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Brexit and the UK regulation of term securitisation – what could possibly go wrong?

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UK Securitisation Regulation 101 (1)

- rated EU term securitisation suffered no defaults during the GFC
- there has been a sustained EU regulatory assault on securitisation – under the guise of protecting investors – since 2009
- placed EU term securitisation issuance in 2020 was still only 17% of 2006 issuance
- regulatory barriers continue to preclude the recovery of the EU securitisation market

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UK Securitisation Regulation 101 (2)

- the Bank of England and HM Treasury have both stated that securitisation is important to fund the UK economy
- upon Brexit, Parliament adopted the entire EU approach to securitisation
- HM Treasury, having been apprised of all of the relevant evidence on term securitisation performance and the effect of the current regulatory regime, announced in December 2021 that it is, broadly, "*continuing to support*" the current regulatory approach

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UK Securitisation Regulation 101 (3)

Let's take a closer look.

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Term securitisation is old (and new)

- 1769 – first Silesian transaction linking small, unmarketable loans with a broader capital market
- 1970 – the first US mortgage-backed securities
- 1985 - first issuance of bonds backed by UK mortgages originated by Bank of America

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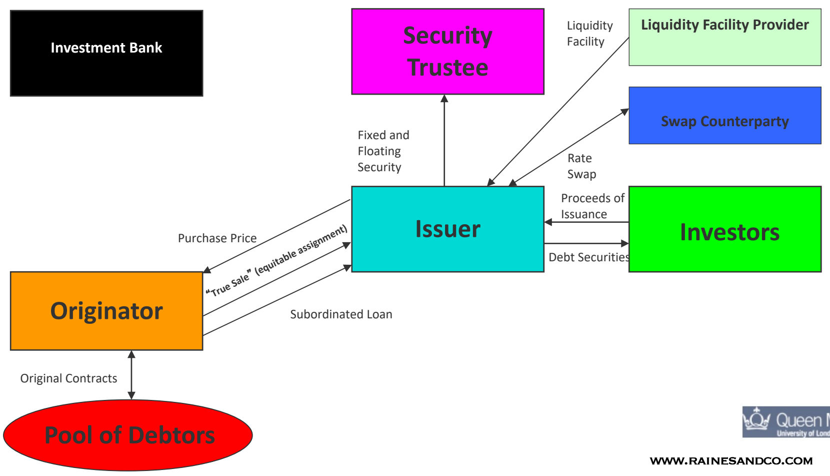
Basic term securitisation



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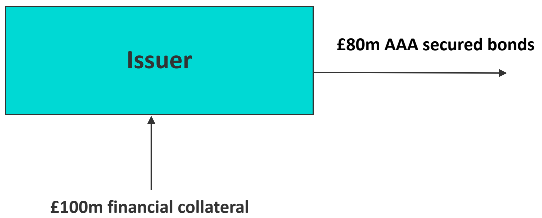
Really basic term securitisation

80 debt/100 financial collateral
= AAA credit



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Term securitisation usually results in the more efficient use of capital

- the originator, for example, a mortgage lender, typically retains an exposure to the first loss on the securitised assets and an interest in the profit generated by the securitised assets (being the excess of income on the securitised assets over the transaction and funding costs of the securitisation)
- assuming the originator applies the sale proceeds of the securitised assets to write more business (usually the case), the originator's book of financial assets increases – but supported by the same shareholder capital

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Securitisation was encouraged by EU Member States - and grew

- from 1988, special legislation was enacted in France, Spain, Portugal, Greece and Italy, Germany, the UK and other EU Member States to facilitate securitisation
- the European securitisation market grew rapidly
- in 2006, €477.6 billion of bonds backed by European assets were issued and placed

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Then investor confidence went…

- in the summer of 2007, prompted by fears about the US sub-prime market (see *The Big Short*), global investor appetite for structured bonds evaporated
- the London interbank market froze in August 2007
- European securitisation placed issuance dropped by nearly 95%, to @€25bn in 2009
  -www.afme.com
- the GFC...

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Stellar performance of European term securitisation during the GFC (1)

- rated European ABS and RMBS: no defaults
  – '*Securitisation can be a sturdy ally for investors*', Financial Times, 15 August 2017.
- losses generally confined to CMBS transactions and some lower tranches of certain ABS and CMBS deals
  – Ibid.
- cumulative default rate for all European structured finance notes rated by S&P including CDOs of ABS, CMBS and corporate securitisations) was – at mid-2014 – 1.58% of original balance
  – '*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.

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Stellar performance of European term securitisation during the GFC (2)

In 2014, the European Banking Authority compared the performance of top-rated European RMBS and ABS with top ratings assigned to corporate issuers, including financial institutions and insurance undertakings:

'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.'

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

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Zero EU regulation of securitisation prior to or during the GFC

- no EU regulation of securitisation prior to July 2009
- the only EU rules relevant to securitisation were:
  1. recognition of risk transfer by originator credit institutions;
  2. risk weighting of ABS and of undrawn liquidity facilities; and
  3. securitisation-specific prospectus requirements

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So, the point is…

During the worst financial crisis since the Great Depression:

- there was virtually no EU regulation of securitisation; and
- European term securitisation performed exceptionally well (and better than comparably rated vanilla debt)

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EU regulation of securitisation following the GFC

- highly detailed and prescriptive
- continually revisited, amended and expanded
- a staggering volume of regulation (our in-house Excel overview and guide runs to more than 3MB)
- EU regulation of securitisation cannot be summarised in five hours, much less in a few slides
- but a few main heads of EU regulation can be identified…

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Main heads of EU regulatory treatment securitisation

- risk retention
- disclosure
- due diligence
- standardisation
- ‘special treatment’ of securitisation exposures

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Risk retention

- meant to align interests of originator/sponsor/original lender and investors
- 5% to be retained by originator, sponsor or original lender
  - Reg (EU) 2017/2402 (Securitisation Regulation) Art 6(1), as amended
- 13 years after first introduced by Directive 2009 111/EC, detailed risk retention requirements are still being amended and supplemented
  - EBA consults on technical standards on risk retention requirements under the Securitisation Regulation, European Banking Authority, 30 June 2021

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Disclosure

- extensive 'transparency' requirements for originators, sponsors and SPV issuers
  - Reg (EU) 2017/2402 (Securitisation Regulation) Art 7
- detailed information on assets and structure to be made available to investors, to 'competent authorities' and, upon request, to potential investors – and, for public deals, to securitisation repositories
  - Reg (EU) 2017/2402 (Securitisation Regulation) Art 7
- technical standards regarding information and details of a securitisation, including format and templates, only came into force on 23 September 2020
  - Commission Delegated Regulation (EU)2020/1224 and ion Delegated Regulation (EU)2020/1225

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Due diligence by institutional investors

- investor must vet credit granting criteria, risk retention, underlying exposures and all structural features that can 'materially impact' performance
  - Reg (EU) 2017/2402 (Securitisation Regulation) Art 5(3)
- establish written procedures to monitor the securitisation position and the underlying exposures on continuing basis
  - Reg (EU) 2017/2402 (Securitisation Regulation) Art 5(4)
- be able to demonstrate to competent authorities a detailed a comprehensive and thorough understanding of securitisation position and underlying exposure
  - Reg (EU) 2017/2402 (Securitisation Regulation) Art 5(4)

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Standardisation

- new category of 'simple, transparent and standardised' ('**STS**') securitisation if it meets 100+ requirements and notified to regulator
  - Reg (EU) 2017/2402 (Securitisation Regulation), as amended, Arts 18-24 and 27-30
- STS is now a condition of LCR eligibility
  - Reg (EU) 575/2013, as amended, Art 13
- STS gives somewhat more favourable regulatory capital treatment for institutions than non-STS and a reduced (but still high) spread risk requirement for insurance and reinsurance companies
  - EU Reg 575/2013 (CRR), as amended, Arts 242-3, 260, 262 and 264; Delegated Reg (EU) No 2015/35, as amended, Art 178

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'Special' treatment of securitisation exposures

- non-STS AAA/Aaa-rated ABS are not eligible for LCR
  -Reg (EU) 575/2013, as amended, Art 13
- non-STS AAA/Aaa-rated ABS and A-rated non-senior STS ABS both cost more capital for an insurer/reinsurer than BB-rated (junk) corporate bond or loan
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 64
- AAA/Aaa-rated non-STS, non-senior RMBS costs a bank twice the risk-weighted capital of a book of residential mortgage loans
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 64

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The European and UK securitisation markets remain moribund

- European securitisation placed issuance was €119.2bn in 2019, €81.4bn in 2020 and €56.2bn in H1 2021
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 50
- so, EU placed issuance hovers around 20-25% of 2006 level, nearly 15 years after the onset of the GFC
- UK placed issuance was approximately €31bn in 2019, €20bn in 2020 and €15bn in H1 2021
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 52

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STS is not getting off the ground

- more than twice as much non-STS as STS securitisation has been issued in the EU and in the UK in 2019, 2020 and H1 2021
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 52
- sophisticated investors do not need STS
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 53
- less sophisticated investors will do the same due diligence and credit analysis for higher-yielding non-STS transactions
  -*Securitisation as a key pillar of the UK Future Regulatory Framework*, AFME, September 2021, p. 53

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The effect of EU and UK securitisation regulation

- it is much more difficult, time-consuming and costly for originators to securitise than it was prior to the EU regulatory project
- securitisation paper is much less attractive to institutional investors by reason of compliance constraints, prohibitions and penalty risk weightings
- the continuing ‘process’ of regulation – some 14 years after it began - results in continuing market uncertainty

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Industry views at September 2021 Global ABS Conference, London

- an "*avalanche of regulation*"
- regulation is "*moving all over the place*"
- investors prefer non-STS so they *"don't have to read all this guff"*
- we need to *"roll back the regulation"*

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Review of the Securitisation Regulation: Call for evidence

- HM Treasury was required by Art 46 of the Securitisation Regulation to report to Parliament by 1 January 2022 on, among other things, the effects of the Securitisation Regulation on the functioning of the securitisation market
- HM Treasury called for evidence in June 2021 and reported in December 2021.

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Response to the Call for evidence (1)

- HM Treasury said they received 21 responses from range of industry participants and from academics
  -*Review of the Securitisation Regulation: Report and call for evidence response,* December 2021, HM Treasury, p. 5
- one response was from Marke Raines
- one response was submitted jointly by the Association of Financial Markets in Europe ('**AFME**') and UK Finance, on behalf their members (together with an 88-page Appendix of explanation and evidence)

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Response to the Call for evidence (2)

- AFME has 45 members, including Clifford Chance, Allen & Overy, Barclays, HSBC, Banco Santander, Citi, S&P, Moody's, Deloitte, BNY Mellon, BlackRock, PwC and more
- UK Finance represents around 300 firms providing finance, banking, markets and payments-related services in or from the UK

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Highlights of the Raines Response (1)

- the evidence shows two things:
  - during the GFC there were no credit losses on rated UK term securitisation (even though there was virtually no EU-level regulation of securitisation at the onset of the GFC and little UK regulation of any consequence); and
  - the UK securitisation market, in terms of placed securitisation issuance backed by UK collateral, has remained moribund since 2007.

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Highlights of the Raines Response (2)

- the adopted UK regulatory approach to securitisation is based on a false premise, that term securitisation is a significantly more dangerous financing technique than others, such as asset-based lending or high-yield bonds
- the post-GFC EU regulation adopted by the UK is impeding the recovery of the UK securitisation market
- the regulatory barriers to UK securitisation distort the credit markets generally
- a wholesale review of UK securitisation regulation is required

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Highlights of the AFME/UK Finance Response (1)

- the impact of the STS framework has been "*disappointing, though not entirely surprising*…"
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 2
- the "*very harsh risk factors*" applied under Solvency II for mezzanine and subordinated risk "*discourage any meaningful engagement by insurers*"
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 6
- LCR treatment has "*significantly harmed secondary market liquidity for [securitisation] instruments and bank treasuries' demand for this issuance*."
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 8

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Highlights of the AFME/UK Finance Response (2)

- the benefits of the Securitisation Regulation "…*are outweighed by higher compliance requirements and costs, especially for issuers*."
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 9
- the Securitisation Regulation, "…*although intended to encourage new investors into the market, has had the opposite effect by increasing the barriers to entry for investors*."
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 9

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Highlights of the AFME/UK Finance Response (3)

- the cumulative effect of the Securitisation Regulation appears to have been "…*to make securitisation markets shallower and less liquid than they otherwise would be*."
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 10
- the Securitisation Regulation diligence and disclosure rules "…*have not in fact created meaningful market safety, nor have they done much to develop the market or increase financing of the real economy at a scale that reflects the potential of the product*."
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 13

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Highlights of the AFME/UK Finance Response (4)

- the Securitisation Regulation is "*excessively prudent*"
  -2 September 2021 Response of AFME and UK Finance to *HM Treasury's Review of the Securitisation: Call for evidence*, p. 16

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HM Treasury's Report and call for evidence response (1)

HM Treasury counted 21 responses and appeared to accord them equal weight, including that of AFME/UK Finance:

- "*16 respondents answered questions on the overall effects of the Sec Reg*."
  -Review of the Securitisation Regulation: Report and call for evidence response, HM Treasury, December 2021, para. 2.5
- "*…the vast majority of respondents conveyed their general support for the Sec Reg*."
  -Review of the Securitisation Regulation: Report and call for evidence response, HM Treasury, December 2021, para. 2.6

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HM Treasury's Report and call for evidence response (2)

- "*…HM Treasury assesses that the Sec Reg remains an important element to the functioning regulation of securitisation in the UK. We remain committed to the ongoing and effective implementation of the Sec Reg...*"
  -Review of the Securitisation Regulation: Report and call for evidence response, HM Treasury, December 2021, para. 2.51
- "*…HM Treasury does not currently see sufficient evidence to support significant changes to the capital treatment of securitisation, which is consistent with the Basel standards.*"
  -Review of the Securitisation Regulation: Report and call for evidence response, HM Treasury, December 2021, para. 11.13

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Where does that leave us?

- all the evidence in the world will not move HM Treasury to revisit the regulatory treatment of securitisation
- the UK securitisation market, in this regulatory environment, will not recover
- "*It is what it is*."

  -S. Quinn, Royal Canadian Navy (ret'd)

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Questions

- When hundreds of billions of GBP of investment funding is artificially diverted from top quality credits to other credit markets:
  - what happens to the pricing of credit?
  - what kinds of market distortions arise?
  - what happens if credit is mis-priced and markets are distorted?
- When those responsible for important decisions that affect the market do not bear the consequences of those decisions, what could possibly go wrong?

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