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The origins of securitisation in Europe

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1. Introduction

Modern securitisation techniques can trace their origins back to the government-sponsored mortgage market initiatives put in place by the US Government in the 1970s. Government support for homeowners had been a consistent policy of the US Government since the 1930s, when the Federal Housing Administration (FHA) was created to provide mortgage guarantee insurance for long-term mortgages following the Great Depression. The US Government subsequently created the Federal National Mortgage Association (better known as 'Fannie Mae') in 1938, primarily to purchase residential mortgages from lenders as a means of increasing market liquidity. As such, the mortgage market had been primed for transition into a mortgage securities market for more than three decades. By 1970, the US Government had chartered specific institutions to facilitate a strong secondary market for the purchase of loan portfolios from mortgage originators (in the form of Fannie Mae and the Federal Home Loan Mortgage Corporation, also known as 'Freddie Mac') and a government-guaranteed programme for the issuance of mortgage-backed securities which were themselves backed by government-insured assets (in the form of the Government National Mortgage Association, also known as 'Ginnie Mae').[1]

As mounting demand for residential mortgages grew throughout Europe in the 1980s, the European banking community was faced with the challenge of meeting market demand while managing balance sheet risk. Up to this point, a US-style mortgage funding model was generally curtailed in Europe as a result of specific challenges such as the constraints of the civil law framework and a hesitance to move away from the traditional, on-balance sheet lending model adopted by the majority of European banks and building societies. Whilst it was true that Europe could point to iterations of a mortgage securities market in certain jurisdictions (for example the Danish

1 For a general overview of Ginnie Mae, Fanny Mae and Freddie Mac, see the Securities Industry and Financial Markets Association, "Federal Agency and Government Sponsored Entities", in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*. Available at: www.sifma.org/resources/general/tba-market-governance/.

mortgage finance market[2] and the German *Pfandbrief* market),[3] a truly comprehensive mortgage securities market as an effective funding tool across the continent remained an ambition to be realised.

2. The United Kingdom: setting the pace on asset-backed security (ABS)

The appetite for off-balance sheet funding was recognised by the then deputy governor of the Bank of England, Sir George Blunden, in 1985, when he identified a number of factors that the bank expected would "encourage the redirection of funds through securities markets rather than across the balance sheet of banks".[4] These included:

- improved credit rating of borrowers, leading to greater use of the bond market;
- greater capital flows between industrialised countries;
- growing investor appetite for securities compared to bank deposits;
- financial market innovation, such as the role of interest rate swaps and note issuance;
- facility to create bespoke solutions for investors while offering flexibility to borrowers; and
- reduced profitability on traditional bank lending and increased pressure on capital ratios.[5]

That said, the Bank of England had concerns around a shift into securitisation as a funding tool without proper understanding of the product. For instance, wholly non-recourse transactions were still undergoing considerable legal refinement and questions remained around the true allocation of credit risk in a relatively untested market. Perhaps for these reasons, the United Kingdom's approach to the residential mortgage-backed securities (RMBS) market was one of considerable caution throughout the mid-1980s. In terms of early movement, whilst there are reports of RMBS transactions occurring in the United Kingdom as early as 1985,[6] there is some

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2 For an overview of the Danish mortgage finance system, see Jesper Berg, Morten Baekmand Nielsen and James Vickery, "Peas in a pod? Comparing the U.S. and Danish Mortgage Finance Systems", *Federal Reserve Bank of New York Economic Policy Review*, vol 24, no 3, December 2018. Available at: www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_us-danish-mortgage-finance_ berg.pdf.

3 For an overview of the *Pfandbrief* market and its interaction with securitisation, see Andrew Jobst and John Kiff, "Germany: Technical Note on the Future of German Mortgage-Backed Covered Bond (PFandBrief) and Securitization Markets", *IMF Country Report*, no 11/369, December 2011. Available at: www.google.co.uk/books/edition/Germany/_1AZEAAAQBAJ?hl=en&gbpv=1&dq=Pfandbrief+book&pg=PA6&printsec.

4 George Blunden, "Change and Development in International Financial Markets", *Bank of England Quarterly Bulletin*, Q3 1985, 1 September 1985. Available at: www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/1985/change-and-development-in-international-financial-markets.pdf?la=en&hash=FA89196E02C2ACE2EDF7665FDCEA9FD1EC21AF28.

5 *Ibid.*

6 For example, see Ian Twinn, "Asset-backed securitisation in the United Kingdom", *Bank of England Quarterly Bulletin*, Q2 1994, 1 June 1994. Available at: www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/1994/asset-backed-securitisation-in-the-uk.PDF.

consensus that the first RMBS transaction came to market in the United Kingdom in 1987, issued by the National Home Loans Corporation, with a transaction value of £50 million.[7] Banks did not enter the market until 1989 when a subsidiary of TSB Bank issued an RMBS in an amount of £135 million.[8] Overall ABS volumes did, however, increase in this period and over the next number of years – by December 1993, there had been 94 ABS issuances with an aggregate principal value of £16 billion.[9]

The initial upsurge in activity was in no small part driven by the introduction of the centralised lender into the United Kingdom mortgage market, essentially an intermediary mortgage lender that funded itself through the securities markets. Key players driving market growth at the time included National Home Loans Corporation (now Paragon Finance), Household Mortgage Corporation, and The Mortgage Corporation (a Salomon Brothers subsidiary).[10] The gradual deregulation of building societies throughout the 1980s also played a key part in early growth, firstly by giving building societies access to the wholesale funding markets and secondly by enabling building societies to both purchase and hold mortgage-backed securities. This increased risk in supply dovetailed with a stark increase in demand for mortgages as a result of the Housing Act 1980 in England and Wales and the Housing Tenants Rights Etc (Scotland) Act 1980, which created a statutory right to buy, at fixed rates of discount, in respect of almost all properties where the landlord was a council or other public sector body, including a legal right to a mortgage.[11] What ensued was a marked increase in net mortgage lending throughout that period, with house prices increasing as much as 22% in 1988.[12]

Despite early momentum, total UK RMBS issuance in the first eight years represented only a very small proportion of total originated mortgages in the same period. The view of Nigel Batley, former global head of securitisation at HSBC, was that banks were still very risk averse to asset-backed securities in the early stages, choosing to work only with trusted originators with whom they had a longstanding relationship:

> *The bank would tend to do transactions only with top-quality originators or top-quality assets, originated by companies that we had known for a long time. We took the view that it was a better way of lending money to a business and we used*

7 See Alex Bowen, Glenn Hoggarth and Darren Pain, "The recent evolution of the UK banking industry and some implications for financial stability", *BIS Conference Papers*, vol 7, March 1999. Available at: www.bis.org/publ/confp07l.pdf.

8 *Ibid.*

9 See Ian Twinn, "Asset-backed securitisation", *supra* note 6.

10 See Mark Boleat, "The 1985–1993 Housing Market in the United Kingdom: An Overview", *Housing Policy Debate*, vol 5, issue 3, 1994. Available at: www.boleat.com/materials/the_1985_93_housing_market_in_the_uk_1994.pdf.

11 See "The Right to Buy in the UK 1980–2005", in Colin Jones and Alan Murie, *The Right to Buy*, Wiley-Blackwell, 2008, p34.

12 *Ibid.*

to consider [the ABS investment] as part of the originator's exposure, even though technically it was not.[13]

Another notable activity at the time which may have detracted from ABS market growth was the origination and servicing of UK residential mortgages by UK building societies on behalf of foreign financial institutions, which was a further feature of deregulation of building societies throughout the 1980s. Owing to the relatively thin liquidity in the early MBS market, some foreign investors preferred this model, already a well-trodden path with predictable results, supported by the mortgage servicing functions of UK building societies. This option was attractive to French and Dutch banks as well as US lenders such as Chemical Bank, which itself entered the market directly before being taken over by BNP Paribas and, later, Halifax.

Commercial property was also experiencing strong financial performance throughout the 1980s, owing in part to a robust rental market as vacancy rates continued to decline.[14] A relaxation of planning constraints in London also allowed for an increase in development activity, which attracted a new wave of international investment through the securities markets.[15] Goldman Sachs arranged the first securitised property financing on a single investment property, Montagu House, in 1986 for Billingsgate City Securities Plc in an amount of £35.5 million. The next four years saw seven further single-property securitised issuances, with a general upward trend in transaction size, the biggest being the £150 million issuance backed by One Finsbury Circus in 1990, arranged by Salomon Brothers.[16]

Commercial property markets soon began to suffer, however, as a result of a steep rise in interest rates and falling demand due to a now oversupply of London office space following the construction boom in the mid- to late 1980s.[17] Recessionary conditions also naturally impacted the residential mortgage market, and much of the momentum built by centralised lenders in the residential mortgage securities market through the late 1980s had come to an abrupt halt by 1992. Fortunately, around the same time the United Kingdom was seeing the introduction of other asset classes into the ABS market, such as auto loans and credit cards. Collateralised loan obligations (CLOs) also emerged by the mid-1990s, the first major CLO transaction in Europe being the $5 billion R.O.S.E. Funding No 1 Ltd transaction sponsored by National Westminster Bank Plc in November 1996.[18]

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13 Nigel Batley, in (virtual) interview with the authors, 2 February 2003.

14 See Nigel King, "Securitisation of UK Real Estate", in Zoe Shaw, *International Securitisation. The scope, development and future outlook for asset-backed finance*, Palgrave Macmillan, 1991, p109.

15 *Ibid*.

16 *Ibid*, at pp117, 123.

17 See "The Market – and who makes it", in Andrew Baum, *Commercial Real Estate Investment*, EG Books, 2009, p70.

18 See Warrick Ward and Simon Wolfe, "Asset-backed securitization, collateralized loan obligations and credit derivatives", in Andrew Mullineux and Victor Murinde (eds), *Handbook of International Banking*, Edward Elgar Publishing, 2003, p67.

The United Kingdom's first auto loan ABS completed in July 1990 in the form of the Cardiff Automobile Receivables Securitisation (CARS).[19] Auto loan ABS transactions continued to provide early diversification for the UK ABS market until credit card ABS was introduced to the United Kingdom in 1995 through the Chester Asset Receivables Dealings (CARDS) No 1 transaction, issued by MBNA EBL.[20] Credit card ABS would prove to be particularly buoyant in the United Kingdom and in Europe over the next seven years. By 2002, the number of European credit card ABS transactions that were backed by sterling-denominated credit card receivables had grown to almost €15 billion.[21]

A notable characteristic from a legal perspective brought about by the inception of credit card ABS was the introduction of the master trust structure. At the outset, the complexity of the master trust technology created much debate amongst lawyers and structuring banks; however, through collective effort, significant synergies were created as the master trust facilitated multiple issuances of securities from a single trust and collateral pool. The master trust structure was particularly suited to the credit card ABS market, which was built on repeat issuances. For instance, MBNA EBL closed 12 issuances from the same master trust between 1995 and 2002, amounting to over €5 billion in original deal value.[22]

Further advancement of the UK ABS market came in 1997 with the introduction of whole business securitisation, or WBS. WBS can be distinguished from many other classes of ABS, as the underlying security comprises general cash-generating assets of a company or borrower, as opposed to a portfolio of receivables. As such, WBS does not involve a true sale of assets and for this reason has been compared to corporate financing or other forms of direct lending. There are certain key differences, however, between WBS and corporate lending, such as the potential for more flexible commercial terms under WBS and the isolation or ring-fencing of certain cash-generating assets (to the maximum extent possible) for the purposes of repayment of the WBS. Due to this strong reliance on cash and cash-generating assets, WBS became suited only to a small number of sectors, in particular the pub sector, which is touched on below.

The first WBS, in 1997, was the Welcome Break transaction – a securitisation of 21 motorway service stations with an original deal value of £321 million.[23] Other sectors followed in the next five years, such as media (Formula One),

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19 See Jonathan E Keighley, "Securitisation of Automobile Receivables: The Experience of CARS (UK)", in Zoe Shaw, *International Securitisation*, *supra*, p85.

20 See Markus Niemeier, "European Credit Card ABS", in Frank J Fabozzi and Moorad Choudhry, *The handbook of European structured financial products*, Wiley, 2004, p180.

21 *Ibid.*

22 *Ibid.*

23 See "Whole Business Securitisation", in John Deacon, *Global Securitisation and CDOs*, Wiley Finance, 2004, p188, section 8.6.

healthcare (Craegmoor Funding) and water services (Sutton & East Surrey Water, Glas Cymru, Anglian Water), but it was the pub sector that enjoyed particular success using the WBS method due, among other things, to their strong cashflow position, stable asset value through real estate and the mature market in which vendors operate.[24] The pub sector saw no less than 15 WBS transactions come to market from 1998 to 2003, with an aggregate deal value of over £6.5 billion, starting with the Wellington Pub Company and followed soon after by Punch Taverns, Unique and Pubmaster. Punch Funding II would bring what was by far the largest pub WBS to market in June 2000, with a deal value of close to £1.5 billion.[25]

While WBS transactions have continued for certain sectors such as leisure (Centre Parcs, Mitchells & Butlers) and water services (Affinity Water), the product itself faces consistent challenges for borrowers through extensive levels of control via financial and performance covenants, as compared to secured lending and other alternative financing models such as high yield bonds, a market that has developed significantly in Europe since the inception of WBS and has been utilised by borrowers to refinance existing WBS debt, such as in the case of Punch Taverns. The barrier to entry also remains high for WBS, making it an unrealistic option for many businesses and sectors without strong, predictable cash flows and robust collateral.

3. Development of the wider European market

Turning to the wider European securitisation market, a significant stumbling block at the outset was the constraints of the civil law framework, which presented impediments to the legal and financial techniques required to efficiently implement a securitisation transaction. As a result, unless a path could be forged through relevant civil codes and existing legislation, a statutory framework was required in each country in order to accommodate the proper functioning of the market. As late as the early 2000s, the IMF were still citing ambiguities in legal framework as one of the principal reasons for slow growth in some European securitisation markets.[26]

One of the early movers in respect of legislative transformation was France, which developed an ABS market with its enactment of the Securitisation Law of December 1988. The law was designed to legislate for some of the specific issues facing the securitisation structure in France, such as bankruptcy remoteness and basic tax inefficiencies. This led to the first securitisation coming to the market in January 1990 (a personal loan-backed issuance arranged by Credit Lyonnais)

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24 See Michael Cox, "Pub securitisation: What next?", *Journal of Retail and Leisure Property*, vol 3, no 2, 19 August 2003, pp130–141. Available at: https://link.springer.com/content/pdf/10.1057/palgrave.rlp.5090170.pdf.

25 *Ibid*, p131.

26 See Agnes Belaisch, Laura Kodres, Joaquim Levy and Anel Ubide, "Euro-Area Banking at the Crossroads", *IMF Working Paper* 01/28, March 2001, p25.

and steady growth through the 1990s, such that in 1996 the French securitisation market had outstanding balances of FFR85 billion (US$14.3 billion).[27] The Securitisation Law would stand for more than 15 years, until further accommodations were introduced by the Ordinance of 13 June 2008 which provided for, among other things, greater optionality in the legal establishment of securitisation vehicles.

The French example took some time to radiate across the rest of Europe, however, even in jurisdictions that lead today's European ABS market. In Italy, for example, the first dedicated securitisation law was not issued until 1999 when 'Law 130' was introduced. Before 1999, securitisation could be effected in Italy only through certain specific legislative acts that were designed to ease burdensome notification requirements under the Italian Civil Code in order for receivables to be removed from a transferor's insolvency estate.[28] The introduction of Law 130 not only dealt with notification requirements, but provided a solution to many outstanding issues that were not yet addressed under piecemeal provisions, such as transfer tax and share capital requirements.[29] Modernisation of securitisation in Italy also became much easier post-1999, as a single piece of legislation could be subject to updates, as has occurred on a number of occasions since 1999, in order to facilitate the specific challenges of a growing, dynamic market. Law 130 paved the way for rapid growth of the securitisation market in Italy, which reached €85 billion by 2004, making it at the time the second highest issuer of ABS in Europe behind the United Kingdom.[30]

A similar story played out in the case of the Netherlands. Despite having an active ABS market for more than 20 years, it took until 2007 to implement a comprehensive single legislative framework to support the country's expanding securitisation market in the form of the Act on Financial Supervision, before which securitisation transactions relied on a number of pieces of legislation enacted through the 1990s and designed to accommodate securitisations within the structure of the Dutch Civil Code. In all, the 2007 Act on Financial Supervision replaced seven other pieces of legislation, which gives an indication of the fragmented way in which a number of European jurisdictions came to realise the potential of securitisation, before adoption of a comprehensive legal framework.

Despite the relatively slow and fragmented uptake of securitisation in many European jurisdictions, growth in the product was consistently strong from the early to mid-1990s through to 2006, with placed issuances reaching €460

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27 See Patrick Van den Eynde, "Securitisation in Europe: Overview and Recent Developments", in Frank J Fabozzi (ed), *Handbook of Structured Financial Products*, Frank J Fabozzi Associates, 1998, p13.

28 See "Global Securitisation Markets", in John Deacon, *Global Secuitisation and CDOs*, *supra*, p316, section 12.24.

29 *Ibid.*

30 See "Italy: Financial System Stability Assessment", *IMF Country Report No 06/112*, March 2006, p19.

billion.[31] This figure fell, however, to just €25 billion in 2009 as the onset of the global financial crisis had a lasting impact on the ABS industry across Europe. The vast majority of issuances for the next number of years post-2008 would be wholly retained issuances, to be utilised as eligible collateral for Eurosystem liquidity purposes.

The global financial crisis was also the catalyst for major market reform, including supervisory techniques that are still being refined at the time of writing, culminating most notably in the Basel III reforms (including Basel IV, also known as 'Basel 3.1') and the European Securitisation Regulation of 2018. At a national level, certain European governments have implemented specific credit support schemes in order to combat high levels of non-performing loans (NPLs) on bank balance sheets. In Italy, the Fondo di Garanzia sulla Cartolarizzazione delle Sofferenze (GACS) scheme was introduced in 2016, whereby the government would guarantee the most senior tranche of an NPL securitisation, contingent on certain characteristics being attributed to the transaction such as an investment-grade rating on the most senior tranche and the sale to private investors of a material portion of the more junior tranches.[32] A similar system was introduced in Greece in 2019 (the Hercules Asset Protection Scheme (HAPS)) which arguably included greater flexibility than the GACS scheme, particularly around certain commercial terms such as minimum ratings. Such schemes have proven to be successful, with NPL ratios in significant institutions in Italy more than halving from above 10% in 2017 to below 5% in 2020, with continued reductions into 2022. NPL ratios reduced in significant Greek institutions from 45% in 2017 to around 25% in 2020, with further reductions at the time of writing as banks continue to reduce NPL exposures through the securities markets.[33]

Market perception has proven to be a challenge for the ABS market following the global financial crisis and the intense regulatory scrutiny that followed; however, the view from the inside remains that the global importance of ABS as a funding tool cannot be overstated. Nigel Batley has aptly summarised this sentiment:

> *Securitisation allows originators to obtain greater leverage than they could otherwise obtain from their balance sheets and the underlying assets have historically performed amazingly well. It has probably become the single most important product that banks can participate in, either through providing funding*

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31 Hans J Blommestein, Ahmet Keskinler and Carrick Lucas, "Outlook for the Securitisation Market", *OECD Journal: Financial Market Trends*, issue 1, 2011, p4.

32 See Ismael Alexander Boudiaf and Fernando Gonzalez, "An empirical study of securitisations of non-performing loans", *ECB Occasional Paper Series No 292*, May 2022, p7. Available at: www.ecb.europa.eu/pub/pdf/scpops/ecb.op292~092b778aa8.en.pdf.

33 *Ibid*, p5. See, for example, the recent acquisition by Waterwheel Capital of junior notes in the Project Mexico securitisation by Eurobank, which qualified for HAPS and allowed Eurobank to halve its NPL exposure: www.mayerbrown.com/en/news/2022/01/mayer-brown-advises-waterwheel-capital-on-3-2-billion-euros-investment-in-project-mexico-haps.

> *through conduits for those businesses that are of the right size or through warehouses for those businesses that will eventually go into the term ABS markets. The securitisation market provides that capacity*.[34]

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www.globelawandbusiness.com/books/european-securitisation

34 Nigel Batley, in interview with the authors, *supra*.