UK regulation of term securitization following a hard Brexit

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Key points

- EU regulation of securitization was virtually non-existent prior to and during the 2007–2008 financial crisis yet European ABS credit losses were almost nil.
- Post-crisis EU regulation of securitization (the EU securitization acquis) is extensive and continually changing and, given the performance of 'unregulated' European ABS during the financial crisis, unnecessary.
- Except for STS and LCR ineligibility, impediments to UK-EU cross-border term securitization following a hard Brexit arise under EU financial regulation of general application and not under the EU securitization acquis.
- Equivalence regimes under relevant EU regulation do not offer a reasonable solution to those impediments.
- Whether or not Parliament enacts the EU securitization *acquis* will make virtually no difference to the ability to place UK ABS with European investors or the ability of UK counterparties to play a role in European term securitization transactions.
- Parliament should decline to enact the EU securitization *acquis* and instead adopt a principled approach of non-discriminatory treatment of securitization as a financing technique subject to appropriate disclosure requirements and purposeful implementation of international norms.
- The substantial de-regulation of UK term securitization as a discrete financing technique will result in greater scope for innovation, increased funding capacity for the UK economy and greater liquidity in the UK credit markets.

1. Introduction

The myriad asset classes and structures comprising the modern term securitization market (as opposed to bank-sponsored asset-backed commercial paper conduits) are all more or less complex variations on one theme: overcollateralized bonds. The bonds are typically issued on the credit of a segregated pool of financial collateral, not the credit of an operating company. Even though securitization documentation is more complex than that found in a typical corporate bond issue, securitization transactions are simpler and, arguably, more 'scientific' credits. That is because the underlying credit analysis is based on the aggregation of many small, broadly homogeneous credits or pools of credits that lend themselves to a quantitative credit analysis. The bonds usually are issued in tranches

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of different priorities, with the most senior tranche typically assigned a top, or AAA/Aaa, credit rating. Thus, a top-rated residential mortgage-backed security, or RMBS, with a face value of, say, 80 might be collateralized by residential mortgages with a principal value of 100. The structuring exercise makes possible funding at rates and maturities not otherwise obtainable in the fixed income market. For convenience, the rubric ABS, or asset-backed securities will also be taken to include RMBS and commercial mortgage backed securities, or CMBS.[1]

Securitization structuring techniques have been used to develop an alphabet soup of other structures, most notably CBOs (collateralized bond obligation—vehicles that issue investment grade and other bonds collateralized by a portfolio of speculative grade bonds), CDOs (collateralized debt obligations—vehicles that repackage and reallocate credit and liquidity risks of portfolios of bonds to suit different investor appetites for credit and tenor), CDO^2s (being CDOs of CDOs), CDO^3s (being CDOs of CDO^2s) and SIVs (structured investment vehicle—vehicles which enable investors to make leveraged investments in rated bonds while arbitraging credit and tenor). The collateral in such structures has typically comprised ABS so they are now styled 'resecuritizations' in post-crisis regulatory parlance. By including ABS in the collateral pools, complexity was compounded, transparency suffered and the investors in a CDO could not be confident that underlying collateral did not include, say, US sub-prime RMBS (still less in the case of a CDO^2 or CDO^3).

Increasing concerns about US sub-prime mortgage fraud sparked a sell-off in mid-2007, initially by US money market fund investors, not only of US sub-prime RMBS but also of CBO, CDO and SIV paper which investors feared might be backed by US sub-prime RMBS. The ensuing liquidity crisis forced those vehicles to sell off their underlying assets, including all categories of ABS, to repay their maturing liabilities. That rout in turn depressed prices of virtually all ABS including top-rated ABS. In the European market, substantial market losses were realized or (with a nod to IAS 39) booked by banks and other institutional investors. Those losses did not, with comparatively rare exceptions, comprise credit losses on ABS. Nonetheless, global securitization, and not just US sub-prime RMBS (and the CBOs, CDOs and SIVs in which it might have lurked), fell into bad odour.

The EU regulatory response to the financial crisis, particularly in relation to securitization, has been vigorous. The summary of that regulatory response found in this article can scarcely hint at the volume, pace and detail of the successive waves of EU regulation of securitization. EU securitization rules continue to be amended and supplemented more than 10 years after the onset of the financial crisis. The EU regulatory burden has been a significant factor in stifling the recovery of the European securitization markets.

This article will first set out two working premises and three factual observations. There will follow a sketch of the relevant EU regulation and re-regulation of

1 For a general introduction to UK securitization, see Marke Raines and Fanny Lau, 'UK Securitisation' (2006) 1 (2) Bankers' Law 1.

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securitization as seen through a senior practitioner's eyes over the past 10 years. The immediate regulatory effect of a 'hard' Brexit on UK term securitization will be analysed, under both securitization-specific EU regulation and under EU financial regulation of general application. The utility of EU equivalence regimes will be considered. Finally, the article will consider the necessity and the advisability of the enactment by Parliament of the current EU securitization *acquis*. The broader legal effect of a hard Brexit on the financial markets has been the subject of other helpful commentaries.[2]

The thesis of this article is that EU regulation of term securitization is based on a false premise, namely that term securitization is an intrinsically dangerous financing technique. The article will conclude that adoption by Parliament of the EU securitization *acquis* is neither necessary nor advisable and will suggest first principles for the appropriate regulation of term securitization. The adoption is not necessary because no losses were sustained when that body of regulation was not in place. It is not advisable because the body of regulation (i) is based on the premise that securitization is intrinsically more dangerous than other forms of structured finance and than vanilla bonds with the same rating, (ii) is overly prescriptive and detailed, (iii) is unstable and continually changing, (iv) is impeding the recovery of the European securitization market and (v) is distorting the European credit markets.

The abandonment by the UK of the EU securitization *acquis* would not prevent UK counterparties from complying voluntarily with EU regulatory requirements in order for UK ABS to be placed with EU investors. The few post-Brexit impediments to placing UK ABS with EU institutional investors will remain regardless of whether the EU securitization *acquis* is adopted.

This article does not address the regulation of bank sponsored conduit securitization, which raises particular bank regulatory considerations. Nor does this article deal with SIVs, CBOs or CDOs (much less CDO^2s or CDO^3s), which are qualitatively different financial exercises to term securitization even though they use similar structuring techniques. The admittedly narrow focus of this article allows the author to make a clean and incontrovertible case for liberalizing the UK regulation term securitization. The other structures are properly the subject of separate analysis and debate. Finally, a qualification must be added regarding synthetic term securitization. Whilst the analysis in this article applies to synthetic as well as what EU regulation styles as 'traditional' term securitization, additional issues relating to bank regulatory capital and the regulation of derivatives arise in the context of synthetic securitization which are outside the scope of this article.

2 See (1) generally, U.K. Withdrawal from the E.U.: Issues of Legal Uncertainty Arising in the Context of the Robustness of Financial Contracts, Financial Markets Law Committee (August 2018) at: <http://fmlc.org/wp-content/uploads/2018/08/Report-Robustness-of-Financial-Contracts.pdf> accessed 3 September 2018 and (2) with regard to derivatives, Brexit FAQs, ISDA (10 April 2018) at: <https://www.isda.org/2018/04/10/brexit-faqs/> accessed 3 September 2018.

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2. Two working premises

Hard Brexit

The first premise is a 'hard' Brexit, which will be taken to mean a withdrawal by the UK from the EU, following which:

(i) the UK is not a member of the European Economic Area;

(ii) UK institutions do not benefit from relevant passporting rights or otherwise retain access to the single market; and

(iii) the UK does not benefit from third country equivalence arrangements under relevant EU legislation.

It assumes that European Union (Withdrawal) Bill (the 'EU Withdrawal Bill') has the effect of incorporating the existing European regulation discussed in this article with only necessary changes to reflect the fact that the UK will no longer be a Member State.

There are two reasons for this premise: first, it is not possible at the moment to forecast the terms of any deal that may be reached between the EU and the UK and, second, a hard Brexit serves as a clear base case for determining the effect of Brexit on the regulation of UK securitization.

Securitization is important to fund the UK economy

The second premise is that securitization will be important to fund the UK economy following Brexit. This premise, although not a factual observation, is a reasonable one that echoes weighty pronouncements.

The Bank of England and HM Treasury have stated that they want to:

> . . .improve the functioning of the securitisation markets including the securitisation of SME loans . . .[3]

The European Commission takes the same position as regards the EU:

> According to the Commission's estimates, if EU securitisation issuance was built up again to pre-crisis average, it would generate between €100-150bn in additional funding for the economy.[4]

In the global context, John Varley, then Chief Executive of Barclays, told the House of Lords Economic Affairs Committee in 2009:

> . . . I believe that there is not enough on balance sheet capacity in banks in the world to allow the world to grow at four per cent or five per cent per annum in the way that it needs to and therefore the importance of securitisation is that it is a means of enabling citizens, businesses, governments to take risk. That is absolutely fundamental to economic growth in the world.[5]

Following on this premise is the simple proposition that the UK securitization market is worth reviving.

3 HM Treasury Press Release, 2 December 2014.

4 EC Press Release—Capital Markets Union: an Action Plan to boost business funding and investment financing, 30 September 2015, IP/15/5731.

5 House of Lords, Economic Affairs Committee, 17 March 2009, response to Q419 by Lord Eatwell <https://publications.parliament.uk/pa/ld200809/ldselect/ldeconaf/101/101ii.pdf> accessed 17 August 2018.

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3. European securitization and the financial crisis—three observations

Three factual observations are in order.

Virtually no EU regulation of securitization prior to financial crisis

Prior to the financial crisis, securitization as a specific financing technique was generally unregulated by EU law. Various Member States had passed special securitization legislation beginning in the late 1980s to facilitate securitization; among them France, Spain, Portugal, Greece and Italy. This national legislation was passed largely to overcome civil code impediments to the transfer of receivables. EU-level law did not specifically address securitization until 2004 when the Prospectus Directive Regulation[6] set out specific disclosure requirements for ABS. Only in 2006 did two EU directives implement the Basel II framework, including rules for the recognition of transfer by credit institutions and investment firms of securitized assets[7] and for credit ratings-based regulatory capital risk weightings for securitization and other exposures[8] (together, the Capital Requirements Directive or CRD). Implementation of the CRD was incomplete and uneven across the EU when the liquidity crisis began in mid-2007[9] but the securitization framework was implemented by the Financial Services Authority (FSA) on 1 January 2007.[10]

By way of illustration, the topics in a 12 March 2002 securitization industry conference in London on the regulation of securitization (including speakers from, among other organizations, Clifford Chance, Allen & Overy and the Financial Services Authority) were: (i) FSA recognition of risk transfers by banks and building societies for regulatory capital purposes, (ii) FSA regulation of mortgage lending, (iii) FSA implementation of Basel II rules on recognition of risk transfers by credit institutions, risk weighting of ABS and treatment of liquidity facilities, (iv) the 1999 Portuguese decree-law establishing a legal framework for Portuguese securitization, (v) the 1999 Italian law establishing a legal framework for Italian securitization, (vi) UK bank secrecy issues in reference pools in synthetic securitization (with comparative notes on Germany and the USA), (vii) structuring and operation issues in a pan-European securitization and (viii) new accounting rules and the impact on issuers.[11] Aside from the pending Basel II rules on recognition of risk transfers and capital risk weightings for securitization exposures and liquidity facilities, there were no EU securitization rules or proposed rules on the agenda.

6 Regulation No 2004/809/EC.

7 Directive 2006/48/EC.

8 Directive 2006/49/EC.

9 Final Report Contract No MARKT/2007/09/H Study on the Implementation of Directive 2006/48/EC and Directive 2006/49/EC by the 27 Member States <http://ec.europa.eu/internal_market/bank/docs/studies/02-2009/crd-final_en_.pdf> accessed 17 August 2018.

10 Prudential Sourcebook for Banks, Building Societies and Investment Firms, Financial Conduct Authority.

11 *The Regulation of Securitisation in Europe*, City & Financial Conferences, London, 7 March 2002.

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Existing European term securitizations performed exceptionally well during the financial crisis

In this market, largely free from securitization-specific EU-level regulation, European ABS performed extremely well during the worst financial crisis in recent times. Indeed, top-rated ABS performed better than top-rated corporate and financial institution debt. In the seven years since the financial crisis began in mid-2007, the cumulative default rate for all European structured finance notes rated by Standard & Poor's was, as at mid-2014, only 1.58 per cent (by original balance).[12] This cumulative rate includes not only top-rated RMBS but also CMBS, corporate securitizations and CDOs of ABS.[13] Moreover, top-rated European RMBS and ABS performed better than top-rated vanilla debt. In 2014, the European Banking Authority compared the performance of top-rated European RMBS and ABS products with the performance of top ratings assigned to corporate issuers including financial institutions and insurance undertakings.[14] They found that:

> Despite being relatively low during the 2006-2009 time period, the default rate of corporate ratings appears to be substantially higher than the default rate of EU RMBS and ABS products, the latter being close to zero.[15]

Losses were generally confined to CMBS transactions and some lower tranches of certain ABS and CMBS deals.[16] Rated European ABS and RMBS suffered no credit losses.[17]

European term securitization issuance to end investors has not reached 25 per cent of its pre-crisis level

European placed issuance dropped from its peak €481bn in 2006[18] to €24.8bn in 2009.[19] It has never reached 25 per cent of the 2006 level, having remained below €90bn from 2010 to 2015 and reaching only €111.7bn in 2017.[20] Levels of retained (by the originator) issuance in the EU, whilst still higher than placed issuance,[21] reflect purchases of ABS by originator banks for use in repo transactions with the European Central Bank and, in the case of UK banks, with the Bank of England. As such, retained issuance does not reflect private investor appetite; rather, it represents central bank funding of the assets being securitized. In the USA, where securitization credit losses were significant, placed issuance

12 'Seven Years On, the Cumulative Default Rate for European Structured Finance Is Only 1.6%', Ratings Direct, Standard & Poor's Ratings Services, 26 August 2014, 2.

13 ibid 3.

14 *EBA Report on Qualifying Securitisation—Response to the Commission's call for advice of January 2014 on long-term financing*, 13.

15 ibid.

16 'Securitisation can be a sturdy ally for investors' *Financial Times* (15 August 2017).

17 ibid.

18 afme Securitisation Data Report Q4: 2015 <https://www.afme.eu/globalassets/downloads/data/securitisation/2015/afme-stn--securitisation-data-report-q4-2015-v2.pdf> accessed 23 August 2018.

19 <https://www.sifma.org/wp-content/uploads/2017/05/afme-esf-securitisation-data-report-2009-q4.pdf> accessed 23 August 2018.

20 <https://www.afme.eu> accessed 17 August 2018

21 <https://www.sifma.org/wp-content/uploads/2018/03/Europe-Securitisation-Quarterly-2018-03-27-AFME-SIFMA.pdf> accessed 17 August 2018.

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dropped from \$2.95tn in 2006 to \$1.68tn in 2014 but recovered to \$2.24tn in 2016 (being 76 per cent of the 2006 level).[22]

4. Post-crisis EU regulation of securitization

Extensive and continuing regulation of securitization

In the decade since the onset of the financial crisis, EU regulation has imposed or proposed the following categories of restrictions on, or adverse regulatory treatment of, securitization. The post-crisis EU securitization *acquis* can be grouped under a dozen heads:

(i) mandatory retention by originators of a 5 per cent net economic interest in the securitized assets and an obligation on institutional investors to verify the retention;

(ii) an obligation to apply the same credit-granting criteria to securitized and non-securitized assets;

(iii) a ban on resecuritization;

(iv) extensive disclosure obligations by originators, sponsors and issuing vehicles, in addition to the issuer's usual prospectus and post-issuance reporting obligations;

(v) extensive securitization-specific due diligence requirements including:

  (a) initial due diligence for institutional investors including, *inter alios*, credit institutions and investment firms, insurance and reinsurance undertakings, alternative investment fund managers (AIFMs) and undertakings for collective investment in transferable securities (UCITS) taking an exposure to a securitization; and

  (b) post-issuance monitoring for such institutional investors, including regular stress tests on the solvency and liquidity of the sponsor of a fully-supported ABCP programme;

(vi) limited exemptions for securitization vehicle rate swaps from new collateralization requirements;

(vii) limitations and penalty haircuts on ABS collateral in non-centrally cleared OTC derivative contracts;

(viii) increasing risk weighting of ABS held by credit institutions and investment firms as investments;

(ix) penalty spread risk applicable to ABS held by insurance and reinsurance undertakings as investments;

(x) limitations and penalty haircuts on the use of ABS to meet liquidity coverage ratios (LCRs);

(xi) limitations and penalty haircuts for ABS collateral used for credit risk mitigation; and

22 <www.sifma.org> accessed 17 August 2018.

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(xii) more than 100 requirements for a new category of 'simple, transparent and standardised' (STS) securitizations that will benefit from more favourable regulatory capital treatment.

The new body of regulation is accompanied by strict administrative sanctions for breach of retention, disclosure, credit-granting and STS requirements with risk-weight penalties for breach of due diligence and other rules. The following summary offers some indication of the scope of post-crisis EU regulation addressing securitization.

Mandatory retention of a net 5 per cent economic interest

The principle that securitization sponsors or originators should retain part of the risk of the underlying assets was endorsed by the G20 leaders (5 per cent was not specified) at the September 2009 Pittsburgh Summit.[23] It was first implemented in the EU by CRD2 and prohibited a credit institution from being exposed to a securitization position in its trading book or non-trading book unless the originator, sponsor or original lender disclosed to that credit institution that it would retain, on a continuing basis, a net economic interest of not less than 5 per cent in the securitized exposures, which could be determined in a variety of ways.[24] The details of this 5 per cent requirement were amended and replaced in January 2014 by the Capital Requirements Regulation (CRR),[25] which permitted the taking of a securitization exposure only if the originator, sponsor or original lender disclosed to the credit institution that it was retaining at least a 5 per cent net economic interest, and these rules were supplemented that year by a further regulation.[26] The 5 per cent requirement was further amended and replaced in the 12 December 2017 Securitisation Regulation which, among other things, will *require* the originator, sponsor or original lender to retain at least a 5 per cent net economic interest[27] and require (among others) credit institutions, investment firms, insurance and reinsurance undertakings, AIFMs and UCITS management companies, other than the originator, sponsor or original lender, to verify compliance with the 5 per cent retention requirement before taking a securitization position.[28]

Duty to apply the same credit granting criteria to securitized and non-securitized assets

This requirement complements the 5 per cent economic retention requirement for the same policy reason. It was introduced in the CRR on 1 January 2014[29] and was 'moved' to the 12 December 2017 Securitisation Regulation.[30]

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23 *Leaders' Statement*, The Pittsburgh Summit, 24–25 September 2009 <https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf> accessed 17 August 2018.

24 Directive 2009/111/EC art 30, which added a new art 122a to Directive 2006/48/EC.

25 EC Regulation 575/2013 art 405.

26 Commission Delegated Regulation (EU) 625/2014.

27 Regulation (EU) 2017/2402 art 6(1).

28 ibid art 5(1).

29 EU Regulation 575/2013 art 408.

30 Regulation (EU) 2017/2402 art 9(1) and Regulation (EU) 2017/2401 art 1(11).

Effective ban on resecuritization

The CRR doubled the risk-weightings for resecuritization exposures (being a securitization exposure where at least one of the underlying exposures is a securitization exposure) for banks using the Standardised Approach[31] (and so followed Basel 2.5[32]). The Securitisation Regulation, however, will effectively ban resecuritization.[33] Grandfathering aside,[34] resecuritization will only be permitted if used for 'legitimate purposes': these are limited to facilitating the winding up, or ensuring the viability of a going concern to avoid a winding up, of a credit institution, investment firm or financial institution or to preserving investor interests when underlying exposures are non-performing.[35]

Extensive disclosure obligations in addition to prospectus disclosure

Securitization disclosure obligations were first expanded beyond prospectus obligations of the issuer in CRD2, which required the originator and sponsor credit institutions in a securitization to disclose the level of their commitment to maintain a net economic interest in the securitization and to ensure that prospective investors have access to all materially relevant data on the underlying exposures, cash flows and collateral and enough information to conduct stress tests as at the date of securitization and thereafter.[36]

The CRR extended these requirements to the original lender in a securitization[37] and the requirements were supplemented in a further regulation.[38] A new parallel disclosure obligation was then imposed by CRA3, the second amendment to the Credit Rating Agencies Regulation, which obliged the originator, issuer and sponsor to publish jointly on a European Securities and Markets Authority (ESMA) website detailed information on the underlying assets, structure, cash flows and collateral sufficient to conduct 'comprehensive and well-informed stress tests' on cash flows and collateral values.[39]

The CRR disclosure obligation was proposed to be complemented in the 30 September 2015 draft Securitisation Regulation and to expand originator, sponsor and issuer disclosure requirements to holders of securitization positions but exempt original lenders from the disclosure obligation.[40] The final Securitisation Regulation will further expand those disclosure requirements and extend the obligation to disclose, upon request, to potential investors.[41] The disclosure will need to be made through a 'securitisation

31 EC Regulation 575/2013 art 251 Table 1.

32 Basel Committee on Banking Supervision—Enhancements to the Basel II Framework published July 2009, para 567.

33 Regulation (EU) 2017/2402 art 8.

34 ibid art 8(1)(a).

35 ibid arts 8(1)(b) and 8(3).

36 New art 122a(7) in Directive 2006/48/EC, added by Directive 2009/111/EC art 30.

37 EU Regulation 575/2013 art 409.

38 Commission Delegated Regulation (EU) 625/2014.

39 Regulation (EC) No 1060/2009 art 8b, added by Regulation (EU) No 462/2013 art 1(11), supplemented by Commission Delegated Regulation (EU) No 2015/3.

40 Proposed Regulation 2015/0226 (COD) art 5.

41 Regulation (EU) 2017/2402 art 7.

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repository' registered with ESMA.[42] The Securitisation Regulation will repeal the relevant CRA3 disclosure provisions.[43]

Securitization-specific initial due diligence and continuing monitoring requirements for institutional investors taking an exposure to a securitization

CRD2 required credit institutions investing in securitized positions to be able to demonstrate to their supervisor that they have a 'comprehensive and thorough understanding' of, and have implemented trading book as well as non-trading book policies and procedures in relation to, enumerated subjects including, among others, net economic interest retained, risk characteristics of underlying exposures and valuation methodologies[44] (with 'look through' due diligence where underlying assets were securitization positions)[45] and all structural features of the transaction that would 'materially impact' the performance of the exposures. Breach of these requirements could give rise to (i) risk weight penalties (for breach by negligence and omission) ranging, for a first infringement, from 250 per cent to 1,250 per cent (the latter representing a deduction of the total exposure from capital)[46] and (ii) on-balance sheet treatment.[47] Credit institutions, other than originators, sponsors or original lenders, were required to establish formal procedures for trading and non-trading books to monitor these and other performance factors, including detailed delinquency and default rates on underlying assets.[48]

The CRR extended these due diligence requirements and penalties to investment firms, enumerated six heads of due diligence and required continuing monitoring and stress testing.[49] This was supplemented by more detailed due diligence requirements and procedures in a March 2014 Technical Standard.[50] The CRR due diligence obligation was proposed to be further supplemented, and extended beyond credit institutions and investment firms to (among others) insurance and reinsurance undertakings and AIFMs, in the 30 September 2015 Proposed Securitisation Regulation.[51] Those proposed due diligence and monitoring requirements were further supplemented and expanded in the final Securitisation Regulation,[52] which will exempt the originator, sponsor and original lender from the due diligence requirements.[53]

42 ibid arts 7 and 10.
43 ibid art 40.
44 New art 122a(4) in Directive 2006/48/EC, added by Directive 2009/111/EC art 30.
45 New art 122a(5) ibid.
46 ibid.
47 New art 122a(6) ibid.
48 New art 122a(5) ibid.
49 EU Regulation 575/2013 art 406.
50 Commission Delegated Regulation (EU) 625/2014.
51 Proposed Regulation 2015/0226 (COD) art 3.
52 Regulation (EU) 2017/2402 arts 5(1) and 5(3).
53 ibid arts 5(3) and 5(4) and arts 2(12)(a) and 2(12)(b).

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The securitization due diligence requirements have successively been extended to insurance and reinsurance undertakings,[54] to AIFMS[55] and to UCITS.[56]

Limited exemptions for securitization vehicle rate swaps from new collateralization requirements (proposed but now unlikely)

The 2012 European Market Infrastructure Regulation (EMIR), as amended and with related regulations, imposes clearing, reporting and risk mitigation rules for OTC derivatives. Their effect on securitization vehicles that hedge their interest and exchange rate exposure or use credit derivatives for a synthetic risk transfer raised obvious industry concerns. Securitization vehicle derivatives are bespoke and thus not practicably clearable and these vehicles are not, by current design, able to comply with EMIR-based risk mitigation requirements. The swap payment obligations of these vehicles, however, typically rank *pari passu* with or senior to the vehicles' top-rated note obligations. Therefore securitization vehicle swap payment obligations are effectively top-rated. EMIR imposes reporting requirements on these vehicles but proposed changes to collateral requirements that could require restructuring of virtually all existing hedged European securitization transactions, at significant cost, and that would impose additional future costs on new European securitization transactions.

The EMIR obligation of all counterparties to report details of any derivative contract they have concluded and of any modification or termination to a registered trade repository the next working day,[57] noted above, has not been a significant problem for European securitization vehicles.

As for clearing, the EMIR requirement that OTC derivatives be cleared through a central counterparty (CCP)[58] contains an exemption for non-financial counterparties ('financial counterparties' being CCPs, investment firms, credit institutions and insurance or reinsurance undertakings[59]) who do not exceed specified clearing thresholds. Securitization vehicles are currently non-financial counterparties under EMIR and the clearing thresholds for the exemption are €1bn for credit derivatives and €3bn for interest and foreign exchange derivatives, excluding derivatives used for hedging.[60] The result of the clearing exemption is that these requirements generally do not pose a problem for off-balance sheet European securitization vehicles, particularly in non-synthetic transactions.

As for collateralization, current EMIR rules require all financial counterparties (but not non-financial counterparties) to uncleared derivatives to have in place risk-management procedures requiring the segregated exchange of collateral.[61] These risk-management rules

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54 Directive 2009/138/EC art 135(2), Commission Delegated Regulation (EU) No 2015/35 art 256, Regulation (EU) No 462/2013 art 5a and Regulation (EU) 2017/2402 arts 5(3) and (4) and arts 2(12)(b) and (c).

55 Commission Delegated Regulation (EU) No 231/2013 art 52, Regulation (EU) No 462/2013 art 5a and Regulation (EU) 2017/2402 arts 5(3) and 5(4) and arts 2(12)(d).

56 Regulation (EU) 2017/2402 arts 5(3) and (4) and arts 2(12)(e) and (f).

57 EU Regulation 648/2012 art 9.

58 ibid arts 4, 10 and 11.

59 ibid arts 2(8) and 2(9).

60 ibid arts 4(1)(a)(ii), 10(1)(b) and 10(3) and EU Delegated Regulation (EU) No 149/2013 art 11.

61 ibid art 11(3).

have recently been implemented and require the posting by counterparties of variation margin (to collateralize the risk of daily changes in market value of swaps, which can be netted)[62] and initial margin (to collateralize market and counterparty risk between the time of last collection of margin and liquidation of positions following a default),[63] although the initial margin requirement is subject to the high threshold (determined on a group basis, if applicable[64]) noted below. Non-financial counterparties, including securitization vehicles, are only required to have such procedures in place if they exceed the clearing thresholds.[65]

Proposed changes to EMIR announced in May 2017 would pose a threat to existing European securitization structures by recategorizing securitization vehicles as financial counterparties.[66] Whilst the amendments would extend the exemption from the clearing requirement to financial as well as non-financial counterparties who do not meet the clearing threshold,[67] financial counterparties (unlike non-financial counterparties) would continue to be required to collateralize uncleared derivatives regardless of whether they fall within the clearing threshold exemption. This should not be a problem for the initial margin requirement since it does not apply where one of the counterparties has an aggregate month-end notional amount of non-cleared derivatives of less than €8bn for March, April and May of the preceding year.[68] It would, however, be a problem for securitization vehicles in relation to variation margin. That virtually all European securitization vehicles are neither designed to post, nor are capable of posting, variation margin as collateral is obvious and no proposal was made to grandfather existing transactions. In the absence of grandfathering, liquidity facilities and other structuring solutions would need to be added to existing transactions at some considerable cost.

Following industry opposition the European Parliament has recently adopted, on first reading, an amendment to the Commission's May 2017 proposal that would, in line with the Council's opposition, not extend the financial counterparty definition to securitization SSPEs (securitisation special purpose entities).[69] Further interinstitutional negotiations will take place but it is now unlikely that the proposed extension of the definition will be enacted.

It should be noted that under the amended proposed Securitisation Regulation, STS securitizations as well as covered bonds will be exempt from the clearing requirements[70] and, it seems likely, margining requirements.[71]

62 Commission Delegated Regulation (EU) 2016/2251 arts 12 and 1(2).

63 ibid arts 13 and 1(3).

64 EU Regulation 648/2012 art 10(3).

65 ibid art 11(3).

66 4 May 2017 Proposed Regulation 2017/0090 (COD) art 1(1) amending art 2(8) of EMIR.

67 ibid art 1(3) adding a new art 4a to EMIR.

68 Commission Delegated Regulation (EU) 2016/2251 art 28.

69 Amendments adopted by the European Parliament on 12 June 2018 <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P8-TA-2018-0244> accessed 17 August 2018.

70 Regulation (EU) 2017/2402 art 42; 4 May 2018 Consultation Paper JC 2018 14 on Amendments to the EMIR Clearing Obligation under the Securitisation Regulation.

71 Regulation (EU) No 648/2012 (as amended by Regulation (EU) 2017/2402) art 4(6); 4 May 2018 Consultation Paper JC 2018 15 on Draft Regulatory Technical Standards amending Delegated Regulation (EU) 2015/2251.

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Limitations and penalty haircuts on ABS collateral in non-centrally cleared OTC derivative contracts

Under EMIR and related technical standards, counterparties can only collect collateral falling within specified asset classes, including government and corporate bonds, certain convertible bonds and equities and the most senior tranche of a securitization that is not a resecuritization.[72] Applicable haircuts on long-term senior securitization collateral are twice those applicable to corporate bonds, and four times those of central government bonds, of the same tenors and credit ratings.[73]

Increasing risk weighting of ABS held by credit institutions and investment firms as investments

Prior to and since the financial crisis, European credit institutions have been required to risk weight top-rated, senior ABS at 20 per cent or, for IRB banks (where ABS are backed by granular pools), 7 per cent.[74] These risk weightings, which followed Basel II,[75] were carried forward in the CRR and extended to investment firms.[76]

Following Basel III,[77] the 12 December 2017 amendment to the CRR will require credit institutions and investment firms to use one of three methods to calculate risk weighted exposure amounts in relation to their securitization positions. These methods are to be applied in a hierarchy: (i) a Securitisation Internal Ratings-Based Approach (SEC-IRBA) where certain conditions are met or (ii) where SEC-IRBA may not be used, a Securitisation Standardised Approach (SEC-SA) or (iii) where SEC-SA may not be used, a Securitisation External Ratings-Based Approach (SEC-ERBA) must be used for rated (or inferred rated) positions,[78] the hierarchy being subject to various exceptions.[79] An institution may decide to apply to apply SEC-ERBA instead of SEC-SA to all of its rated securitization positions or positions where inferred ratings may be used.[80] National authorities may, on a case by case basis, prohibit institutions from applying SEC-SA having regard to risks to the institution or to financial stability.[81] Broadly, SEC-IRBA is available when the credit institution or investment firm is able to calculate a capital charge applicable to the underlying pool of securitized assets.[82] The floor for risk weighted securitization positions under all three methods is 15 per cent,[83] an increase of more than 100 per cent for both the SEC-IRBA and the SEC-ERBA over the comparable risk weight under the current IRB method.

72 Commission Delegated Regulation (EU) No 2016/2251 art 4(1) (as corrected by Commission Delegated Regulation (EU) No 2017/323 arts 35-40).

73 ibid Annex II 2. Table 1.

74 Directive 2006/48/EC arts 80(5) and 94 and Annex IX, Pt 4.

75 Basel Committee on Banking Supervision, Revisions to the securitisation framework, 11 December 2014 paras 567, 606 and 615.

76 Directive 2013/36/EU and Regulation (EU) No 575/2013 arts 251 and 261.

77 Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006.

78 EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) art 254(1).

79 ibid art 254(2).

80 ibid art 254(3).

81 ibid art 254(4).

82 ibid arts 255 and 258.

83 ibid arts 259, 261(1) and 263.

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Penalty spread risk applicable to ABS held by insurance and reinsurance undertakings as investments

The Solvency II directive[84] established a new prudential framework for insurance firms in the EU with an implementation deadline of 1 January 2016. Insurance and reinsurance undertakings are required to meet a Solvency Capital Requirement,[85] which corresponds to the Value-at-Risk of the basic own funds of an insurance or reinsurance undertaking subject to a confidence level of 99.5 per cent over a one-year period.[86] The 'market risk module' of the capital requirement contains an element for 'spread risk', being a subset of market risk that relates to the sensitivity of the values of assets to changes in the level or volatility of credit spreads over the risk-free interest rate term structure.[87] Spread risk on securitization positions has been set significantly higher than for similarly rated corporate bonds and loans of the same tenor.

A 'Type 1' securitization is one that meets 20 credit, structural and rating criteria (including no synthetic securitization or resecuritization and rated CQS3 (investment grade) or better) and is limited to a few asset classes (broadly, certain categories of residential mortgages, commercial loans primarily to SMEs, auto finance and consumer credit)[88] and a Type 2 securitization is any other securitization than a resecuritization.[89]

A three-year top-rated corporate bond will have a spread risk of 2.7 per cent.[90] A top-rated three-year Type 1 securitization instrument will have a spread risk of 6.3 per cent.[91] A three-year top-rated Type 2 securitization instrument (say, a top-rated corporate loan securitization) will have a spread risk of 37.5 per cent.[92]

On 1 June 2018, the European Commission adopted a Delegated Regulation effective 1 January 2019 that, if approved by the European Parliament and the Council, will incorporate the STS requirements into the spread risk calculations for insurance and reinsurance companies and change the current spread risk calculations for non-STS securitization transactions. Henceforth, a three-year top-rated senior non-STS securitization instrument, that would have been Type 1 under the existing regime with a spread risk of 6.3 per cent, will have a spread risk of 37.5 per cent[93] (for non-STS securitization instruments, no distinction will be made between the current Type 1 and Type 2). Senior three-year top-rated senior STS securitization instruments will have a spread risk of 3 per cent, still higher than a three-year top-rated corporate bond. It is widely understood that yields on top-rated ABS are not attractive to insurance companies and that the spread risks on lower rated ABS make such investments capital-inefficient.

84 Directive 2009/138/EC (as amended by Directive 2014/51/EU).
85 ibid art 100.
86 ibid art 101(3).
87 ibid art 105(5).
88 Commission Delegated Regulation (EU) No 2015/35 art 177(2).
89 ibid art 177(3).
90 ibid art 176(3).
91 ibid art 178(1).
92 ibid art 178(2).
93 Revised calibrations for securitization investments by insurance and reinsurance undertakings under Solvency II, European Commission Reference Ares (2018)2037113.

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Limitations and penalty haircuts on the use of ABS to meet liquidity coverage ratios

Credit institutions and investment firms are required under the CRR to hold a liquidity buffer, being liquid assets sufficient to cover net liquidity outflows during a 30-day period of 'gravely stressed conditions'.[94] By delegated act the Commission has prescribed, among other things, eligible liquid assets and minimum haircuts for those assets, which are grouped into Level 1 assets, Level 2A assets and Level 2B assets.[95]

Level 1 assets include certain claims against central banks, certain governmental authorities and credit institutions and 'extremely high quality' covered bonds that meet certain requirements.[96] The 'extremely high quality' covered bonds are subject to a haircut of at least 7 per cent of market value.[97]

Level 2A assets include certain 20 per cent risk weighted claims against governments, 'high quality' covered bonds, third country covered bonds that meet certain requirements and certain top-rated corporate debt securities that meet original size and tenor requirements.[98] The market value of all Level 2A assets is subject to a 7 per cent haircut.[99]

Level 2B assets include investment grade corporate debt securities that meet original size and tenor requirements, 'high quality' covered bonds that meet certain requirements, shares that meet certain requirements and top-rated senior ABS. The ABS must be backed by certain categories of residential property loans, SME-heavy loan and lease portfolios, car loans and leases and consumer loans and meet more than 20 other requirements.[100] The market values of investment grade corporate debt securities and certain shares are subject to a 50 per cent haircut and the market values of 'high quality' covered bonds are subject to a 30 per cent haircut.[101] The market values of top-rated, senior securitization instruments backed by certain categories of residential property loans and auto loans and leases are subject to a 25 per cent haircut (more than three times as high as that applied to top-rated corporate debt securities) and those backed by SME-heavy loan and lease portfolios and by consumer loans are subject to a 35 per cent haircut (more than five times as high as that applied to top-rated corporate debt securities).[102]

The liquidity buffer for credit institutions must be composed of (a) at least 60 per cent Level 1 assets, (b) at least 30 per cent Level 1 assets excluding 'extremely high quality' covered bonds and (c) a maximum 15 per cent Level 2B assets, after haircuts have been applied.[103]

94 EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) art 412(1).
95 Commission Delegated Regulation (EU) No 2015/61 arts 10–12.
96 ibid art 10(1).
97 ibid.
98 ibid art 11(1).
99 ibid art 11(2).
100 ibid arts 12 and 13.
101 ibid arts 13(2).
102 ibid arts 13(14).
103 ibid arts 17(1) and 17(2).

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On 24 January 2018, the Commission announced a proposal to replace the existing catalogue of Level 2B assets with STS securitization transactions.[104] As noted below, this will entail transactions meeting some 100 requirements in order to qualify for the STS label.

Penalty haircuts for ABS collateral used for credit risk mitigation

Under Basel II[105] and the CRD,[106] investment grade debt securities issued by corporates (whether ABS or not) were included in the same class of eligible collateral.

Under Basel III, supervisory haircuts for all securitization collateral have been set at twice that of top-rated corporate issuers[107] although these multiples will vary slightly in the latest revision to Basel III.[108] The CRR makes specific provision for eligibility of investment grade or better securitization positions that are not resecuritization positions and rated CQS 3 or higher using ratings-based risk-weightings, which are set twice as high as those for top-rated corporate issuers.[109]

More than 100 requirements for the STS securitization label with its more favourable regulatory capital treatment

Following the Basel Committee on Banking Supervision July 2015 'Criteria for identifying simple, transparent and comparable securitisations',[110] which provided alternative capital treatment for, per the title, 'simple, transparent and comparable' (STC) securitizations, the European Parliament and the Council published a proposed Securitisation Regulation and proposed amendments to the CRR setting out similar requirements for alternative capital treatment for 'simple, transparent and standardised' securitizations held by credit institutions and investment firms on 30 September 2015,[111] amended them on 26 June 2017 and finalized and enacted them on 12 December 2017.[112] As noted above, the STS regime will be available to achieve a relatively lower spread risk element in the market risk module of the Solvency Capital Requirement for ABS held by insurance and reinsurance companies and STS certification will also be a requirement for LCR eligibility.

Term STS securitizations will be required to meet, potentially, just over 100 conditions.[113] These include at least 13 'simplicity' conditions (eg only one asset type), 15

104 24 January 2018, Draft Delegated Act amending the Commission Delegated Regulation on the Liquidity Coverage Ratio (LCR) Ref: Ares(2018)418078 art 1(8).

105 Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, paras 145(c) and 146(a).

106 Directive 2006/48/EC art 92 and Annex VIII item 7(c).

107 Basel Committee on Banking Supervision—Basel III: A global regulatory framework for more resilient banks and banking systems, 1 June 2011, para 111.

108 Basel Committee on Banking Supervision—Basel III: Finalising post-crisis reforms, 12 December 2017, para 163, Table 14.

109 EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) arts 194(3), 197(1)(h) and 224, Tables 1 and 2.

110 'Criteria for Identifying Simple, Transparent And Comparable Securitisations', Basel Committee on Banking Supervision/ Board of the International Organization of Securities Commissions, July 2015.

111 Respectively, Proposed Regulation 2015/0226(COD) arts 7–22 and Proposed Regulation 2015/0225(COD)262–64.

112 Regulation (EU) 2017/2402 arts 18–24 and 27–30 and EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) arts 242–3, 260, 262 and 264.

113 As determined by Prime Collateralised Securities (PCS) UK Limited <http://pcsmarket.org/draft/wp-content/uploads/bsk-pdf-manager/STS_Criteria_22.pdf> accessed 17 August 2018.

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'standardisation' conditions (eg early amortization required when the value of the underlying exposures falls below a pre-determined threshold) and five 'transparency' conditions (eg information regarding environmental performance of certain assets).[114] All relevant conditions must be met or the label will not be available and it has been estimated that in any one transaction about 80 conditions will be relevant.[115] Synthetic securitizations will not qualify[116] although the European Commission may report to the European Parliament with a legislative proposal for balance sheet synthetic securitization within 12 months of the effective date of the Regulation.[117] Also, it appears that the originator and sponsor in an STS-branded securitization are jointly responsible for compliance with the general securitization transparency requirements in the new Securitisation Regulation, with some timing modifications,[118] which suggests that a breach of these disclosure requirements would attract additional penalties as well as loss of the preferential risk-weighting. The originator and sponsor must jointly notify ESMA where a securitization meets the STS requirements of a non-ABCP STS programme (only the sponsor in the case of an ABCP programme)[119] and may use a third party authorized under the Securitisation Regulation to confirm compliance although this does not relieve them of liability.[120] The originator, the sponsor and the issuer must all be established in the EU in order for a securitization to qualify as an STS.[121]

The risk weight floor for senior STS securitization positions held by credit institutions and investment firms will be 10 per cent,[122] compared to 15 per cent for all non-STS securitizations.[123] Under SEC-ERBA, top-rated senior tranches of STS securitizations will attract a risk weight of 10 per cent for both one-year and five-year maturities,[124] compared to 15 per cent and 20 per cent respectively for non-STS securitizations.[125] The spread risk for ABS held by insurance and reinsurance companies will be about twelve times higher for senior top-rated non-STS ABS than for senior top-rated STS ABS.[126]

Severe penalties for non-compliance with EU securitization regulation

Member States will be required under the Securitisation Regulation to impose administrative sanctions on originators, sponsors, lenders or securitization special

114 Regulation (EU) 2017/2402 arts 20, 21 and 22, respectively.

115 Ian Bell, PCS Secretariat, quoted in '(I can't get no) STS-faction' *SCI Magazine*, London (Summer 2018) <https://www.structuredcreditinvestor.com/SCI_Magazine.asp> accessed 17 August 2018.

116 Regulation (EU) 2017/2402 art 20(1).

117 ibid art 45(2).

118 ibid art 22(5).

119 ibid art 27(1).

120 ibid art 27(2).

121 ibid art 18.

122 EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) arts 260, 262 and 264.

123 ibid arts 259, 261 and 263.

124 ibid art 264(3) and Table 4.

125 ibid art 263(3) and Table 2.

126 Commission Delegated Regulation (EU) No 2015/35 art 178(1) and 1 June 2018 draft Commission Delegated Regulation art 178(8).

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purpose entities (issuers), as applicable, for breaches of the risk retention, disclosure, credit granting and STS rules.[127] Penalties include fines of up to €5 mn for individuals and up to €5 mn or 10 per cent of annual net turnover for corporates and a fine of up to twice the amount of benefit derived from the infringement where that benefit can be determined, as well as cease and desist orders and bans.[128] The amended CRR provides for risk weighted penalties of between 250 per cent and 1,250 per cent (the latter amounting to a deduction from capital of the entire principal amount) on relevant securitization positions where an institution fails to meet the due diligence, risk retention disclosure, credit-granting and no-resecuritization rules.[129]

Regulation of credit rating agencies and the use of ratings

Ratings are central to securitization, and to other structured vehicles such as CBOs, CDOs and SIVs, and the performance of the rating agencies came under close scrutiny during the financial crisis.[130] The EU, like the USA, blamed the rating agencies for assigning top ratings to structured notes that became impaired, including but not limited to US sub-prime ABS and structures that were supported by those assets, and determined that the rating agencies needed to be regulated. Even though the ensuing Credit Rating Agency Regulation (the CRA)[131] was of general application, it was in many respects aimed at, and regulated the rating of, securitization transactions. Also, as noted below, CRA3 established extensive new disclosure obligations for securitization transactions. It required, from 20 June 2013, that rating agencies be registered under the CRA as a condition of being recognized as an External Credit Assessment Institution (ECAI) under the CRD.[132] Credit institutions, insurance and reinsurance undertakings, UCITS and institutions for occupational retirement provision could use ratings for regulatory purposes only if issued by a rating agency established in the EU and regulated under the CRA.[133]

The CRA regulated, among other things and in some detail, the independence of rating agencies and avoidance of conflicts of interest,[134] rating analysts (including their rotation),[135] compensation and performance reviews of analysts,[136] disclosure of rating methodologies, models and rating assumptions[137] and disclosure and presentation of ratings.[138]

The CRA could endorse a rating issued in a third country if certain conditions were met[139] and certify rating agencies established in third countries based on regulatory

127 Regulation (EU) 2017/2402 art 32(1).
128 ibid art 32(2).
129 EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) art 270a(1).
130 See eg the *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, United States Securities and Exchange Commission, July 2008.
131 Regulation (EC) 1060/2009.
132 ibid art 2(3).
133 ibid art 4(1).
134 ibid art 6.
135 ibid art 7.
136 ibid art 7(5).
137 ibid art 8.
138 ibid art 10.
139 ibid art 4(3).

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equivalence (see below).[140] Ratings related to non-EU entities or instruments and issued by non-EU CRAs could be used in the EU without being endorsed,[141] provided certain conditions were met.[142] This is discussed more fully below.

The CRA was subsequently amended by CRA2[143] to extend its application to the use of ratings by investment firms.[144] The CRA's provisions relating to the endorsement of ratings issued in third countries and the certification of regulatory equivalence in third countries were also amended,[145] as well as its provisions on independence and avoidance of conflicts of interest[146] and on disclosure and presentation of ratings.[147]

The CRA was further amended by CRA3,[148] which extended its application to the use of ratings by, among others, AIFMs and central counterparties.[149] It also introduced disclosure obligations for originators, issuers and sponsors established in the EU regarding 'structured finance instruments' (being notes issued in a securitization as defined in the Banking Consolidation Directive[150]), including sufficient information on the underlying assets, the structure and the cash flows to conduct 'comprehensive and well-informed stress tests on the cash flows and collateral supporting the underlying exposures'.[151] These extensive additional disclosure obligations will be repealed as of 1 January 2019 under the new Securitisation Regulation.[152] CRA3 also, among other things, amended the already-amended CRA provisions regulating conflict of interest,[153] the compensation and performance evaluations of analysts,[154] endorsement of ratings issued in third countries[155] and disclosure of methodologies, models and assumptions.[156] It also required the rating agencies to publish proposed material changes to their methodologies and assumptions on their websites, explain them and invite comments from, and consult, stakeholders.[157] A new civil liability, in relation to investors and issuers, was also imposed on rating agencies.[158] Interestingly, CRA3 also added, on the one hand, a requirement that structured finance instruments, if rated, must be rated by at least two rating agencies,[159] and

140 ibid art 5.
141 ibid arts 4(3)(b) and 4(8).
142 ibid art 5(1).
143 Regulation (EU) No 513/2011.
144 Regulation (EC) 1060/2009 (as amended by Regulation (EU) No 513/2011) art 4(1).
145 ibid arts 4(3) and 5.
146 ibid art 6.
147 ibid art 10.
148 Regulation (EU) No 462/2013.
149 Regulation (EC) 1060/2009 (as further amended by Regulation (EU) No 462/2013) art 4(1).
150 Directive 2006/48/EC art 4(36).
151 Regulation (EC) 1060/2009 (as further amended by Regulation (EU) No 462/2013) art 8b.
152 Regulation (EU) 2017/2402 arts 40 and 48.
153 Regulation (EC) 1060/2009 (as further amended by Regulation (EU) No 462/2013) arts 6 and 6a.
154 ibid art 7.
155 ibid art 4.
156 ibid art 8.
157 ibid art 5a.
158 ibid art 35a.
159 ibid art 8c(1).

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on the other hand, a requirement that the Commission attempt to delete all references to ratings in EU law for regulatory purposes by 1 January 2020.[160]

5. The regulatory effect of a hard Brexit on UK term securitization

In the event that Parliament adopts all of the EU securitization *acquis*

If Parliament adopts all of the existing EU securitization *acquis* (with adjustments necessary for coherence but not otherwise for reciprocity), certain limitations on UK cross-border securitization and on placing UK ABS with EU-regulated institutions will arise under the heads of EU securitization regulation outlined above, under the CRA and under EU financial regulation of general application. They include the ineligibility of UK ABS for EU STS treatment and to satisfy EU LCR requirements, the invalidity for EU regulatory purposes of ratings issued and prospectuses approved in the UK and the loss by UK institutions of their passporting privileges.

Under the dozen heads of the EU securitization acquis

The focus of most EU securitization regulation has been on structures, disclosure, investor behaviour and risk weighting of securitization exposures and does not differentiate originators, issuers or other counterparties on the basis of whether they are established in Member States or in third countries. The two main exceptions are the STS regulations and LCR eligibility criteria.

As noted above, STS treatment under EU regulation will not be allowed for a securitization transaction with a third country originator, issuer or sponsor. As noted above, non-STS transactions will not be exempt from EMIR clearing and margining requirements. Also, for EU investor credit institutions and investment firms, the risk weight floor will be 50 per cent higher for non-STS securitizations than for STS securitizations and the spread risk for the Solvency Capital Requirement for insurance and reinsurance companies will be about 12 times as high as for non-STS securitizations.

Nor will securitization transactions with underlying debtors in the UK be eligible to meet LCR requirements for EU credit institutions except for transactions backed by residential mortgages and then only if the assessment of the borrower's creditworthiness meets a third country's equivalent to the requirements[161] set out in the Mortgage Credit Directive[162] (transactions backed by auto loans, leases, consumer loans and CapEx credits not made to obligors established or resident in a Member State are ineligible[163]). There is no provision for an equivalence determination by the European Commission in relation to those requirements, leaving it to the originator and the investing credit institution to form a view. Also as noted above, the Commission has proposed restricting LCR eligibility to securitizations that qualify as STS, which would preclude transactions with UK originators, sponsors or issuers.

160 ibid art 5c.
161 Commission Delegated Regulation (EU) No 2015/61 art 13(7).
162 Directive 2014/17/EU art 18.
163 Commission Delegated Regulation (EU) No 2015/61 art 13(2).

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Thus, other than in relation to STS and LCR eligibility, the fact that UK assets or counterparties would be situated in a third country following a hard Brexit makes virtually no difference under the EU securitization *acquis*. It is a different story, however, under the more general EU financial regulation.

Under the CRA

Ratings issued by rating agencies established and regulated in the UK—including ratings of securitization transactions—will not be able to be relied on for regulatory purposes by EU credit institutions, investment firms, insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision, management companies, investment companies, AIFMs and central counterparties.[164] As this list does not include the EU credit rating agencies, they are able to rely on UK- or other non-EU-regulated ratings of swap and liquidity providers in rating EU ABS.

Under the Prospectus Regulation

UK Listing Authority approval of prospectuses, including those for securitization transactions, will no longer be recognized where an approved prospectus is required under the Prospectus Regulation,[165] such as for an offer to the public or for securities to be admitted to trading on a regulated market in the EU.[166]

Under MiFID2

The new MiFID2 allows UK investment firms and banks to 'provide investment services or perform investment activities' in other Member States by way of the passporting procedure prescribed in MiFID2.[167] 'Investment services and activities' include placing transferable securities, execution of rate and credit swaps and portfolio management.[168] Since passports are not available to third country institutions, after a hard Brexit a UK firm will need (where the provision of services is not at the exclusive initiative of the client)[169] either (i) local authorization or an exemption from the relevant Member State or (ii) a determination of equivalence under MiFID2[170] in order to place UK ABS with an EU investor, to provide a swap to an issuer or other counterparty in the EU or to manage (say, in the case of a managed CLO) a portfolio of assets.[171]

Under CRD4

Member States are required under Directive 2013/36/EU (CRD4)[172] to allow credit institutions authorized in another Member State to carry out activities listed in Annex I,

164 Regulation (EC) 1060/2009 (as further amended by Regulation (EU) No 462/2013) art 4(1).

165 EU Regulation 575/2013 (as further amended by Regulation (EU) 2017/2401) art 107(3). Also see s 3.1 of 'Principle one: No automatic recognition of existing authorisations' of the European Securities and Markets Authority, *General Principles to Support Supervisory Convergence in the Context of the United Kingdom Withdrawing from the European Union* (Brussels, 31 May 2017).

166 Regulation (EU) 2017/1129 arts 28 and 29.

167 Directive 2014/65/EU art 34.

168 ibid art 4(1)(2) and ss A and C of Annex 1.

169 ibid arts 24 and 42.

170 ibid art 25(4).

171 ibid arts 1, 4.1(2) and 4.1(15) and Annex 1 s A.

172 art 33.

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which include, *inter alia*, taking deposits and lending. Passports are not available to third country credit institutions.[173] Since there is no equivalence regime for these banking activities, UK credit institutions will require local authorizations or exemptions in the relevant Member States to accept deposits (as a GIC bank) or lend (as a liquidity bank).

Summary: regulatory effect of hard Brexit on existing cross-border term securitization deals

The regulatory effect of a hard Brexit on existing cross-border term securitization transactions involving one or more UK counterparties may be summarized as follows:

(i) UK arrangers will lose passporting rights for placing securities in the EU (tap issues; programmes);

(ii) UK issuers' ratings issued in the UK will no longer be able to be used for regulatory purposes by EU investors and the ABS they issue will not be eligible for EU STS treatment or for EU LCR purposes;

(iii) UKLA-approved (supplementary) prospectuses will not be valid in the EU;

(iv) UK originators will not be able to have their ABS placed with EU investors who require EU STS or EU LCR eligibility;

(v) UK assets other than residential mortgages will not be eligible for EU LCR requirements;

(vi) UK swap providers' ratings, if issued in the UK, will no longer be able to be relied upon for regulatory purposes by EU counterparties and the swap providers will lose their passporting rights (so there will be a *caveat* regarding, for example, the amendment or novation of existing swaps with EU issuers or other counterparties);

(vii) UK liquidity banks' ratings, if issued in the UK, will no longer be able to be relied upon for regulatory purposes by EU counterparties; the liquidity banks will need local authorizations or exemptions in Member States to make advances or take deposits; and these banks will no longer be recognized as EU credit institution exposures; and

(viii) UK collateral managers will lose their passporting rights.

Summary: regulatory effect of hard Brexit on new cross-border term deals

The regulatory effect of a hard Brexit on new cross-border term securitization transactions will be broadly the same as for existing transactions except that new transactions can be structured to work around the prospectus limitations (by arranging for a competent authority in a Member State to approve the prospectus) and rating limitations (by arranging for a rating agency approved under the CRA to rate, or endorse the UK rating of, the bonds). Restrictions on eligibility for LCR requirements and STS treatment will be the same, as will the difficulties faced by 'passportless' UK arrangers, swap counterparties and liquidity banks on cross-border term deals.

173 Directive 2013/36/EU arts 34–39.

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In the event that Parliament adopts none of the EU securitization *acquis*

If Parliament declines to adopt any of the EU securitization *acquis*, that will make virtually no difference as a matter of EU law to the ability to place UK term deals with EU investors or to the ability of UK counterparties to participate in EU securitization transactions. Actual compliance with the requirements of EU securitization *acquis* is what matters; not whether the compliance is required under the laws of a third country. Thus even if none of the EU securitization *acquis* was adopted by Parliament, the parties to a UK securitization might choose to comply with the retention, disclosure and other requirements of the EU securitization acquis if they wished to place the ABS with EU investors.

6. What about equivalence?

Few relevant equivalence regimes

There are multiple and diverse third country equivalence provisions across EU law but only 15 EU legislative acts have been identified by the European Commission as applying to banking and finance.[174] These equivalence provisions establish, broadly, rules and procedures for treating regulated third country entities as if they were EU-regulated entities. Few of those equivalence provisions are relevant for post-Brexit UK securitization but they merit a brief survey in the context of UK securitization and a hard Brexit.

Relevant EU equivalence rules include those setting conditions for (i) allowing ratings issued by rating agencies established and regulated in third countries to be used by EU-regulated institutions for regulatory purposes,[175] (ii) allowing prospectuses drawn up under the laws of a third country to be used for the purposes of the Prospectus Regulation,[176] (iii) allowing third country firms to provide investment services to or perform investment activities in relation to eligible counterparties and professional clients established in the EU,[177] (iv) allowing institutions to treat exposures to third country credit institutions, investment firms and exchanges as exposures to EU credit institutions or investment firms[178] and (v) allowing a CCP established in a third country to provide clearing services to clearing members or trading venues established in the EU.[179]

Ratings

Ratings issued by agencies established and regulated in third countries can be used if the Commission has adopted an equivalence decision recognizing the legal and supervisory framework of that third country as equivalent to the requirements of the CRA.[180]

174 EU equivalence decisions in financial services policy: an assessment (Commission Staff Working Document SWD (2017) 102 final, 27 February 2017) and Equivalence Decisions adopted by the European Commission, 3 October 2017 <https://ec.europa.eu/info/sites/info/files/overview-table-equivalence-decisions_en.pdf> accessed 17 August 2018.

175 Regulation (EC) No 1060/2009 (as further amended by Regulation (EU) No 462/2013) arts 4 and 5.

176 Regulation (EU) 2017/1129 art 29.

177 Regulation (EU) No 600/2014 arts 46(1) and 47(1).

178 Regulation (EC) 1060/2009 (as further amended by Regulation (EU) No 462/2013) art 5 and Regulation (EU) 2017/2401 art 107(3).

179 EU Regulation 648/2012 (as amended) art 25.

180 Regulation (EC) No 1060/2009 (as further amended by Regulation (EU) No 462/2013) art 5.

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Observations on equivalence decisions will be made below. Ratings issued by third country rating agencies can also be used for EU regulatory purposes if the ratings have been endorsed by an EU-regulated rating agency.[181]

At the time of writing, only nine third countries, including Canada, the USA, Australia, Japan and Singapore have equivalence determinations under Article 5(6) of the CRA.[182]

The endorsement requirements include, *inter alia*, that the EU-regulated rating agency can demonstrate to ESMA that the conduct of the other rating agency fulfills requirements at least as stringent as those under the CRA,[183] that 'there is an objective reason for the credit rating to be elaborated in a third country'[184] and that 'there is an appropriate cooperation arrangement between ESMA and the relevant supervisory authority' of the third country rating agency for the exchange of information and coordination of supervisory activities in order to enable ESMA to monitor rating activities.[185]

It was reported in autumn 2017 that Standard & Poor's and Moody's were planning staff moves from London to EU destinations[186] and in December 2017 that Standard & Poor's will open a post-Brexit entity in Dublin.[187]

Prospectuses

The Commission may establish equivalence criteria and determine whether information requirements imposed by the national law of a third country are equivalent to the requirements under the Prospectus Regulation.[188]

Alternatively, the competent authority of the 'home Member State' (being, broadly and usually, the EU Member State in which the offering or listing is first made[189]) of a third country issuer may approve a prospectus drawn up under the national laws of the third country issuer where the information requirements of the third country laws are equivalent to the Prospectus Regulation requirements and the competent authority of that home Member State has concluded cooperation arrangements with the supervisory authorities of the third country issuer.[190]

Finally, the third country issuer can apply for the approval of its prospectus by the competent authority of its home Member State under the Prospectus Regulation.[191]

181 ibid art 4(3).

182 Equivalence Decisions adopted by the European Commission (n 174).

183 Regulation (EC) No 1060/2009 (as further amended by Regulation (EU) No 462/2013) art 4(3)(b).

184 ibid art 4(3)(e).

185 ibid art 4(3)(h).

186 *Financial News* (London, 9 October 2017) <https://www.fnlondon.com/articles/rating-agencies-plan-brexit-moves-as-watchdog-ups-demands-20171009> accessed 17 August 2018.

187 *Irish Times*, Dublin (14 December 2017).

188 Regulation (EU) 2017/1129 art 29(3).

189 ibid art 2(m)(ii) and (iii).

190 ibid art 29(1).

191 ibid art 28.

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At the time of writing, no third country has been granted equivalence under Article 20(3) of the Prospectus Directive nor has any equivalence determination been made under Article 27(3) of the Prospectus Regulation.[192]

MiFID2

Under the Markets in Financial Instruments Regulation (MiFIR) a third-country firm may provide investment services to or perform investment activities in relation to eligible counterparties and to professional clients established in the EU where the firm is registered with ESMA and (subject to other conditions) where the European Commission has adopted an equivalence decision to the effect that the legal and supervisory arrangements of that third country (i) ensure that firms authorized in that third country comply with legally binding prudential and business conduct requirements which have equivalent effect to the requirements set out in MiFID2, MiFIR and Directive 2013/36/EU (CRD4) and (ii) have an effective third country equivalence regime.[193] At the time of writing, no third country has yet been granted equivalence for these purposes (the equivalence provisions applying since 3 January 2017[194]).[195]

Credit institutions, investment firms and exchanges

Exposures to third country credit institutions, investment firms and exchanges will be treated as exposures to an EU institution only if the third country applies prudential and supervisory requirements to the entity that are at least equivalent to those applied in the EU.[196] At the time of writing, twenty-one third countries have been granted equivalence under Article 107 in relation to credit institutions.[197]

The reality of equivalence

The Financial Markets Law Committee[198] have observed that '...the European Commission views equivalence as a tool to benefit and protect E.U. market participants and not a vehicle for liberalizing international trade in financial services.'[199] They note that the timetable for obtaining an equivalence determination is lengthy and may be disrupted by intervening changes in the EU or third country regulatory framework.[200] Also, an equivalence determination is discretionary and can be amended or rescinded at any time.[201]

192 Equivalence Decisions adopted by the European Commission (n 174).

193 Regulation (EU) No 600/2014 arts 46(1) and 47(1).

194 ibid art 55.

195 Equivalence Decisions adopted by the European Commission, 9 January 2018 (n 174).

196 EU Regulation 575/2013 (as amended by Regulation (EU) 2017/2401) art 107(3).

197 <https://ec.europa.eu/info/sites/info/files/overview-table-equivalence-decisions_en.pdf> accessed 17 August 2018.

198 <www.fmlc.org> accessed 17 August 2018.

199 Issues of legal Uncertainty Arising in the Context of the Withdrawal of the U.K. from the E.U.—the Provision and Application of Third Country Regimes in E.U. Legislation, July 2017, Financial Markets Law Committee, 1.22.

200 ibid 1.20, vi.

201 ibid 3.4.

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With regard to timing, it is '. . .strongly to be inferred that the process of reaching a decision on the application of Third Country regimes to the U.K. will only begin once the U.K. has withdrawn from the E.U.'[202] They note:

> The timetables for the assessments of Third Country regulatory frameworks are likely to be . . . long and fraught with uncertainty. For instance, while ESMA negotiated 11 cooperation agreements in relation to access to Third Country CCPs under EMIR in under two years, the deliberations pertaining to the U.S. application for equivalence with regards to CCPs . . . extended over nearly four years. The period of time taken to reach equivalence decisions with respect to credit rating agencies under the [CRA] have been similarly diverse and unpredictable: one (Japan) took just over six months, three (Australia, Canada and the U.S.) took between 18 months and two years and five (Argentina, Brazil, Hong Kong, Mexico and Singapore) took over four years.[203]

Thus, if we assume a hard Brexit then it is also fair to anticipate no early equivalence determination by the European Commission in relation to any of the relevant regimes.

7. Adoption of the EU securitization *acquis*?

The question is whether adoption of the post-crisis EU securitization *acquis* is necessary or advisable for the purposes of the prudent regulation of the UK domestic financial markets.

Necessity

The post-crisis EU securitization *acquis* was not necessary in order to protect investors in rated ABS (other than CMBS) from the worst financial crisis since the Great Depression. Had all of that regulation been in place prior to 2008, it might have reduced losses sustained by investors in CMBS and in unrated junior positions in some ABS. As noted above, however, such losses were very small in the context of the market and virtually non-existent in the rated European ABS market (excluding CMBS). For that reason alone, the EU post-crisis securitization *acquis* cannot be said to be necessary. Whether it might have been, or is now, advisable is another question.

In this context, the CRA has not been grouped by the author under the securitization *acquis* largely because it is a regulation of general application, notwithstanding its significant effect on securitization transactions. So long as credit ratings remain relevant for bank regulatory capital purposes, which started in the EU with the CRD, a common sense basis for the regulation of rating agencies remains. How they ought to be regulated is a large topic and properly the subject of a separate analysis.

Advisability

There are five considerations for determining the advisability of adopting the EU securitization acquis for the prudential regulation of the UK financial markets:

(i) the false working premise of the EU regulatory approach;

(ii) the detailed and highly prescriptive nature of the EU regulations;

(iii) the unstable nature of the EU regulatory approach;

202 ibid 4.2.
203 ibid 4.3.

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(iv) the effect of the EU regulatory approach on the recovery of the European securitization market; and

(v) the effect of the EU regulatory approach on market pricing and liquidity of ABS.

False premise

The working premise for the EU regulatory approach to securitization is that it is a significantly more dangerous financing technique than other forms of finance such as asset-based lending or high-yield bonds and more dangerous than comparably rated vanilla corporate bonds. This is evidenced by the immense body of regulation described above and can be inferred from public pronouncements, not least those of the European Commissioner for Internal Markets and Services:

> . . .securitisations—the kind of highly complex products that have caused huge losses for banks. . .[204]

and

> . . .we do not wish to repeat the mistakes made with the special securitisation vehicles, which were left to develop by the supervisory authorities and which served no purpose other than regulatory arbitrage.[205]

The Governor of the Bank of England has also used language that reflects this false premise. In a 2014 article on 'shadow banking', Mr Carney mentioned securitization three times:[206] 'complex and opaque securitisation structures', 'unsound securitisation structures' and 'resumption of sound securitisation activity.' The premise that securitization is dangerous is also reflected in the common, cautionary formulation that 'securitisation, *if* undertaken properly, *can* be a useful financing tool'. Per the European Commission:

> If it is structured soundly securitisation is an important channel for diversifying funding within the economy.[207]

This premise is false on the evidence, namely the performance of 'unregulated' European ABS during the financial crisis.

Detailed and highly prescriptive

This false premise explains the detailed and highly prescriptive nature of the EU securitization *acquis*, perhaps most notably the STS regime, which describes only a narrow class of securitization transactions as 'simple, transparent and standardised' (as noted above, more than 100 requirements have been stipulated, of which perhaps 80 must be met on any transaction). The implied corollary is that all other securitization transactions are 'complex, opaque or unusual'. Thus if there is more than one asset type in the pool, the transaction cannot be classified as STS.[208] Or if the securitized assets consist of residential loans, car loans or leases and 'the available information related to

204 Michel Barnier, European Commissioner for Internal Market and Services, 7 July 2010, MEMO/10/304.

205 Michel Barnier, European Commissioner for Internal Market and Services, 'Towards better regulation of the shadow banking system', 27 April 2012, SPEECH/12/310.

206 Mark Carney, 'The need to focus a light on shadow banking is nigh' *Financial Times* (5 June 2014).

207 European Commission <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/securitisation_en> accessed 17 August 2018.

208 Regulation (EU) 2017/2402 art 20(8).

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the *environmental performance* of the assets financed' (emphasis added) is not disclosed, the transaction cannot be certified as STS.[209] Or if exposures can be substituted, other than in the case of breach of warranty, it cannot be STS.[210] The earlier lengthy description of the EU securitization *acquis* can scarcely hint at the detailed nature of the regulatory requirements. It bears repeating that the credit performance of European ABS during the last financial crisis belies the need for such an approach.

Unstable

The dynamic nature of the EU regulatory approach is an important consideration. EU legislators and regulators have continually revisited elements of the EU securitization *acquis* with a view to amending existing rules (eg CRA, CRA2 and CRA3), promulgating new rules (eg Article 8b of the CRA and the STS regime) and making the rules more detailed (by way of regulatory technical standards) and repealing relatively new rules (eg Article 8b). Thus the EU securitization *acquis* is seen not to be a relatively stable body of existing legislation and regulation but rather a continuing process of regulation and re-regulation. Therefore, if the EU securitization *acquis* is adopted by Parliament, elements of it likely will be superseded by new or amended EU rules and criteria not long after their adoption. Unless Parliament determines that UK law and regulation should track the changing EU securitization *acquis*, significant regulatory divergence would appear to be inevitable. UK market participants will find their ability to comply with both the 'frozen' UK *acquis* and with evolving EU securitization regulation diminishing over time in relation to cross-border deals or UK deals to be placed with EU investors. That prospect would of course also hold for the regulation of other types of cross-border finance. The difference is that adoption by Parliament of the EU securitization *acquis* is unnecessary.

Impedes securitization market recovery

The EU regulatory approach has likely slowed the recovery of the European securitization market. It is true that a number of other factors have contributed to the failure of the European securitization market to recover to pre-crisis levels of issuance. General investor wariness following large-scale fraud in the US securitization markets and significant market losses (not credit losses) on European ABS are obvious factors. The availability to European banks of subsidized central bank funding,[211] according to Standard & Poor's, has largely removed banks' incentive to securitize their assets.[212] The disappearance of SIVs and CDOS, which were large purchasers of European ABS, is another significant factor. However, the EU regulatory approach, driven by its false premise, and with its overly prescriptive rules and continually changing and expanding requirements, cannot have helped. On the contrary, that approach can only have impeded the recovery of the European ABS market. The liquidity of European ABS has

209 ibid art 22(4).

210 ibid art 20(7).

211 For example, the European Central Bank's LTRO and T-LTRO programmes and the Bank of England's Funding for Lending Scheme.

212 'Ten Years After the Financial Crisis, Global Securitization Lending Transformed by Regulation and Economic Growth', S&P Global Ratings, Structured Finance Research, 21 July 2017.

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also undoubtedly suffered by reason of the extension of new due diligence requirements to ABS held on the trading book as well as ABS held on banking book. What impairs the secondary market for ABS must also impair the primary market.

Credit market distortion

The barriers set up by the EU regulatory approach to European securitization necessarily divert investment in fixed income securities away from ABS. That money finds a home elsewhere and, theoretically, the increased demand exerts downward pressure on the price of other credits. The pricing of credit varies wildly across markets and over time but a regulatory framework that is based on a false premise and impedes investment in an otherwise sound credit cannot be good for the markets, particularly when the next financial crisis arises.

8. A new UK securitization framework

Considerations for UK securitization regulation

If adoption of the EU securitization *acquis* is neither necessary nor advisable for the prudent regulation of the UK financial markets, what main considerations should inform Parliament's approach in replacing it? The author suggests that the three most important are:

(i) non-discriminatory treatment of term securitization compared to other financing techniques as a guiding principle;
(ii) appropriate disclosure requirements; and
(iii) the willingness of our legislators and regulators to adapt and vary the non-binding Securitisation Framework published by the Basel Committee on Bank Supervision (BCBS) in the course of implementing it.

Non-discriminatory treatment of term securitization

As noted at the outset, term securitization is essentially an overcollateralized bond issue; frequently simple, occasionally complex. There is no reason to discriminate against term securitization in the regulatory sphere: indeed, the opposite case can easily be made. The combination of the discipline of the rating process and the disclosure requirements associated with a public bond issue require more legal and analytical rigour than do, say, project finance and asset-based lending transactions, not to mention high-yield securities. Paradoxically, a top-rated term securitization bond can be seen as a simpler credit than a top-rated vanilla corporate bond: a large pool of small, relatively uniform credits lends itself to a more reliable credit analysis than does a large operating business. Only once Parliament and UK regulators have discarded the false premise that term securitization is intrinsically more dangerous than other 'unregulated' structured financing techniques can they consider a sensible regulatory approach.

Appropriate disclosure requirements

In the fixed income markets, disclosure is all-important. No matter how arcane the asset or elaborate the structure, if disclosure is sufficient then the market can price the risk. Louis D.

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Brandeis famously wrote, ‘Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.’[213] The general duty of disclosure for listing particulars has long been set out clearly in subsection 80(1) of the Financial Services and Markets Act 2000 (FSMA):

> ...all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of –
> (a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the securities; and
> (b) the rights attaching to the securities.

Market participants have grown accustomed to significantly higher levels of disclosure under the EU securitization *acquis*. Thus, even if none of the post-financial crisis EU securitization disclosure requirements was adopted by Parliament, the general FSMA duty of disclosure would likely still require much of that information to be disclosed. That is not a reason for Parliament to adopt all of the incremental disclosure requirements under the EU securitization *acquis*, merely recognition that the general duty of disclosure will be determined in no small part by reasonable market expectation.

Purposeful implementation of post-financial crisis international norms

Much of the EU securitization *acquis* is derived from successive post-financial crisis amendments to the Basel II Framework. Examples include new securitization due diligence requirements,[214] eligibility and risk weighting of ABS for LCR requirements,[215] retention of economic risk[216] and ‘simple, transparent and comparable’ securitizations, which foreshadowed ‘simple, transparent and standardised’ securitizations.[217] If term securitization is not dangerous *per se*, however, the rationale for much of what the BCBS have published regarding securitization is also based on a false premise.

Nonetheless, the BCBS securitization framework represents a current international norm. Some elements of BCBS can, however, be implemented purposefully. For example, if Parliament declined to implement the STS regime (or another variation on the BCBS STC principles mentioned above), this could fairly be described as a more conservative regulatory approach. Parliament would not accord the more favourable risk weightings otherwise available to STS-compliant ABS. Equally, and more importantly, this approach would not brand non-STS-compliant ABS as suspect. Relative structuring freedom would prevail and over time the market would benefit.

Similarly, the principle of retention of economic risk by originators articulated by the G20 in Pittsburgh did not specify a percentage. Thus the UK risk retention requirement

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213 Louis D Brandeis, ‘Other People’s Money, and How the Bankers Use it’, Frederick A. Stokes, New York (1914) p. 92. Retrieved 29 April 2016 via Internet Archive: <https://archive.org/stream/otherpeoplesmone00bran#page/92/mode/2up/search/sunlight> accessed 17 August 2018.

214 Basel Committee on Banking Supervision, ‘Enhancements to the Basel II Framework’, July 2009, para 565.

215 Basel Committee on Banking Supervision, ‘Basel III: The Liquidity Coverage Ratio and Liquidity Monitoring Tools’, January 2013.

216 Basel Committee on Banking Supervision, ‘Basel III Document, Revisions to the securitisation framework’, 11 December 2014, para B12.

217 Basel Committee on Banking Supervision, ‘Basel III Document, Revisions to the securitisation framework’, Amended to include the alternative capital treatment for ‘simple, transparent and comparable’ securitisations, 11 December 2014 (rev July 2016).

could, for example, be lowered to 1 per cent, which would adhere to the principle while giving junior funders the opportunity to re-enter the origination market (as they would not have to fund such a large percentage of the retained securitized assets). Parliament could also lighten or eliminate the extreme investor due diligence requirements to exposures taken on the trading book, which in principle should encourage the UK secondary market in ABS.

Finally, some of the EU securitization *acquis* goes further than the BCBS securitization framework and the principles articulated by the G20. A notable example is the effective ban on resecuritizations. The BCBS securitization framework calls for higher risk weightings for resecuritizations, not an outright ban. Nor does Parliament need, by reference to international norms, to require that all rated structured finance transactions be rated by two rating agencies. Nor should a UK equivalent to EMIR require that top-rated securitization vehicles be subject to clearing or collateralization requirements.

Consequences of substantially de-regulating UK securitization

The substantial de-regulation of UK securitization as a discrete financing technique will not compromise the ability of UK counterparties to follow EU rules in order to participate in EU cross-border securitizations or to place UK ABS with EU investors. But it will result in greater scope for innovation, increased funding capacity for the UK economy and greater liquidity in the UK credit markets.

An honest approach to regulation

The EU regulatory approach to securitization has been based on a false premise and has impeded the recovery of the European securitization market and thereby distorted the allocation of credit. The agenda driving EU securitization regulation cannot, on the evidence, be the protection of investors. What the actual EU agenda might be is a matter of conjecture. What will be most important for Parliament, however, is an honest, evidence-based approach to the regulation of term securitization.

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