walls. As the video explains:

"[I]t would help Anna and other businesses to raise capital more easily and it would help Paul and other savers to get more for their money. That's the goal of the Capital Markets Union."

And without much empirical evidence the very same causal claim is repeated over and over again in the Memorandum itself (see also Pesendorfer 2015): securitization would help "sustainable" economic growth and job growth, where "sustainable" is meant to refer to real economic growth in contrast to financialized growth. The suggestion clearly is that securitization helps SMEs and hence helps "jobs and growths".

Does it? It pays to take a closer look at this causal claim at the heart of both CMU as well as the STS securitization-initiative since according to the European Securitisation Forum (ESF) before the crisis securitization in Europe was predominantly used to finance mortgage loans, a "fact" that suggests that the Commission is not making a "truth claim" at all but is doing something else altogether. Before the crisis SME-loans were only a marginal source of assets used to back securitizations. Of the total stock of securitizations in Europe at the end of 2008 to the tune of € 1700 bn, over € 1000 bn were mortgage securitizations, while asset-backed securities (ABS) made up less than € 200 bn of that total; securitised SME-loans are somewhere in there, but so are car loans, student loans and credit card debits (see Figure 1. below).

[ Figure 1. about here ]
The reason is that the riskiness of mortgage contracts is much easier to assess than that of SME-loans and that risk assessments of the former are much more costly. Since the difficulty of assessing the riskiness of SME-loans is not addressed in the proposal (there is no regulatory attempt to standardize SME-loans for instance, to simplify the "raw material" that may enter securitizations), mortgage lending can be expected to be again the main beneficiary of the sanitized securitization market the Commission aims to set up. This implies that most of the extra funding will end up financing already existing 10 assets (real estate), resulting at best in asset inflation and, ultimately, in the very same housing bubbles that, during the crisis, proved to be such a drag on economic growth in a number of Eurozone member states (see Sufi & Milan 2014; Borio et al. 2014 for an empirical analysis of the macroeconomic harm housing bubbles can do; see Engelen 2015 for a similar story on the Dutch case). In other words, the causal argument for securitisation is not only weak but the empirics actually suggest the reverse of what the Commission claims and intends: not SME financing and sustainable economic growth but real estate bubbles and financial instability.

Interestingly, Hill, the former travelling salesman of the CMU, seems to acknowledge as much. In a Q and A at the Brookings Institute in late February 2015, Hill admitted that the link between the CMU and SMEs was weak at best and merely served to mobilize policy makers behind the initiative. Here is the quote in full:

"I agree with you that this is not and must not be explained as solely a set of measures that will benefit small- and medium-sized enterprises. I think if it works properly, by increasing investment flows, there will be a whole range of beneficiaries, from people who want to save their retirement in a broader range of investment products, from businesses of all sizes that need capital to expand. So I utterly take the point that this is not solely about SMEs. I think the fact that within the European debate there feels to be an emphasis on, that is because they are seen as being such an important part of the economy and people want to rally around ideas that will enable them to be strengthened" [our emphasis] (Hill 2015a: 12-13).

This is saying that since everyone is in favour of "strengthening" SMEs, they will "rally around" any "idea" that can be linked to SMEs, no matter how loose or how strong that link is. In the same vein, at a meeting with Hill, organized in Brussels last December by Euromoney and co-hosted by the Royal Bank of Scotland, the International Capital Market Association (ICMA) and AFME among others, one of the speakers, Jean Lemierre of BNP Paribas, explicitly "thanked" Hill and the Commission for framing the CMU as being about SME finance for that would "expedite" its implementation, while stating in the next sentence that BNP Paribas was not so much interested in SME finance as such but much more in the opportunities for real estate finance opened up by the CMU (see www.euromoneyconferences.com/CMU.html).

The Memorandum further speaks of the function of securitization as:

"[P]roviding banks with a tool for transferring risk off their balance sheets (...) and free up more capital that can then be used to grant new credit including SMEs" (p. 11).

Again, it is hard to reconcile these claims with a financial crisis that has clearly demonstrated that, despite assurances from bankers, regulators and financial economists alike that securitization has dispersed risk among a much wider array of financial institutes and had thus made the overall financial system more robust (see Engelen et al. 2010; 2011 for examples), risks were instead highly concentrated raising the issue of banks being too-interconnected-to-fail. Eight years after the crisis
one would have expected any proposal to again allow banks to transfer risks from their balance sheet to at least demonstrate why this time it is different and how the issue of interconnectivity is solved. One looks in vain for any sort of assurance in the Memorandum.

The stated aim of the framework is to remove the "stigma of securitization" by constructing a legally certified market segment called "Simple, Transparent and Standardized securitization" that differs in key respects from regular securitizations. The argument comes in two steps. First, that the current "stigma" of European securitizations is undeserved. Second, that the "stigma" nevertheless exists and that it is thus of the utmost importance to create a new securitization label to signal to end investors that European securitizations have nothing in common with US sub prime securitization and have merely been found "guilty by association".

To that end the Memorandum stresses several times that European securitizations have performed (much) better than US securitizations but that, nevertheless, US securitization have recovered in terms of transaction values whereas European ones have remained subdued. Here is a typical quote to that extent:

"Since the beginning of the financial crisis, European securitization markets have remained subdued. This is in contrast to markets in the US which have recovered. This is despite the fact that unlike the US, European securitization markets withstood the crisis relatively well with realized losses on instruments originated in the EU having been very low compared to the US" (pp. 2-3; see also p. 7, p. 10).

The Memorandum next presents some data points on default rates of some of the different tranches of US and EU securitizations to demonstrate the fact that indeed 12 default rates on European securitizations have been much lower than in the US. While the observation itself is factually correct (see Figure 2. below), what the Memorandum fails to do is to provide an explanation. The implicit suggestion is that it is either due to superior risk management by European banks, higher quality of the securitization process itself, or better regulatory supervision. In that sense the Memorandum merely reproduces the self-congratulatory view of European banks and finance of politicians, regulators and bankers in the immediate aftermath of the bankruptcy of Lehman Brothers, when the crisis was still very much framed as an Anglo-American one with European banks being held to be above the fray (see Eichengreen 2015 for quotes).

[ Figure 2. about here ]

Is the claim that there is nothing wrong with securitization European-style correct? The only way to answer that question affirmatively is by excluding alternative explanations for the much lower default rates of European RMBSs, which the Memorandum fails to do. One that offers itself from the side of comparative legal studies is that the noticable differences in terms of default rates between the US and the EU could be caused by legal difference in bankruptcy law as well as mortgage contracts. Whereas in the EU all mortgage loan are full recourse loans, meaning that the contract gives the creditor full legal protection against payment risks, in the US many (but not all!) mortgage contracts are non-recourse contracts, meaning that the debtor can simply walk away from his/her mortgage obligations ("jingle mail"), resulting in an actual default and a rapid fall in value of the
mortgage security in question if the scale of default is widespread enough, as was the case in 2006–2009 (see Singer 2015).

Actually the US provides us with a kind of "natural experiment" to test this claim, since many state jurisdictions do provide lenders with "recourse" to the borrower if the value of the collateral in the case of foreclosure generates a shortfall, while others do not. In other words, the US is partly just like Europe in terms of its legal treatment of delinquencies and partly textbook US. Empirical research of the incidence of mortgage defaults related to whether a state does or does not provide full recourse to the lender has shown large differences in defaults in the two legal regimes. In 2011 two economists of the Federal Reserve Bank of Richmond estimated that borrowers have been 30 percent more likely to default in non-recourse states than in full recourse states. In the price range of 500,000 to 750,000 dollar ("jumbo loans") defaults were even twice as high in non-recourse states as in full recourse ones (Ghent & Kudlyak 2011). This suggests that the differences in default rates between the US and the EU can largely be attributed to differences in bankruptcy law and have nothing to do with the assumed "superiority" of European securitisation standards or "superior" risk management by European banks.

More important is that the European Commission, by claiming excellent market performance for European securitizations throughout the crisis period, is falling victim to a fallacy of composition of sorts. That individual European securitizations kept their market value throughout the crisis is not to say that securitization as such did not severely harm the long term interests of households, SMEs and national economies. The real estate bubbles it helped create in countries like Ireland, Spain and the Netherlands by providing banks with external sources of funding over and above national saving surpluses have since the crisis forced a substantial proportion of Dutch, Irish and Spanish households to cut back on consumer spending to contain the increasing discrepancies between the nominal value of their mortgage and the market value of their collateral. Combined with eurozone-wide austerity policies, this has extended the recession and has substantially hurt the long term earning capacities of citizens and economies alike, as recent research by economists from the Bank of International Settlements (BIS) has shown (Law & Singh 2014; Borio et al. 2014). It raises awkward questions that a mere eight years after the crisis, an official document of the European Commission fails to discuss these kinds of "externalities" and reproduces the industry claim that there never was anything wrong with European securitizations (see Engelen 2015). From the perspective of an individual end-investor the claim that securitization is safe may well be true, but from a citizens’ perspective it definitely is not. One would have expected the European Commission to align itself with the latter, not the former.

Now that we have looked at the narratives provided by the Commission for its initiative to set up a Europe-wide market for STS securitizations, we next turn to the legal details in order to assess what it means for securitizations to be "simple", "transparent" and "standardized".

3. "Building" a Market for STS securitizations (II)

To overcome the "stigma" of securitization pre-crisis and re-open this crucial source of bank funding post-crisis, the European Commission wants to set up, as we already intimated, a new market niche of "simple", "transparent" and "standardized" securitisations, without prohibiting the "production" and "consumption" of regular, or better: "complex", "opaque" and "bespoke" securitizations. The
message to end-investors, as well as the wider public, is merely that they will have the option to invest in 14 extra safe "qualifying securitizations", in the language of the Bank of England (BoE) and the European Central Bank (ECB), which are inherently different from the complex, unreliable instruments that stood at the cradle of the Great Financial Crisis that broke in 2008. How does the European Commission suggest to make such a distinction legally actionable? What makes a securitized asset "simple", "transparent" and "standardized"? When do securitizations "qualify" for the "STS"-label? And how does the Commission aim to legally ensure that assets that qualify thus are traded on markets that are "well functioning"? These questions deal with the legal details of market construction and are hence couched in a legal-technocratic language that is emphatically not meant for the "frontstage" and is – as we will show below – remarkably at odds with the marketing arguments for STS securitization repeated "frontstage".

We base our subsequent analysis on two legal documents that were published on the website of the European Commission on December 2, 2015, which give further technical detail to what is meant by "simple", "transparent" and "standardized". One spells out the criteria of "simple", "transparent" and "standardized" (EC 2015b), while the other speaks to the capital requirements for buyers of STS securitizations aiming to provide "a more risk-sensitive regulatory treatment for STS securitisations" (EC 2015c). The aim here is to provide an incentive to end-investors as well as structurers to buy and "produce" STS-securitizations instead of "regular" ones.

The first thing to note once one goes into the details is that the STS criteria only address the "quality" of the securitization process (structuring, tranching, rating and distribution) and have anything to say about the "quality" of the "raw material" (the mortgage contracts) that feeds the money flows going through the securitization structure. This is odd, since, as the events during the Great Financial Crisis have amply demonstrated, the "quality" of the securitized assets hinges crucially on the "quality" of the underlying mortgage contracts. Here, just like anywhere else, "garbage in" means "garbage out", however much intimidating prospectuses and impressive ratings may for a time at least delay the day of reckoning. As the first document explicitly stipulates:

"The satisfaction of any STS requirements does not indicate anything about the credit quality underlying the securitisation" (14b).

There is for example no maximum threshold for loan-to-value or loan-to-income ratios of mortgages to be eligible for STS securitizations, even though those two are the most important indicators for risk in contemporary lending. So legal protection of laymen from predatory lending or the prevention of socially unsustainable investment is no aim of the new STS-label. There are a few minimum standards regarding the underlying 15 assets, but they are minimum indeed. To give an example, one of them states that a securitization cannot be considered STS if it is filled with loans that are already in default at the time of getting securitized, which is at most a measure against outright fraud rather than a quality standard. Even more so, said stipulation is promptly followed by exceptions, including loans that have gone into arrears but have "successfully" gotten a new debt servicing plan, which typically reduces monthly burdens by extending the maturity of the debt from thirty to forty years. "Successful" meaning here that the debtor has for at least one year regularly paid the monthly dues within this new plan, not including the question of how the loan will play out during the extended period until it is fully repaid, often thirty years. In brief, even the European equivalent of "sub prime borrowers" can be included in STS securitizations.
Our second observation is that claiming that it is possible to make securitization "simple", "transparent" and "standardized" at all may be misleading since it negates the fact that securitization even by the Commissions own recognition is inevitably complex. In fact, the proposal explicitly stresses that STS securitizations are meant for professional investors only and are forbidden territory for retail investors. An early draft gave as reasons for excluding them from the market for STS securitizations that their "potential level of risk and their complexity [our emphasis]" (page 7) made them unsuitable for investors who are not professionally involved in financial markets on a daily basis. This passage was crossed out in the version of the document that was later sent to the European Council. About the reasons for this we can only guess. But the legal aides of the Commission may have wanted to avoid raising awkward questions from politicians unfamiliar with High Finance if securitizations that were meant to be "simple, transparent and standardized" were in the same sentence described as "risky and complex".

To illustrate their inherent complexity, take Article 5 of the draft proposal, from page 31 onwards, which stipulates the types of documents that the different parties in any securitisation (originators, structurers, sponsors, the managers of the special purpose vehicles used in securitization) have to make available to investors in order to fulfill the transparency requirements of STS securitization. This adds up to a long list indeed, covering more than four pages of the draft, suggesting an ultimate file that could easily add up to 1000+ pages, and which would inevitably contain contestable assumptions about risks, returns and macroeconomic conditionalities as well as open legal clauses that turn any notion of simplicity, transparency and standardizability into a parody, as the quote from the representative of the buy-side adorning this paper indicates. 16

Furthermore, the draft explicitly calls for the use of interest and FX swaps in STS securitizations. On page 44 it reads:

"Interest rate and currency mismatches arising at transaction level shall be appropriately mitigated and any measures taken to that effect shall be disclosed. The SSPE [Securitization Special Purpose Entity] shall not enter into derivatives, unless for the purpose of hedging currency risk or interest rate risk. Those derivatives shall be underwritten and documented according to common standards in international finance" [our emphasis].

In essence, this means that swaps are mandatory for any securitization to be eligible for the STS label. However, derivates hugely complicate the risk-and-return profile of any financial contract, increase counterparty-risk and hence systemic instability, and allows banks again to leverage up their trading and banking books. All things considered the proposal again creates strong incentives for large financial institutes to actively try and manipulate money markets, either directly (see LIBOR scandal), or indirectly by lobbying monetary policy makers, especially central banks. All in all, swaps make contracts less simple and less transparent, which begs the question why they should be part of STS securitizations in the first place.

As such, the proposal reads as if the notion of STS securitization has been stretched to such an extent as to more or less "cover" the standard industry practices that had developed before the crisis (see Glasmacher 2016 for a description of Dutch practices), as is suggested in the quote above by the phrases "appropriately" and the reference to "common standards in international finance". What is more, the draft also opens up the possibility for particularly risky types of securitizations to receive
the STS label in the future, despite explicit acknowledgement of their riskiness. And here it is necessary to quote the passage in full:

"In securitisations which are not "true sale", the underlying exposures are not transferred to such an issuer entity, but rather the credit risk related to the underlying exposures is transferred by means of a derivative contract [CDS] or guarantees. This introduces an additional counterparty credit risk and potential complexity related to the content of the derivative contract. To date, no analysis on an international level or Union level has been sufficient to identify STS criteria for those types of securitisation instruments. An assessment in the future of whether some synthetic securitisations that have performed well during the financial crisis and are simple, transparent and standardised are therefore eligible to qualify as STS would be essential. On this basis, the Commission will assess whether securitisations which are not "true sale" should be covered by the STS designation in a future proposal. The Commission should present a report and if appropriate a legislative proposal to the European Parliament and to the Council on the eligibility of synthetic securitisations as STS securitisation by one year after entry into force of this Regulation" (Section 1(16), p. 9) [our emphasis].

Not only synthetic securitisations using credit default swaps (CDS), but also "resecuritisations", which is the Commissions euphemism for "CDOs-squared", that is collateral debt obligations (CDOs) backed by tranches of other securitisations, could in the near future receive the STS stamp (e.g. Section 1(12), page 6; for a definition of “resecuritisation,” see Article 2(4), page 20). Both of these versions of securitization had been frequently used in the US in the years leading up to the crisis, resulting in highly opaque crosslinking claims that turned local housing crises into a global phenomenon (see Gorton 2010; 2012), but had not made it yet on a sufficiently large scale into the repertoire of European banks due to the underdeveleoped nature of securitization markets in most EU member states,² their opaqueness to end-investors and the difficulty to adapt them to national jurisdictions. The mere fact that the proposal considers to give synthetic securitisations and re-securitisations "STS" status in the future signals to banks and investors today that creating and trading those kinds of securitisations is not forbidden and might even be rewarded soon; it certainly has the opposite of a deterring effect.

Despite being already over 100 pages long, so far the proposal has only spelled out a broad legal framework for STS securitisations and their regulatory treatment. Much of the fine-tuning still needs to be done. As a result the proposals are full of inconclusive statements ending with formulations like "power will be delegated to the Commission" to work out the details, meaning that they will be delegated to legal and financial specialists operating "backstage" and will be kept outside the reach of democratic control, either by European Parliament or by the parliaments of member states. Even better, industry representatives are explicitly invited to participate in fine-tuning the law they will be subject to: "the views of market participants should also be requested and taken into account to the extent possible" (Section 1(10), p. 5 [our emphasis]).

A telling example is the passage were the so-called "information requirements" are addressed, that is the kind of information banks have to provide about the assets backing STS securitizations to any

² Re-securitisation requires a sizeable amount of "rest material" from regular securitisations and hence large scale securitization, which was practiced on the scale required for re-securitisation only in the UK and the Netherlands (see Engelen 2015).
potential buyer. On page 15 it says that in order to facilitate investors "continuous, easy and free access to reliable information on securitisations" the full power to adopt Acts concerning this issue "should be delegated to the Commission", suggesting that their adoption is kept outside any form of regular democratic process. At the same time, the European financial market regulator, which in Brussels is even closer to the industry than regulators are at the national level, is to be explicitly included in future rule making. In view of the expertise required to further define the clauses of the delegated acts, the Commission should rely on the European Securities and Markets Authority (ESMA) in the preparation of these clauses. ESMA, in turn, should consult with the other two European Supervisory Authorities, the European Banking Authority (EBA) and the European Insurance and Occupational Pension Authority (EIOPA).

The same happens in the passages dealing with legal requirements concerning risk retention, ie. the obligation that banks selling securitisations have "skin in the game" to overcome pre-crisis abusive practices to sell customers risky products by ensuring that the originator would be burned too if anything went wrong with the underlying assets. Normally that would mean that securitizing banks sell only the safest tranches ("senior" and possibly parts of the "mezzanine" tranches too) to end-investors, while keeping the riskiest tranches (particularly the "equity" tranche) on their balance sheet. Again, the Commission delegates the responsibility to specify in greater detail the risk retention requirements to the EBA. Together with ESMA and EIOPA, EBA is supposed to put a proposal before the Commission within six months after the enactment of the Securitization Act (p. 30).

However, the directive has already set the tone of an industry friendly interpretation of risk retention requirements in that it defines it very broadly indeed. The proposal stipulates (i) that the risk only has to be retained by either the sponsor or the originator or the original lender, which would open the loophole of shifting risks to empty letterbox companies;³ (ii) that banks can pick and choose with regard to which particular parts of the securitization are retained ("equity" tranches as well as "mezzanine" tranches); and (iii) that there will be no risk retention requirements if the assets are “fully, unconditionally and irrevocably guaranteed by” public bodies such as central governments, central banks, regional governments, local authorities, public sector entities, which means that conflicts of interest are rife when tax-payers money is at stake (p. 28ff). In other words, instead of binding legal prescriptions with regard to what is arguably the most important piece of regulation to solve endemic "conflict of interest"-problem in securitization, the STS-proposal again offers banks a menu of choice options, which opens the door to precisely the kind of regulatory arbitrage that had brought about the striking pre-crisis complexity and opaqueness of securitizations in the first place. What is more, instead of closing the door on infamous "socializing risks"-practises in banking and finance, doing so is explicitly invited by turning it legally into the cheapest way of doing securitizations.

Even more important is what the proposed directive on the amendment of existing rules "on prudential requirements for credit institutions and investment firms" reveals. For it stipulates the lowering of capital requirements for (STS) securitizations, which is a hugely attractive trait

³ In the final draft of the proposal (2015/0226 (COD)) the respective section is amended in response to an “EBA recommendation to close a potential loophole”, as it is explicitly pointed out (Final Draft p. 14). However, the option to choose the party which is to assume the risk retention, and thus the fundamental problem of complex risk-distributions, remains.
particularly for insurers and asset managers, which are an important group of buyers for securitizations that however gravely struggle to meet capital targets at the moment. On page 9 the Commission speaks of "broad support" for a more "risk sensitive" capital charge for European securitisations, pointing to a coalition of interests that will be discussed in detail in the following section. To understand what is meant by more "risk sensitive" capital charges, some explanation is needed about what went wrong before the crisis and what has been done about that post crisis. Basel 2, the regulatory regime installed just before the crisis (phased in from 2004 onward), allowed banks to asses their own risk exposure and calibrate their equity base accordingly. The regulatory gaming this made possible allowed banks to minimize their equity base (and maximize their profits in terms of Return on Equity (ROE)) and resulted in banks – European more so than US ones – being severely undercapitalized when the crisis struck. In order to strengthen banks' abilities to withstand market volatility, the Basel Committee of Banking Supervision (BCBS) has post-crisis beefed up the capital charges for different asset classes and has tried to constrain the ability of banks to use in-house risk assessment tools. This is Basel 3, which is currently being phased in.

This suggests a different explanation for the breakdown of European securitisation markets than the one offered by the Commission and others. Securitization breakdown happened in Europe not because of its misplaced association with US "sub prime" and its presumed "toxicity" but because in the post-crisis regulatory environment securitisations have simply become too "expensive" in terms of capital requirements, 20 both for structurers (who have to have more skin in the game, see above) and endinvestors, often asset managers or insurers, who too face stricter capital charges for the securitizations on their balance sheets. Lowering these expenses, and hence increasing the gains from securitization, by lowering the regulatory capital charges for securitization as defined by Basle 3, is the true aim of the proposal;

"The methodology would result in a significant reduction of the capital charge for non-senior tranches of STS securitizations" [our emphasis] (EC 2015c: 10).

This is relevant for risk-seeking asset managers as well as lenders, originators and banks that produce securities, that is those parties which will accumulate risky tranches on their balance sheet in order to comply with the "risk retention" requirements discussed above or due to a lack of demand for them, which is currently the case.

In the next sentence the Commission adds:

"Technical improvements will also be made to the methodology of calculation of the calibrations for the senior tranches" (ibid.).

Which talks to buy-side concerns, particularly institutional investors with strict investment guidelines. All in all, reducing capital requirements without a doubt provide powerful incentives to end-investors to buy, and to structurers to "produce" STS securitizations.

Noteworthy is the neutral terminology of "technical improvements" for factually lower capital requirements, which is similar to the choice of words of the European Banking Federation (EBF), which in a public statement on the matter also avoids openly naming the "significant reduction" of capital charges linked to STS-securitisations which the second directive clearly implies (EBF 2016). Instead, the EBF statement uses the neutral "to revise the relevant capital calibration for banks", which could either mean upward or downward revisions and which hence serves to obfuscate what
is at stake here. The choice of words is relevant because it indicates a new sensitivity for the public spotlight amongst organisations involved in financial law making, which wasn’t there before the crisis, as well as a new willingness to rhetoricallly manipulate readers even within legal texts and technical reports (see footnote 4 below) for a similar example.

There is a reason for not being candid about the effects of the proposed new capital requirements for STS, which is that it does not make economic sense. They make 21 holding mortgage loans (and other assets) in securitized form either considerably cheaper or at least never more expensive than holding them in unsecuritized, "raw" form, even though securitization always and inevitably introduces additional risks to holding these assets, no matter how high the quality of the securitization process, as the Commission itself explicitly acknowledges. However, the Commission fails to draw the only logical conclusion from that observation, which is that securitizations should require higher capital charges not lower ones.

Nevertheless, former Commissionar Hill was quite outspoken about this "goal" in a September 29, 2015, op-ed piece in the Financial Times:

"To help free up banks’ balance sheets, making it easier for them to increase lending, I am proposing a new EU framework, with lower capital requirements, to encourage simple, transparent and standardized securitization" (Hill 2015b [our emphasis]).

In order to do so, the Commission has to revisit and revise post-crisis regulatory efforts to increase capital requirements that have already gone through Parliament. In fact, the legislative sweep of the STS securitization proposal requires amendments in no less than eleven complementary pieces of legislation, four related to banking, two to insurance, two to asset management, two to credit rating agencies and one related to prospectuses. What the legal amendments are going to be, how "significant" the reduction in capital charges will be, as well as who is going to decide on that (the draft suggests that regulators in close colaboration with the industry itself should do this) is as yet uncertain. And while the legal complexities and possible financial consequences are large, the European Parliament will have only one vote to decide on it.

If this proposal makes it through Parliament unscathed, which at the moment of writing (early July 2016) is likely but still uncertain, the Commission will gain full legal powers over the determination of not only risk retention requirements (p. 15, 30) and information requirements (p. 15, 36), but also over the information flows between regulatory bodies of different jurisdictions (p. 15, 77), the template for STS notifications (p. 16, 59), the authorization of "third parties" to be granted powers to certify STS compliance (p. 62ff), the downward adaptation of capital requirements for non-bank end-investors, notably insurers and asset managers (p. 80), any future changes in the regulation of covered bonds and over-the-counter (OTC) derivative contracts (p. 83-84), and more. In fact, it is impossible to tell at this point whether the proposed market for securitization will ever be "simple", "transparent" and "standardized" since key points will only later, after the consent of the European Parliament, be clarified.

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4 The Dutch Ministry of Finance was not so blunt in the advise on the CMU it sent to Dutch Parliament on February 4, 2016. On page three, where it summarized the documents related to the STS-securitization proposal, it stated that "the second document adapts the capital requirements for banks" (Ministerie van Financiën 2016). Of course, the Draft talks of "a significant reduction", not adaption, which could go either upwards or downwards.
Despite the lack of democratic control over decisive details of the proposal, the future interpretation of the Commission of what STS means would automatically become law in all member states, since EU law trumps national law – for reasons of efficiency as the proposal argues unconvincingly:

"Since the objectives of this Regulation cannot be sufficiently achieved by the Member States given that securitisation markets operate globally and that a level playing field in the internal market for all institutional investors and entities involved in securitisation should be ensured but, by reason of their scale and effects, can be better achieved at Union level, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Regulation does not go beyond what is necessary in order to achieve those objectives" (p. 35).

The various technical weaknesses of the two proposals for regulatory change, their unsuitableness to address pressing problems in the financial system, raises questions about the interest coalition behind the proposal, a topic to which we turn in the next section.

4. The Interest Coalition behind the STS-proposal

We have learned from Cohen, March & Olsen's (1972) decision making theory that policy initiatives are hardly ever the outcome of a rational process of policy makers trying to find policy solutions to well defined policy problems, but rather the reverse. Discrete policy ideas tend to circulate aimlessly in a specific policy field, like garbage in a garbage can, until a contingent coalition of policy makers has succeeded in finding a policy problem or a set of policy problems to which their preferred policy idea is the "perfect" solution. Coalitions, narratives, contingencies are at the heart of this theory, not rationality, problem solving and engineering. Hence Cohen, March & Olsen's preferred name for this messy process: the "garbage can model" of organizational 23 choice (Cohen, March & Olsen 1972). It suggests that a policy gets selected if it serves the interests of a mixed group of agents and hence is able to solve multiple "problems" in one go, again given specific "problem definitions" and given specific spatio-temporal conditions. So what are the "problems" that STS securitisation is meant to "solve"? And whose "solution" is it? And what is their interest in selecting this "solution"? Below we walk through the members of the interest coalition behind the STS-proposal one by one.

European Policy Makers

The first thing to note here is that the wider CMU initiative, as Dorn in one of the few available academic reflections upon it has stressed (Dorn 2015), fits a much older narrative shared by EU policy makers to look towards the US as a deliverer of "policy solutions" to European problems. The Lisbon agenda, for instance, is strongly geared towards emulating the US venture capital-model of technological innovation that has come to fruition in Silicon Valley. Similarly, the Single Market was explicitly set up as a counterpart to the integrated markets of the US, while the services directive contained references to the American shareholder-culture which the European Commission, again, perceived as the global standard. In a sense, this is true for the project of European integration as a whole; emulating the US, with substantial US support, has always been at the core of it (see Milward 1984 for many). The same goes for the CMU, for it explicitly frames the economic performance differences between the US and the EU since the crisis as the outcome of underdeveloped debt and
capital markets, which forms the backdrop for the renewed push to finally integrate those markets in order to create a capital markets union, with the emphasis on the latter, that, again, mimics an idealized US-model (see Pesendorfer 2015; Dorn 2015; Ertürk 2015).

National Banking Associations

Second, there have been a number of pre- and post-crisis initiatives in different member states of the EU to "construct" a national securitization-standard or label to enhance their attractiveness to end-investors. Here we do not pretend to give a complete overview of such initiatives but merely pick and choose two telling examples. In Germany, True Sale International (TSI) presents itself as being "at the heart of the German securitisation market". Established in 2004 by 13 German banks, ranging from Bayerische Landesbank to Deutsche Bank, the aim was very much to make investors as well as regulators familiar with this "new" asset class (see www.true-saleinternational.de). This reflected the "underdeveloped" nature of German financial markets and the willingness on the side of regulators, with some prodding from public and private banks, to "modernize" the German financial system, as was the explicit aim of the federal governments' Financial market promotion-plan ("Finanzmarktförderplan") 24 (Lütz 2005). Other attempts of a similar nature are KfW's so-called Promise and Provide platforms, which mainly cater to buyers of securitized SME loans. However, those initiatives were not only relatively late in the day, but also by and large unsuccessful. While the number of SME securitizations in Germany increased sizeably between 1998 and 2008, the total stock of German securitizations remained rather subdued given the size of the German economy, as Figure 1. above illustrates. This partially explains the absence of a real estate bubble in Germany before the crisis. However, as a result of the extremely lax monetary policy by the ECB things are in the process of changing, with rapidly rising real estate prices and sharply increasing credit flows, suggesting a future dependence of German banks on the very same sources of funding that securitization opened up earlier to British and Dutch banks.

There, the story is completely different. In both the UK and the Netherlands, securitization had already become a widely used financial technique, predominantly to fund residential mortgages, well before the crisis. Regulators and politicians had over time adapted the legal framework to make large scale securitisation possible and accommodate the institutional preferences of the largest mortgage banks, with large real estate bubbles pre-crisis and sizeable macroeconomic deleveraging effects postcrisis as a result (Aalbers et al. 2011; Wainwright 2009; Engelen 2015). Here, initiatives to standardize securitizations and enhance market liquidity did not precede the crisis but succeeded it. A case in point is the Dutch Securitization Association (DSA) which was established in September 2012 by a consortium of banks, law firms and trust companies and whose mission statement reads:

"[T]he promotion of the interests of both issuers of and investors in Dutch securitisation transactions. Its ultimate objective is to create a healthy and well functioning market for Dutch securitisation transactions" (www.dutchsecuritisation.nl/mission) [our emphasis].

The aim is not so much the "establishment" of a market for securitizations, as in the German case, but rather its rebranding after the crisis as a safe and reliable ("healthy", "well functioning") financial technique. Of course, this has everything to do with the existential dependence of Dutch (and UK) banks on securitization as a funding tool, which had developed between 1995-2008. Well over half of all Dutch mortgages have been securitized, providing Dutch banks pre-crisis with access to funding...
that went far beyond the national supply of deposit savings, a state of play that is known in the Dutch finance as the "deposit funding gap" and is ascribed to the Dutch pre-funded pension system (see Engelen 2015 for a critique). Moreover, since these securitizations in 25 general reach maturity between 5-7 years, there is a growing "wall" of maturing securitizations approaching, which has to be "rolled over" in the upcoming years and hence requires a sufficiently sized "demand" from end-investors (see Figure 3 below).

[ Figure 3 about here ]

In our view this may explain the urgency on the side of European banking representatives in their dealings with the Commission and European Parliament. In fact, since the raporteur responsible for helping the STS proposal through Parliament has already indicated that he needs more time to assess the macroprudential consequences, implying that the proposal will not be able to meet the deadline of January 2017, Brussels-based bank lobby organizations have put considerable public pressure on members of European Parliament responsible for signing off on the proposal. On April 27, 2016, the European Banking Federation (EBF) published a public statement, calling upon the European Parliament to "bring forward the adoption of the STS proposal":

"After an initial review of the European Commission status report on the progress made during the first six months since the adoption of the Capital Markets Union Action Plan the European Banking Federation wishes to underline the need for EU policy makers to accelerate the adoption of the EU proposal for Simple, Transparent and Standardised securitisations, also known as the STS proposal. The EBF encourages EU policy makers to find an agreement on the new regulatory framework to restart markets for STS securitisation and the proposal to revise the relevant capital calibration for banks. The EBF is concerned about the current length timetable set by the Parliament for the adoption of these proposals and would urge MEPs to find a swift compromise" [our emphasis] (EBF 2016).

The very same day, the AFME in the Financial Times reiterated the need to speed up the legislative process, indicating their "frustration" with the "slow pace of change" and pointing out the unintended consequences of a moribund securitization market in the form of "loss of expertise", "collapse in liquidity" and "collapse in inventory" (FT 2016). The unprecedented directness of these interventions (the EBF could has well have put the name of the raporteur in its statement) as well as the tone of voice ("need", "accelerate", "urge", "concerned", "urge", "swift", "frustration") hints at a sense of desperation on the side of the banking industry.

Central Banks

The refinancing problem has partly been buffered and pushed forward in time by the ECB providing short term funding through repo-transactions using "retained" RMBSs as collateral. If anything this brings a third agent in play, with an interest in making European securitizations marketable again. Take the joint May 2014 BoE/ECB Discussion Paper, titled: "The case for a better functioning securitisation market in the European Union". While this document critically discusses the role of
securitisation in the crisis (see Box 4.), the blame is put on negligent risk management rather than on macroprudential concerns having to do with a misallocation of credit, asset bubbles and the structural economic damage that causes. As the title already gives away, the two central banks don’t question securitisation per se but merely want to take away the causes of its malfunctioning pre-crisis through better regulation, along the lines of the proposal of the European Commission. Telling, in our view, is the following quote, where the paper talks about the "potential benefits of securitisation":

"As a funding tool, securitisation can contribute to a well-diversified funding base, in terms of maturity, investor type and currency. [...] Looking ahead, the banking system is likely to need access to a wider range of funding sources. The revival of the ABS market can therefore play a useful role in ensuring that there is not a renewed build-up of systemic risk, including from excessive reliance upon any single source of financing" [our emphasis] (BoE/ECB 2014: 3).

The interesting thing to note here is that the BoE and the ECB seem to be anticipating a post-crisis world where a revamped securitisation-market will again allow banks to diversify their funding sources and end the current "excessive reliance upon any single source of financing", which can be read not only as proposing an alternative to traditional bank based financing, but also as an implicit reference to the quantitative easing-programs upon which both the ECB and the BoE have embarked since the crisis and which currently still serve as the dominant funding sources for European banks, a situation which is perceived by both parties as unsustainable in the long run. This is the third "problem" STS securitization is meant to "solve": in order to allow central banks to return to the status quo ante and end the exceptional monetary measures embarked upon since the crisis, the resuscitation of European securitisation markets is key. Again, provided they are "safe", "transparent" and "simple" or, in the terminology used by the BoE/ECB paper: "qualifying securitisations" that are traded on "well functioning" RMBS markets. Apparently, macro prudential considerations, having to do with the aggregate interests of citizens and national economies in financial stability and "well functioning" 27 credit and capital markets that serve the real economy instead of steering credit flows into already existing asset markets, do not play a role here. It is the funding needs of banks, together with the wish to end monetary exceptionalism that informs the thinking of the BoE and the ECB.

*Regulators*

The next member of our interest coalition is the new European banking regulator, the European Banking Authority (EBA), established in 2011, which has been mandated to ensure the solvency of the largest European banks as well the quality of their credits. Its thinking on securitization nicely illustrates the extent to which regulators still identify themselves with the needs and wishes of the banking industry, despite or regardless of the crisis. Take its background report on securitization, which stresses the benefits of securitization (EBA 2014: 46), fails to mention its role in causing real estate bubbles, and mimicks industry organizations in its list of lessons to be drawn from the crisis, which doesn’t mention bubbles and their macro-economic consequences but focuses instead on a limited set of technical issues: leverage, originate-to-distribute, maturity transformation and transparency (EBA 2014: 48). Already before the “STS”-label was invented, the report strongly endorsed the industry initiative to established a European securitization standard by the Prime
Collateralized Securities Association (PCS) as a "solution" to the "problem" of the current securitization market crunch.\(^5\)

It is a well-chosen monicker that bears textual analysis: the adjective "prime" suggests a stark contrast with the "sub prime" mortgages in the US that have become linked to the crisis in the public eye and have, according to the industry, "undeservedly defiled" European securitizations, while "collateralized" talks to the "secured" nature of the product, ie. the end-investor buys a financial product whose market value is "secured" by the value of the underlying "collateral" (mainly real estate), which, in combination with the substantive "securities", a reference to the legally protected status of the title, which "guarantees" a fixed income and a fixed maturity date (usually 5-7 years) as well as a legally protected place in the role of creditors in the case of bankruptcy,  suggests a double form of "securedness" or "securedness squared" if you like. What could ever go wrong?

The report describes PCS as:

"[A]n independent not-for-profit initiative set up to reinforce the asset-backed securities market in Europe as a key to generating robust and sustainable economic growth for the region. At the heart of the PCS initiative is the PCS Label designed to enhance and promote quality, transparency, simplicity and standardisation throughout the asset-backed market" [our emphasis] (2014: 48).

It is a description that is copied one-to-one from the mission statement of PCS itself that is available on its webpage which strikingly obscures its true lineage. For PCS is not "an independent not for-for-profit initiative" but a well connected lobbying organization with strong British and Dutch backing (among others DSA), which pushes for the formal recognition of its PCS-label. PCS was established in 2012 by AFME and the European Financial Services Roundtable (EFR), the two most powerful lobby organizations for the financial services sector in Brussels (see Engelen 2015), and his hence hardly "independent". This lineage used to be explicitly stated on its website but has since the last time we checked (April 2014) been carefully erased from its "history" and "mission" pages. Instead its mission statement now includes the rider that not only the sector itself believes "that a strong and resilient asset backed market is an indispensable part of European growth and prosperity" but so "do many policy makers". Which seems a fair assessment of the current state of play, given the willingness of EBA to gloss PCS' origins over and present it as an "independent" initiative.

5. Conclusion

Giving this diverse set of agents who all, albeit for different reasons, have strong interests in believing that STS-securitisation is the best "solution" to the different "problems" they face, it becomes understandable that the very same financial instruments which stood at the cradle of the crisis and which post crisis have not been forbidden but have merely been subjected to stricter regulation, are again, a mere eight years after the crisis, going to be treated as low risk assets by European regulators, if it is up to the European Commission. So as to ensure that banks can again kick-start their securitization desks and can "roll over" the large wall of securitization; that asset managers and insurers can reap a bit of yield over and above sovereign bonds in the current low-yield environment; that the regulator can be sure that banks in time have access to independent

\(^5\) Which closely resembles and explicitly builds forth upon national initiatives to standardize RMBSs prospectusses, such as the one of the Dutch Securitization Association (DSA) described above
sources of funding; and that the ECB can gradually move to a more normal monetary universe without having to consider the consequences for bank funding. Add a conjuncture in which the policy instruments to aid the slow recovery in the eurozone have either become blunt (QE) or have been declared politically off limits (fiscal stimuli), and the conclusion should be that we are facing here an almost perfect instance of a "garbage can model of political decision making". It is a perfect illustration of how a "problem" becomes a "solution" if one is able to make lawmakers wait long enough.

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Figure 1. Total stock of securitizations in Europa ultimo 2008, in billion €

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<th>Country</th>
<th>ABS</th>
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<th>CMBS</th>
<th>RMBS</th>
<th>WB</th>
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Figure 2. Default rates on securitized assets, EU versus US, 2001-2009

Source: European Banking Authority, 2014: 12
Figure 3: Total Dutch securitization reaching maturity in euro, as per Q4 2010
(only publicly quoted triple A tranches)

Source: Bloomberg