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OPINION

Brexit: Time to Revisit UK Regulation of Term Securitisation

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Brexit; Economic conditions; EU law; Securitisation

Abstract

The post-crisis EU regulatory framework for term securitisation is based on the false premise that securitisation is dangerous. EU regulation impedes investment in this strong credit and distorts the markets. In the event of a hard Brexit, Parliament should abandon the EU framework in favour of an honest, evidence-based approach to regulation.

On 19 December 2018, HM Treasury published its draft Securitisation (Amendment) (EU Exit) Regulations 2019,[1] intended "to ensure that the new securitisation regime continues to operate effectively in a UK context once the UK leaves the EU".[2] This, like its companion statutory instruments, is "not intended to make policy changes, other than those necessary to reflect the UK's new position outside the EU, and to smooth the transition to this situation".[3] When the Brexit dust settles, however, policy changes regarding the UK regulation of term securitisation should be a priority for HM Treasury and Parliament. That is because one of the great anomalies in the post-financial crisis regulatory edifice is the EU regulation of term securitisation, which will be carried over—at least in the short term—into UK domestic law.

Term securitisation—stripped of jargon and detail—involves the issuance of over-collateralised bonds. The bonds are backed by the credit of a segregated pool of financial collateral, not the credit of an operating company. Thus, an AAA-rated residential mortgage-backed security, or RMBS, with a principal amount of 80 might be collateralised by residential mortgages with a principal value of 100. The modern European term securitisation market began in the mid-1980s, peaked in 2006 when placed issuance reached €481 billion[4] and has provided funding for residential mortgages, car loans, corporate loans and other financial needs.

If term securitisation—and, to be clear, we are not talking about collateralised debt obligations (CDOs), collateralised bond obligations (CBOs), structured investment vehicles (SIVs) and other structured vehicles—is as simple and as useful as it sounds, it is also as safe as it sounds. Over the course of the worst financial crisis in modern history, credit losses on rated European term securitisation paper were nil.[5] The price of term securitisation paper fell dramatically in the 2007–08 market rout but the credit held.

It is important to note that term securitisation as a specific financing technique was virtually unregulated at the EU level prior to and during the financial crisis. With minor exceptions, it was treated, from an EU regulatory perspective, no differently than project finance, asset-based lending or high-yield debt. Indeed, special securitisation legislation enacted since the late 1980s in a number of EU Member States had as its primary purpose the removal of local law impediments to securitisation.

On those simple facts, one might have thought European term securitisation had earned its stripes during the financial crisis. One could not have been more wrong. Since 2009, dozens of EU directives, regulations and regulatory technical standards now govern how European securitisation transactions are structured and how risks are transferred or retained. Beyond existing prospectus and continuous disclosure requirements, detailed new rules govern extensive disclosure regarding the financial collateral and the structure.[6] They stipulate what due diligence and monitoring EU-regulated institutions must undertake before taking and while holding an exposure

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[1] See HM Treasury, *Draft Securitisation (Amendment) (EU Exit) Regulations 2019* (2018) available at: *https://www.gov.uk/government/publications/draft-securitisation-amendment-eu-exit-regulations-2019* [Accessed 4 February 2019].

[2] See HM Treasury, *Draft Securitisation (Amendment) (EU Exit) Regulations 2019* (2018).

[3] See HM Treasury, *Financial services legislation under the EU (Withdrawal) Act 2018* (2018) available at: *https://www.gov.uk/government/collections/financial-services-legislation-under-the-eu-withdrawal-act* [Accessed 4 February 2019].

[4] See Association for Financial Markets in Europe (AFME), *Securitisation Data Report: European Structured Finance: Q4: 2015* (2015) available at: *https://www.afme.eu/globalassets/downloads/data/securitisation/2015/afme-stn-securitisation-data-report-q4-2015-v2.pdf* [Accessed 4 February 2019].

[5] See "Securitisation can be a sturdy ally for investors", *Financial Times*, 15 August 2017.

[6] Regulation 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65, 2009/138 and 2011/61 and Regulations 1060/2009 and 648/2012 [2017] OJ L347/35 art.7.

to a securitisation—whether as an investor, a swap provider, a liquidity provider or otherwise.[7] Banks investing in securitisation paper suffer penalty haircuts if they use that paper to meet their liquidity coverage ratios requirements.[8] Insurance companies are all but prohibited, by punitive spread risk factors, from investing in this asset class (being an asset class that, to repeat, suffered no credit losses on rated paper during the last financial crisis).[9]

It gets worse. A new set of requirements for "simple, transparent and standardised" (STS) securitisation came into force on 1 January 2019.[10] It has been estimated that about 80 of more than 100 conditions must be satisfied on any deal before the "STS" label, with its less unfavourable regulatory capital risk weightings, can be used.[11] The conditions are all or nothing: compliance with, say, 79 out of 80 applicable conditions means the STS label will not be available and the regulatory capital cost will jump. Depending on the method used, the risk weighting for non-STS securitisation exposures could be double that of STS exposures.[12] For insurance companies, the "spread risk" for a three-year AAA-rated exposure will be 3% if it bears the STS kitemark and 37.5% if it does not.[13] So if, for example, the financial collateral includes more than one asset type, the securitisation cannot be STS.[14] If proper disclosure is not made in relation to the environmental performance of certain classes of assets, the securitisation cannot be STS.[15] And if those 80-plus conditions are not all met for a term securitisation, the logical inference must be that the transaction is complex, opaque or unusual—or maybe all three.

Quite apart from the detailed, prescriptive and punitive nature of these regulations, the EU securitisation regulatory regime is dynamic: it is continually being reviewed, amended and expanded. Thus, the credit rating agencies regulation of 2009[16] was amended in 2011,[17] amended again in 2013[18] and further amended on 1 January 2019.[19] These have not been minor or inconsequential amendments. And the regulatory refinement, so to speak, of EU securitisation regulations can take time. In 2009, the Banking Consolidation Directive was amended to prevent banks from investing in securitisation paper unless the originator, sponsor or original lender retained a "material net economic interest" in the securitisation of at least 5%.[20] Only in August 2018—some nine years later—did the European Banking Authority (EBA) publish final draft requirements for calculations to determine a net 5% economic interest[21] (and there is now a positive requirement that the originator, sponsor or original lender of a securitisation retain a net 5% economic interest).[22]

It is fair to say that the EU regulatory approach to term securitisation has been based on a false premise; namely, that securitisation generally is dangerous and in need of special, tight regulatory constraints. The evidence—nil credit losses on rated European term securitisation paper during the financial crisis—belies that.

The European term securitisation market has not fared well in the years following the financial crisis. Placed securitisation issuance in the EU dropped to €24.8 billion in 2009.[23] By 2017, 10 years after the market rout began, placed in Europe issuance had still not reached 25% of its 2006 peak of €481 billion.[24] Placed issuance in the US securitisation market, by contrast, reached USD 2.4 trillion in 2016, being 140% of its 2008 level.[25] This raises two questions: first, why has the European term securitisation market failed to recover and, secondly, should we care?

As to the failure of the European market to recover, there are several factors: general investor wariness in the aftermath of large-scale fraud in the US securitisation markets, the availability to European banks of subsidised central bank funding and the disappearance of SIVs and CDOs (both structured bond arbitrage vehicles), which were large purchasers of European securitisation paper. Another factor, arguably the most important, is the EU

[7] Regulation 2017/2402 art.5(1), (3).
[8] Regulation 2015/61 to supplement Regulation 575/2013 with regard to liquidity coverage requirement for Credit Institutions [2015] OJ L11/1 arts 10–13.
[9] *Revised calibrations for securitisation investments by insurance and reinsurance undertakings under Solvency II* (2018)2037113.
[10] Regulation 2017/2402 arts 18–24, 27–30 and Regulation 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation 648/2012 [2013] OJ L176/1 (as amended by Regulation 2017/2401 amending Regulation 575/2013 on prudential requirements for credit institutions and investment firms [2017] OJ L347/1) arts 242–3, 260, 262, 264.
[11] Ian Bell, PCS Secretariat, quoted in "(I can't get no) STS-faction", *SCI Magazine*, Summer 2018 available at: *https://www.structuredcreditinvestor.com/SCI_Magazine summer.asp* [Accessed 4 February 2019].
[12] Regulation 575/2013 (as amended by Regulation 2017/2401) art.263(3), Table 2, art.264(3), Table 4.
[13] *Revised calibrations for securitisation investments by insurance and reinsurance undertakings under Solvency II* (2018)2037113.
[14] Regulation 2017/2402 art.20(8).
[15] Regulation 2017/2402 art.22(4).
[16] Regulation 1060/2009 on credit rating agencies [2009] OJ L302/1.
[17] Regulation 513/2011 amending Regulation 1060/2009 on credit rating agencies [2011] OJ L145/30.
[18] Regulation 462/2013 amending Regulation 1060/2009 on credit rating agencies [2013] OJ L146/1.
[19] Regulation 2017/2402 art.40.
[20] Directive 2009/111 amending Directives 2006/48, 2006/49 and 2007/64 as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management [2009] OJ L302/97.
[21] European Banking Authority (EBA), "EBA Final Draft Regulatory Technical Standards", EBA/RTS/2018/01 (2018).
[22] Regulation 2017/2402 art.6(1).
[23] See AFME, *Securitisation Data Report: Q4: 2009* (2017) available at: *http://www.sifma.org/wp-content/uploads/2017/05/afme-esf-securitisation-data-report-2009-q4 .pdf* [Accessed 4 February 2019].
[24] See AFME, *Securitisation Data Report: European Structured Finance: Q4: 2017* (2018) available at: *https://www.sifma.org/wp-content/uploads/2018/03/Europe -Securitisation-Quarterly-2018-03-27-AFME-SIFMA.pdf* [Accessed 4 February 2019].
[25] See Securities Industry and Financial Markets Association (SIFMA), *US Securitization: First Half 2017* (2017) available at: *https://www.sifma.org/wp-content/uploads /2017/11/US-Securitization-First-Half-2017-11-01-SIFMA.pdf* [Accessed 4 February 2019].

regulatory approach, driven by its false premise, with its overly prescriptive rules and continually changing requirements.

Should we care? Yes, for two reasons. First, the proposition that securitisation is important to fund the UK economy is virtually a given, per the Bank of England and HM Treasury.[26] The European Commission also accepts that securitisation is important to provide funding for the European economy.[27] Secondly, the barriers set up by the EU regulatory approach to European securitisation necessarily divert investment in fixed income securities away from securitisation paper. That money finds a home elsewhere and, theoretically, the increased demand exerts downward pressure on the price of other credits. A regulatory framework that is based on a false premise and impedes investment in a strong credit must result in a distortion of the credit markets, which bodes ill for the next financial crisis.

This leads to the next question: what should Parliament do about term securitisation if we do not strike a deal with the EU that obliges us to retain the EU securitisation regulatory edifice (the "EU securitisation *acquis*"). The interesting starting point is that, legally, whether or not Parliament retains the EU securitisation *acquis* makes virtually no difference to the ability of arrangers to place UK securitisation paper with EU-regulated institutions. That is because the EU rules governing securitisation can be complied with by UK originators, arrangers and issuers regardless of whether these parties are actually obliged to do so under UK law. To be sure, there will be post-Brexit difficulties for these UK parties (mainly, no eligibility for STS treatment or LCR for EU-regulated investors) but these difficulties arise by virtue of the UK becoming a "third country".[28] As will other post-Brexit difficulties unrelated to the EU securitisation *acquis*, such as loss of passporting rights for UK arrangers and swap counterparties under MiFID II.[29] The inescapable conclusion is that retention by Parliament of the EU securitisation *acquis*, as it relates to term securitisation, is unnecessary both as a practical matter (there were no credit losses on rated European term securitisation paper during the financial crisis) and as a legal matter (enactment of the EU securitisation *acquis* gives UK market participants nothing and a failure to enact it takes away nothing).

This in turn leads to the final question. If the EU securitisation *acquis* is based on a false premise, if it has impeded the recovery of an important source of funding for the UK economy, if it is unnecessary, if it arguably distorts the pricing of credit and if its retention by Parliament does not help UK market participants, then why not abandon it?

Abandonment of the EU securitisation *acquis* would not necessarily entail a legislative vacuum. Just because the EU securitisation *acquis* was not necessary to protect investors from term securitisation exposures during the financial crisis does not mean that, as modern City folk might say, "things haven't moved on". What a sensible regulatory framework should look like is another interesting exercise. The starting principles, however, should be: (1) non-discriminatory treatment of term securitisation as a financing technique; (2) revisiting and possibly amplifying the ordinary prospectus and continuing disclosure requirements for term securitisation to take into account changed investor expectations; and (3) purposeful implementation of post-financial crisis international norms. As to the last principle, some of the EU securitisation *acquis* is derived from G20 and Basel Committee of Banking Supervision (BCBS) principles. Even if some of those principles are ill-founded, they can be implemented purposefully and creatively (e.g. the retention of risk retirement comes from the G20 but no percentage was stipulated: the UK could lower it). Above all, it is incumbent on Parliament to take an honest, evidence-based approach to the regulation of term securitisation. And an honest appreciation of the evidence precludes continuing with the EU securitisation *acquis*.

[26] HM Treasury Press Release, "Funding for Lending Scheme: Bank of England and HM Treasury announce extension" (2 December 2014) available at: *https://www.gov.uk/government/news/funding-for-lending-scheme-bank-of-england-and-hm-treasury-announce-extension* [Accessed 21 February 2019].
[27] EC Press Release, "Capital Markets Union: An Action Plan to boost business funding and investment financing", IP/15/5731 (30 September 2015).
[28] Regulation 2017/2402 art.18 and Draft Delegated Act amending the Commission Delegated Regulation on the Liquidity Coverage Ratio (LCR) (2018)418078 art.1(8).
[29] Regulation 2014/65 on markets in financial instruments and amending Directive 2002/92 and Directive 2011/61 [2014] OJ L173/496 art.34.