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Securitisation

UK
Sanjev Warna-kula-suriya and Kamal Dalal
Latham & Watkins

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Law and Practice

Contributed by:
Sanjev Warna-kula-suriya and Kamal Dalal
Latham & Watkins ***see p.19***

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Contributed by: *Sanjev Warna-kula-suriya and Kamal Dalal,* ***Latham & Watkins***

1. Structurally Embedded Laws of General Application

1.1 Insolvency Laws

Structurally Embedded Laws of General Application

The UK ceased to be a member of the EU on 31 January 2020 under the terms of the withdrawal agreement, which was given effect in UK law through the European Union (Withdrawal Agreement) Act 2020. The UK then entered a transition period that lasted until 31 December 2020, during which time the UK continued to be treated as a member of the EU for most purposes and EU law still applied in the UK. The UK's relationship with the EU is now governed by the trade agreement that was announced on 24 December 2020, pursuant to which, the UK is being treated as a third country for purposes of EU financial services regulation from 1 January 2021.

There is lingering uncertainty regarding the impact of Brexit on the legal and regulatory framework applicable to securitisations in the UK, or with a UK nexus, in particular for cross-border EU–UK transactions. The European Union (Withdrawal) Act 2018 (the "Withdrawal Act") aims to ensure continuity in law in the UK following Brexit through retained EU law, together with various statutory instruments (SIs). The relevant SIs from a securitisation perspective, including the Securitisation (Amendment) (EU Exit) Regulations 2019, will create a dual securitisation regime in the EU and the UK, which could diverge over time. While this chapter focuses on the regime applicable at the time of writing, reference is made to the regime that could emerge after the transition period.

Insolvency Laws

In securitisations, structural and contractual protections are used to isolate the credit risk of the assets that are being securitised (and therefore the credit risk of the notes that are being secured and serviced by such assets) from the credit risk of the originator. In this way, investors in the notes are only exposed to the credit risk of the underlying obligors rather than of the originator, enabling the notes to carry a higher credit rating. "Originator" is used to refer to the seller of the underlying assets (as a result of being the generator or owner thereof).

Typically, the de-linking of credit risk in securitisations is achieved through a "true sale" of assets from the originator to the issuer. Upon a true sale, the assets cease to belong to the originator or form part of the originator's insolvency estate. The two primary risks in relation to a true sale analysis are whether the sale transaction could be re-characterised as a secured loan and/or be subject to claw-back; ie, whether, on an insolvency of the originator, the sale of assets could be contested successfully, avoided or set aside under the Insolvency Act 1986 (IA 1986).

True Sale v Secured Loan

In determining whether the transfer of assets constitutes a true sale or secured loan, the courts would look to the sale agreement to determine whether the sale was a sham or did not meet the legal criteria for a sale. The substance of the transaction would be assessed, notwithstanding any labels given to it by the parties.

There are three key differences between a sale and a secured loan:

- under a secured loan the chargor has a right to the return of the charged assets upon repayment of the loaned amount, whereas upon a sale the seller is not entitled to have the transferred assets returned in exchange for a return of the purchase price;
- under a secured loan the chargee has to account to the chargor for any profits made on a disposal of the charged assets, known as the "equity of redemption", whereas in a sale if the purchaser re-sells the transferred assets, it is not obliged to account to the seller for any profit or gain made; and
- conversely, while under a secured loan the chargee typically passes on the risk of losses or damages incurred on the charged assets to the chargor, in a sale if the purchaser re-sells the transferred assets at a loss, it has no right to recover that loss from the seller.

While these distinctions are generally applicable, a transfer of assets may be characterised as a sale even though (i) the purchaser has recourse to the seller for any shortfall if the underlying obligor fails to pay, or (ii) the purchaser has to adjust the purchase price after recovery by the seller against the underlying obligor. Moreover, the following concepts are generally acceptable in a true sale securitisation.

- The obligation of an originator to repurchase assets in limited circumstances, such as:
  - (a) a breach of warranty relating to those assets; or
  - (b) a "clean-up call", whereby the originator repurchases all outstanding assets once the principal amount outstanding of the notes reaches a sufficiently low threshold (typically 10% of the initial amount outstanding) to allow the redemption of the notes and wind-down of the securitisation.
- A deferral of part of the purchase price payable by the issuer to the originator.
- A degree of credit risk on the assets being held by the originator as a first loss position (including as fulfilment of risk retention requirements).
- The originator receiving residual profits as part of the structure.

Protection of Assets

The effect of a true sale securitisation is to transfer beneficial title (and, following requisite perfection steps, legal title) to the assets from the originator to the issuer, such that they cease to be assets of the originator. In contrast, under a secured loan a charged asset would remain an asset of the originator – albeit subject to the security granted to the issuer – and, upon the insolvency of the originator, the issuer would have to rely on its security interest to realise its rights to the charged asset.

As a general rule, security created by a company incorporated in England and Wales must be registered at Companies House within 21 days of the date on which it was granted, or else it will be void against other creditors, administrators and liquidators of the chargor. No registration would be made pursuant to a sale of assets (as this could impact the true sale analysis). The risk is that if a purported true sale were to be re-characterised as a secured loan, in an insolvency of the originator, the assets would form part of the originator's insolvency estate and the security would be void for lack of registration. The issuer may be left with an unsecured or subordinated claim, depending on the nature of the security interest and relative ranking of other creditors' claims. Even if the issuer benefited from first-ranking security, it would need to rely on the insolvency process to realise its rights to the assets.

While less common, certain types of securitisations use a secured loan structure. One example is a whole business securitisation, where the cash flows are generated from the operating revenues of a business (rather than a pool of assets). One way of mitigating the issuer's credit risk is for the issuer to hold a qualifying floating charge over all or substantially all of the assets of the business.

Fixed or Floating Security

If a court were to consider whether security granted constituted fixed or floating security, its description would not be determinative. The hallmark of a floating charge, and a characteristic inconsistent with a fixed charge, is that the chargor is free to use the assets subject to the charge.

Security by way of floating charge has several potential disadvantages, including the following.

- In an enforcement scenario, the claims of the security trustee for the secured creditors would be subject to the claims of preferential creditors. Under the Finance Act 2020, which came into force on 22 July 2020, HMRC will obtain preferential status as a secondary preferential creditor in respect of certain tax liabilities – including VAT, pay as you earn and National Insurance contributions, but excluding corporate income tax – of insolvent companies from 1 December 2020.
- If an administrator, liquidator, provisional liquidator or floating charge receiver is appointed in relation to the chargor, a prescribed part of the net realisations derived from the floating charge has to be ring-fenced for the benefit of unsecured creditors under Section 176A, IA 1986 and the Insolvency Act (Prescribed Part) Order 2003. Until recently, the prescribed part was up to a maximum fund of GBP600,000, but was increased in April 2020 to GBP800,000.
- A floating charge may be invalid if granted in the 12 months (or, in some cases, two years) prior to the commencement of the chargor's insolvency if granted in exchange for prior consideration only and if at the time of creation the chargor was unable, or became unable, to pay its debts as they fell due (Section 245, IA 1986).
- If the chargor enters into administration, the administrator would be free to dispose of or otherwise deal with assets that are subject to a floating charge without the consent of the floating charge holder or release of the charge.
- If the chargor is subject to liquidation commencing on or after 6 April 2008, the liquidation costs are payable from any amounts realised from the sale of assets secured by the floating charge, in priority to the claims of the floating charge holder.

Claw-Back Risks

A key risk when structuring a "bankruptcy-remote" sale of assets is that the transfer could be subject to claw-back on an insolvency of the originator, for any of the following reasons.

Transaction at an undervalue (Section 238, IA 1986)

The court may set aside a transaction made at an undervalue by the originator in the two years prior to the onset of an administration or liquidation of the originator if (i) the originator was at the time, or as a result of the transaction became, unable to pay its debts as they fell due (within the meaning of Section 123, IA 1986), and (ii) the originator received no consideration or the value of the consideration received by the originator, in money or money's worth, is significantly less than the value of the consideration provided by the originator. For the sale of assets to the issuer to be valid, the court must be satisfied that:

- the originator entered into the transaction in good faith for the purpose of carrying on its business and there are reasonable grounds for believing that the transaction would benefit the originator; or
- the originator was not at the time of the transaction, and did not as a result of the transaction become, unable to pay its debts as they fell due.

The originator should give the confirmations above in its corporate authorisations prior to entry into a securitisation and provide a solvency certificate on closing.

Defrauding creditors (Section 423, IA 1986)
A sale can be set aside if both (i) the transaction was at an undervalue and (ii) the purpose of the transaction was to put assets beyond the reach of the originator's creditors, or to otherwise prejudice any creditor's interests in relation to claims they may make against the originator. If it can be demonstrated that limb (i) does not apply, limb (ii) is rendered irrelevant.

Preference (Section 239, IA 1986)
If during the six months prior to the onset of an administration or liquidation of the originator (or, in some cases, two years), the transaction is considered to be a preference that can be set aside by the court. As a general rule, a transaction may be held to be a preference if it has the effect of putting one of the originator's creditors in a better position than it otherwise would have been in upon the originator's insolvency, and the originator was influenced in entering into such transaction by a desire to prefer that party.

The sale of assets may nonetheless be valid if the court is satisfied that the originator was not unable at the time of the preference to pay its debts as they fell due and did not become unable to do so as a consequence of the preference.

Onerous property (Section 178, IA 1986)
Upon a liquidation of the originator, the liquidator has the right, among other things, to disclaim any onerous property of the originator. This could include the sale agreement if it is held to be an unprofitable contract, whereby the performance of future obligations of the originator thereunder would prejudice the liquidator's duty to realise the assets and make a distribution to the originator's creditors. Practitioners are generally comfortable that a liquidator would not disclaim the sale agreement if the effect would be to take away from the issuer its interests in the transferred assets.

Rescission of contract by court (Section 186, IA 1986)
If the originator is subject to liquidation, any person who is entitled to the benefit, or subject to the burden, of a contract with the originator may apply to the court for an order rescinding that contract on such terms as the court thinks just. Practitioners are generally comfortable that a court would not rescind the sale agreement as it would render ineffective the transactions effected by such agreement.

1.2 Special-Purpose Entities

A key aspect of a traditional securitisation generally involves establishing the issuer as a bankruptcy-remote special-purpose entity (SPE).

The SPE must preserve legal separateness from the originator's insolvency estate, and minimise the risk of filing for bankruptcy protection itself, to achieve the intended isolation of credit risk. It is typically an orphan limited liability company whose activities are restricted by comprehensive negative covenants, including prohibitions on engaging in activities beyond those contemplated by the transaction documents, having employees or subsidiaries, incurring indebtedness or granting other security.

None of the directors of the SPE should be nominated by the originator, to mitigate the risk of the SPE being viewed as connected/associated with the originator for purposes of the Pension Act 2004, which could lead to the SPE being required to provide financial support for any deficit in a defined benefit pension scheme of the originator group.

Where the SPE forms part of a group with other companies for tax purposes, secondary tax liabilities may be relevant, including the following.

- Corporation tax– where the SPE is treated as being in a chargeable gains group with the originator, as unpaid corporation tax on chargeable gains can fall to be paid by the principal company of the chargeable gains group and any member of the group in the 12 months prior to the relevant gain accruing that also owned the asset disposed of.
- VAT – where the SPE is in the same VAT group as the originator, it is jointly and severally liable for the VAT liabilities of the originator and any other members of the group. VAT grouping might be elected to manage any charge to VAT that may arise in relation to servicing of the assets, in which case a form of tax covenant would generally be expected from the operating group companies to mitigate associated risks to the SPE.

The other parties to the securitisation should agree not to commence insolvency proceedings against the SPE (under non-petition provisions) and that each party's recourse against the SPE is limited to the transferred assets held by it (under limited recourse provisions).

Risk of Consolidation
The doctrine of substantive consolidation, which permits the pooling of assets and liabilities of distinct corporate entities, is not recognised by the English courts. Even if the SPE is owned by, or connected to, the originator, the fundamental principle of English law that a company has a legal personality that is

distinct from its shareholders (known as the "corporate veil") means that assets and liabilities of the SPE would be treated as distinct in all but very limited circumstances.

One exception is where the assets of an entity may be available to meet the liabilities of another entity over which it acts as a shadow director. To mitigate the risk of the court treating assets of the SPE as those of the originator or another party, there should be sufficient grounds for demonstrating that the SPE has a distinct legal personality (including having independent directors, producing separate accounts, maintaining a separate pool of assets, and maintaining arm's-length relationships).

Other Material Relevant Law

- Tax laws relating to an SPE are a key consideration (see **2. Tax Laws and Issues**).
- The regulatory regime applicable to the underlying contracts relating to the securitised assets should be assessed as part of the due diligence (eg, for consumer loans, compliance with consumer credit protection laws).
- Data protection laws relating to the originator's handling of customers' personal data should be taken into consideration. If any personal data is passed on to the SPE, the SPE may also be subject to data protection obligations.

The originator and servicer should hold relevant permissions to carry on regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

1.3 Transfer of Financial Assets

Transfer by Assignment

Under English law, an assignment denotes the transfer of an existing right or interest in intangible property presently owned by the assignor to the assignee. For an assignment to take effect in law rather than equity (such that both legal and beneficial title are transferred), Section 136 of the Law of Property Act 1925 (LPA) provides that the assignment must be:

- only of the benefits of the underlying contract relating to the assets;
- absolute, unconditional and not by way of charge;
- of the whole of a debt;
- in writing and signed by the assignor; and
- notified to the person from whom the assignor would have been entitled to claim the debt (ie, the underlying obligor).

An assignment that does not satisfy the above requirements would generally constitute an equitable assignment, provided that there is a clear intention to assign.

In securitisations, the originator generally prefers to remain the holder of legal title (and lender of record) to preserve its relationship with its customers and avoid having to notify them, which can be impractical. It is common for assets to be transferred to the issuer by equitable assignment, such that only the originator's beneficial rights, title and interest in and to the assets evidenced by the underlying contracts is transferred. The issuer typically has the right to perfect its title by completing the formalities under Section 136 of the LPA upon the occurrence of certain events.

Until notice of assignment is served on the obligors, the primary risks are as follows.

- Cash-flow interruption – the obligor is entitled to continue to pay amounts due under the assigned assets to the originator, which constitutes good discharge of the obligor's obligations without the issuer receiving such payments. Securitisations may minimise this risk by:
  - (a) the originator instructing the obligors to pay directly to the issuer;
  - (b) the originator transferring any payments received in respect of assigned assets (being "collections") to the issuer's account on a regular basis (known as "sweeping");
  - (c) prior to sweeping any payments into the issuer's account, the originator holding such payments on trust for the issuer; and/or
  - (d) the originator collateralising a proportion of expected collections.
- Subject to equities – the originator's rights under the assigned assets will be subject to any equities that arose in favour of the obligors prior to assignment, or that arise in favour of the obligors after assignment but before notice is given. The effect of the issuer giving notice to the obligor is that the issuer's interest in the assets remains subject to equities in existence before notice is given. While equities arising against the originator after notice is given should not affect the issuer, if the equitable right arises out of the same contract, or flows out of and is inseparably connected with the dealings that gave rise to the subject matter of the assignment, the obligor could rely on it as against the issuer. In particular, equitable rights of set-off may accrue in favour of an obligor, enabling the obligor to set-off payments due from it to the originator against amounts due from the originator to it. Securitisations often include the following features to minimise these risks:
  - (a) prohibiting the obligors from exercising rights of set-off in the underlying contracts;
  - (b) requiring the originator to warrant that there are no adverse interests or set-off rights in the underlying contracts, or if there are, that they have not arisen and will not be exercised; and/or
  - (c) excluding or limiting assets under which set-off is more

likely to arise.

- Legal action against the obligors – the issuer is unable to bring any legal action in its own name against any obligor and will have to join the originator as a party to such action. This risk is minimised by requiring the originator to grant a power of attorney in favour of the issuer (or a nominee on its behalf), enabling the issuer to bring proceedings in the originator's name or to give notice of assignment to the obligor.
- Modification of contracts – the originator has the right to amend the underlying contracts without the consent of the issuer. This risk is usually minimised by the originator undertaking in the sale agreement not to modify the underlying contracts (except in accordance with its agreed policy).
- Priority over issuer's rights – a subsequent secured creditor of the originator's rights for valuable consideration acting in good faith and that has no notice of the assignment could gain priority over the issuer if it serves notice of assignment on the obligor before the issuer. This risk is usually minimised by contractual protections prohibiting the originator from granting security over the assets following their assignment to the issuer.
- Prior trust – beneficiaries under a prior trust have priority over a subsequent assignee even if no notice of the trust is given to the assignee. This risk is usually mitigated by requiring the originator to assign the contracts with full title guarantee, which includes an implied covenant that the originator has the right to dispose of the contracts.

Transfer by Novation

The transfer could be effected by novation, which would transfer both the rights and obligations of the originator under the contracts evidencing the assets. However, this is avoided for a couple of reasons. First, a novation requires the consent of all parties to the underlying contract – including the obligor – which is usually impractical. Second, a transfer of the originator's obligations could mean that post-novation the issuer becomes obliged to fund any undrawn commitment.

Transfer Restrictions

The underlying contracts should be reviewed to establish whether they include contractual restrictions on transfer or confidentiality obligations that would prohibit their assignment or unduly limit dealing with information on the obligors.

Under English law, in the absence of an express restriction on transfer, rights under a contract may be assigned. If the contract expressly imposes conditions to assignment, any purported assignment that does not satisfy those conditions would be unenforceable as between the assignor and non-assigning party, but should still be enforceable as between the assignor and assignee. As such, both legal assignment and equitable assignment should be effective to ensure the transfer of assets is enforceable by the issuer against the originator (or its insolvency official and creditors).

1.4 Construction of Bankruptcy-Remote Transactions

As an alternative to a "true sale" of assets, the originator could declare a trust over its rights under the assets for the benefit of the SPE. This is also an effective method to achieve bankruptcy remoteness (for instance, the originator generally agrees to hold collections on trust for the issuer in addition to the true sale of assets). However, if assets were transferred by way of a declaration of trust only, legal title would remain with the originator and the issuer's title would be subject to the limitations set out in **1.3 Transfer of Financial Assets**.

2. Tax Laws and Issues

2.1 Taxes and Tax Avoidance

On the Transfer of Assets to the SPE

Stamp duty or stamp duty reserve tax (SDRT) can be chargeable on the transfer of certain assets. A charge to stamp duty can apply to instruments transferring stock and/or marketable securities at a rate of 0.5% of the consideration for the transfer (or, in the case of a transfer to a connected company and of listed securities, 0.5% of the value of the securities, if higher). Other securities transferred without a written instrument may be subject to SDRT at the same rate. In most cases, the transferred assets will not be stock or marketable securities. If they are, the transferred assets will still be exempt from stamp duty and SDRT where the transferred securities fall within the loan capital exemption provided for in Section 79(4) of the Finance Act 1986.

VAT should not apply to the transfer of assets. HMRC has agreed to follow the decision in MBNA Europe Bank Ltd v HMRC [2006], which found that a transfer of assets as part of a securitisation was not a supply for VAT purposes. Even if HMRC were to decide not to follow this decision, a transfer of assets would generally constitute an exempt supply under item 1 of Group 5 of Schedule 9 to the Value Added Tax Act 1994 (VATA) where the supply is made to a UK SPE.

On the Issue and Transfer of Debt Issued by the SPE

The issue of debt by the SPE is generally not subject to stamp duty or SDRT. Debt issued by the SPE is also generally exempt from stamp duty and SDRT on transfer by virtue of the loan capital exemption referred to above. This exemption is not available where the securities in question have certain equity-like features. Although the exemption is not generally available where the securities in question are results-dependent, securi-

ties are not considered to be results-dependent solely due to being issued on a limited recourse basis.

VAT should not apply to the issue of debt by the SPE. Following the decision in Kretztechnik AG v Finanzamt Linz [2005], HMRC considers that an issue of securities by an SPE will not constitute a supply for VAT purposes. If such an issue were, however, to give rise to a supply for VAT purposes, it would generally be exempt from VAT under item 1 of Group 5 of Schedule 9 to the VATA.

Accounting Position of the Originator

Whether the transfer of assets gives rise to a corporation tax liability for the originator depends upon the accounting treatment applicable to the assets transferred and, where relevant, the tax basis applicable to those assets. Anti-avoidance legislation can apply to certain transfers designed to secure a tax advantage. Securitisations are regularly structured as "on balance sheet" transactions from an accounting perspective, so that no income is recorded in respect of the assets transferred by the originator.

2.2 Taxes on SPEs

If the SPE meets the conditions prescribed by the Taxation of Securitisation Company Regulations 2006, as amended (TSCR), it will be subject to tax only on its retained profit (ie, after all payments and receipts have been made by the SPE). The SPE is not required to earn a particular minimum amount of retained profit; however, HMRC has previously accepted GBP1,000 as a sufficient amount of possible retained profit. Certain defensive features of the UK tax system, such as those in relation to transfer pricing or restrictions on the deductibility of interest, will not apply to an SPE meeting the TSCR conditions.

Where the SPE does not meet the TSCR conditions, it is subject to normal UK corporation tax rules. This would generally cause significant complications. Although the SPE typically pays out almost everything it receives, the SPE could still have a taxable profit under normal UK corporation tax rules (save in a case where all payments made by the SPE qualify for tax deductions). "Limited recourse" debt is typically characterised as a distribution for UK tax purposes and, as such, is not tax-deductible. The SPE could find itself in a dire position if all its income under the assets were taxable but none of the interest payments on the capital market debt was deductible. The SPE can also find itself having to account for taxes that are never realised by the SPE on derivatives as these are held to maturity but taxed in accordance with their accounting treatment (which often requires that derivatives are accounted for on a fair value basis). This issue does not arise for an SPE taxed within the TSCR, as payments and receipts under swaps are treated on a cash basis, with only the issuer's retained profit being subject to tax.

2.3 Taxes on Transfers Crossing Borders

Withholding tax should not apply on the transfer of UK assets, although practitioners do need to consider whether withholding tax applies to payments made on UK assets where the assets have been transferred overseas. Double tax treaty clearances are available if the SPE is in a jurisdiction with which the UK has a treaty with an appropriate interest article. The UK has a large network of double tax treaties that provide for full exemption from withholding on account of UK income tax.

VAT and stamp duty are discussed in **2.1 Taxes and Tax Avoidance**.

2.4 Other Taxes

Servicing fees are generally exempt from VAT, if the exemption for "management of credit by the person granting it" applies. This exemption applies where:

- the servicer is also the originator and retains legal title to the receivables;
- the servicer is a member of the same VAT group as the originator and legal title to the receivables is retained within that VAT group; or
- the servicer holds legal title to the receivables, irrespective of the status of the originator.

Exemption from VAT is not generally available in cases where the servicer (or a member of the servicer VAT group) no longer retains legal title to the receivables. In this scenario, the servicer generally makes a standard rated supply for VAT purposes (chargeable at 20%). Because the SPE is not generally able to recover VAT on the supplies that it receives, tax leakage typically arises when servicing fees are subject to a charge to VAT.

Prima facie, an SPE paying "yearly interest" arising in the UK is required to withhold income tax on a payment of such interest at the basic rate. A number of potential exemptions are relevant. The "quoted Eurobond" exemption, which applies when the notes are listed on a recognised stock exchange, is often relied upon. Where this does not apply, the applicability of other specific exemptions depends upon the identity of the holders of debt (including the availability of double tax treaty clearances).

Withholding tax on annual payments may also be a relevant consideration in the context of payments under any residual certificates. Withholding tax on annual payments does not apply where the SPE is a securitisation company. Withholding tax is not imposed on payments made by a residual certificate holder resident for tax purposes in the UK.

Practitioners typically ensure that the relevant parties to the transaction do not form tax groups with other parties, to avoid

such entities being secondarily liable for the tax of another party. Tax groupings typically exist (or do not exist) by reference to whether entities are under common control. Certain secondary tax liabilities do not apply to securitisation companies taxed under the TSCR.

The introduction of the EU Directive on Administrative Cooperation (DAC 6) requires certain cross-border arrangements to be reported to HMRC. Securitisation structures may be reportable if any of the hallmarks specified in Annex IV of the Directive are met (although some of the hallmarks only require a relevant intermediary to report where a main benefit test is also met). Most securitisation structures are not reportable, but practitioners may need to consider the application of DAC 6.

2.5 Obtaining Legal Opinions

From a tax perspective, legal opinions in relation to securitisations usually cover:

- the tax treatment of the SPE;
- potential stamp taxes and VAT on the transfer of the assets;
- stamp taxes on issue of the notes;
- VAT on the services provided to the SPE;
- withholding tax on payments under the notes; and
- secondary tax liabilities.

3. Accounting Rules and Issues

3.1 Legal Issues with Securitisation Accounting Rules

Balance sheet treatment, and the related question of whether the SPE is consolidated for accounting purposes into the originator's group, is addressed by accountants separately from the legal analysis.

3.2 Dealing with Legal Issues

As above, accounting analysis is undertaken separately from the legal analysis.

4. Laws and Regulations Specifically Relating to Securitisation

4.1 Specific Disclosure Laws or Regulations

EU Securitisation Regulation

Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 (the "EU Securitisation Regulation") has applied in the EU since 1 January 2019. The EU Securitisation Regulation applies to all securitisations (subject to grandfathering provisions) and introduced a framework for simple, transparent and standardised (STS) securitisations.

The EU Securitisation Regulation is directly applicable EU law and has been transferred to the UK statute book as retained EU law by operation of the Withdrawal Act. The Securitisation (Amendment) (EU Exit) Regulations 2019 (the "Securitisation SI") amends the onshored EU Securitisation Regulation to ensure that it can operate effectively at the end of the transition period (for instance, replacing references to the European Securities and Markets Authority (ESMA) and European Banking Authority (EBA) with the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA), respectively). This will result in a UK-specific version (the "UK Securitisation Regulation"), which will be initially identical to, but distinct from, the EU Securitisation Regulation.

At the time of writing, it remains unclear to what extent a dual securitisation regime will emerge whereby distinctions appear between the two. The Withdrawal Act only onshores EU legislation that was legally binding at the end of the transition period, but will not apply to any legislation that may be published following that date (including level 2 measures). The Withdrawal Act does not onshore any level 3 measures, such as ESMA or EBA guidance.

The EU Securitisation Regulation repealed the disclosure, due diligence and risk retention provisions that previously applied to different categories of regulated investors under the Capital Requirements Regulation (CRR), the Alternative Investment Fund Managers Directive (AIFMD) and the Solvency II Directive. These requirements have been replaced with one set of harmonised rules applying to securitisations across all financial sectors.

For these purposes, "securitisation" has the meaning provided under the CRR, being any transaction under which the credit risk associated with an exposure or pool of exposures is tranched and in respect of which:

- payments in the transaction are dependent upon the performance of the exposure or pool of exposures; and
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction.

The EU Securitisation Regulation is relevant to any securitisation in the EU (and the UK Securitisation Regulation is relevant to any securitisation in the UK after the transition period), regardless of whether there is an issue of securities and those securities are marketed or acquired bilaterally.

Securitisations that closed prior to 1 January 2019 are subject to grandfathering, such that the previous regime continues to apply to such transactions. However, grandfathering is lost if there is a new issue of securities under such transactions on or

after 1 January 2019 (or new securitisation positions are created where there is no issuance of securities). Parties should consider the rules relating to grandfathering when pre-2019 transactions are subject to amendment as this could lead to grandfathering being lost. Drawings under committed variable funding notes or revolving credit facilities should not be considered a new issue of securities.

Currently, STS designation is only available for traditional true sale securitisations where the originator and issuer are established in the EU. Against the backdrop of the COVID-19 pandemic, however, the European Commission published a package of proposed measures dubbed the "Capital Markets Recovery Package" in July 2020 (the "Commission Proposals"), to facilitate access to financing for SMEs and support the economic recovery. The Commission Proposals recommend the creation of a cross-sectoral STS framework for balance sheet synthetic securitisations and the adoption of differentiated prudential treatment for such transactions. At the time of writing, they are subject to EU parliamentary approval.

Detailed requirements in relation to provisions of the EU Securitisation Regulation are included in regulatory technical standards (RTS) and implementing technical standards (ITS). On 3 September 2020, the following RTS and ITS were published and applied from 23 September 2020:

- RTS and ITS specifying the information to be made available by originators, sponsors and/or SPEs (each a reporting entity);
- RTS and ITS on securitisation repositories (registration and operational standards); and
- RTS and ITS on notification of STS securitisations.

The EBA's draft RTS EBA/RTS/2018/01 on risk retention requirements under the EU Securitisation Regulation has not yet been finalised (and at the time of writing it is unclear when it will be).

The CRR Amending Regulation (EU) 2017/2401 (the "CRR Amending Regulation") has applied since 1 January 2019 and provides for a more risk-sensitive prudential treatment for STS securitisations. See **4.6 Treatment of Securitisation in Financial Entities** for further details.

Under the UK Securitisation Regulation, EU STS securitisations notified to ESMA before and up to 31 December 2022, and which remain on ESMA's list, will be treated as STS securitisations in the UK regime. To qualify as a UK STS securitisation, the UK Securitisation Regulation only requires that the originator or sponsor is established in the UK, with no mention of issuers. By contrast, to qualify as an EU STS securitisation, the originator, sponsor and issuer must be established within the EU, which means that UK securitisations would not (absent another step by the EU) qualify for STS treatment in the EU Securitisation Regulation, leading to an expected divergence between the two regimes, with the UK being more permissive.

Specific Transparency and Disclosure Laws or Regulations

Securitisation-specific disclosure obligations are placed on transaction parties under the EU Securitisation Regulation. The RTS relating to disclosure provides that, as of 23 September 2020, transaction parties must report under the disclosure templates annexed thereto (the transitional disclosure provisions under Regulation 462/2013 (CRA 3) have ceased to apply).

The EU Securitisation Regulation places disclosure requirements on the originator, sponsor and the SPE, directly under Article 7 and indirectly due to institutional investors' Article 5 due diligence requirements. These entities must designate one entity (the "Reporting Entity") to fulfil the requirements. Reporting Entities were required to migrate their reporting systems to accommodate the new templates by 23 September 2020. No transitional or grandfathering provisions have been provided, although Reporting Entities are not required to re-report previously reported information.

The requisite information must be made available to investors, competent authorities and, if requested, potential investors. For public transactions, the Reporting Entity must make such information available:

- through filings with a securitisation repository; or
- pending registration of an entity to act as a securitisation repository, on a website (satisfying safety and operational requirements). The application process for authorisation of securitisation repositories began on 23 September 2020, which means that interim arrangements for publication of such data continue to apply.

For private transactions, this information should be provided directly to the aforementioned entities. The PRA and FCA have developed forms of notification to be used in the UK.

Prior to pricing a securitisation, the Reporting Entity must make the following available.

- Documentation that is essential for the understanding of the transaction.
- For an STS securitisation, the STS notification (explaining how each STS criterion is satisfied).
- For a securitisation where a prospectus has not been prepared, a transaction summary including:
  (a) diagrams containing an overview of the transaction;

(i) the ownership structure;
(ii) the cash flows;
(iii) details regarding the exposure characteristics;
(iv) the priority of payments; and
(v) details of the voting rights of noteholders and their relationship with other secured creditors.

- The STS notification templates are annexed to the RTS for STS notifications, which came into effect on 23 September 2020.

4.2 General Disclosure Laws or Regulations

For general disclosure rules to be relevant to securitisations, there must be an issue of securities. The level of disclosure turns on whether there is an offer to the "public" and the notes are expected to be admitted to trading on a trading venue that constitutes a "regulated market" for the purposes of the Markets in Financial Instruments Directive (MiFID II) (a "MiFID-regulated market") or an exchange-regulated market.

Where an offering document for securities is subject to Regulation (EU) 2017/1129 (the "Prospectus Regulation"), it is referred to as a "prospectus", while an offering document falling outside the scope of the Prospectus Regulation can have a variety of names, including offering circular, listing particulars or offering memorandum (the generic term "offering document" is used herein). The Prospectus Regulation governs the content, format, approval and publication of prospectuses in the EU, and is onshored as retained EU law in the UK pursuant to the Withdrawal Act after the transition period.

Under the Financial Services and Markets Act 2000 (FSMA), offers of transferable securities in the UK cannot be made without the publication of an approved prospectus, unless the notes offered or the person to whom the offer is made satisfies an exemption. Such exemptions include offers to professional investors, or notes issued in denominations of at least EUR100,000. For securitisations, noteholders are typically professional investors. Nonetheless, a prospectus or offering document may be required where the notes are to be admitted to trading on a MiFID-regulated market or an exchange-regulated market.

Material Forms of Disclosure

A prospectus (or offering document) is a listing, marketing and disclosure document that describes the issuer, terms of the notes, originator, assets, transaction and risks of investing in the notes. The content of prospectuses is primarily governed by the Prospectus Regulation, while the content of offering documents is governed by local legislation, rules of the listing authority or stock exchange and market custom.

For debt securities to be admitted to trading on a MiFID-regulated market of the LSE, the prospectus must satisfy the following.

- Specific content requirements found in the Annexes to the Delegated Regulation (EU) 2019/980 supplementing Regulation (EU) 2017/1129 and the UKLA's rules.
- General content requirements of Section 87A of FSMA, which provides that the prospectus must contain "... information necessary to enable investors to make an informed assessment of –
  (a) the assets and liabilities, financial position, profits and losses, and prospects of the issuer of the transferable securities and of any guarantor; and
  (b) the rights attaching to the transferable securities."
- The requirement under FSMA that the prospectus should be comprehensible and easy to analyse, and reflect the particular nature of the securities and the issuer.

In addition, the Benchmarks Regulation and PRIIPs Regulation may be applicable, depending on the nature of the securities.

The level of disclosure required in a prospectus is significantly less if the offering is governed by the wholesale regime rather than the retail regime (this requires securities to have a minimum denomination of EUR100,000 or more).

The requirements of a prospectus are incorporated into UK law by the Prospectus Regulation Rules published by the UKLA, which form part of the FCA Handbook.

4.3 Credit Risk Retention

The EU Securitisation Regulation provides that the originator, sponsor or original lender in respect of a securitisation must retain on an ongoing basis a material net economic interest in the securitisation of not less than 5% via one of the five methods of retention:

- vertical slice;
- originator's pari passu share;
- randomly selected exposures kept on balance sheet;
- first loss tranche (similar to the US horizontal slice option); and
- first loss exposure to every securitised exposure in the securitisation.

For these purposes:

- an originator must (i) either (a) itself or through related entities be directly or indirectly involved in the original agreement which created the obligations being securitised or (b) purchase a third party's exposures on its own account

and securitise them, and (ii) be an "entity of real substance", as opposed to an entity established or operating solely for the purpose of securitising exposures;
- a sponsor includes a credit institution or an investment firm (other than the originator) that (i) establishes and manages a securitisation that purchases exposures from third parties or (ii) establishes a securitisation that purchases exposures from third parties and delegates day-to-day portfolio management to an entity authorised under the UCITS Directive, AIFMD or MiFID II; and
- an original lender is an entity that, itself or through related entities, directly or indirectly, concluded the original agreement that created the obligations being securitised.

The retained exposure must be held for the life of the transaction and cannot be hedged or transferred.

There is also an "indirect" due diligence obligation on institutional investors to verify that the above retention obligation is being fulfilled.

4.4 Periodic Reporting

The EU Securitisation Regulation also places periodic reporting obligations on the originator, sponsor and issuer. During the life of a securitisation, the Reporting Entity must make the following available on a quarterly basis.

- Information on the securitisation positions (loan-level reporting).
- An investor report, including information on:
  (a) performance of the underlying exposures;
  (b) trigger events entailing any changes in the priority of payments or substitution of any party;
  (c) cash flows generated by the underlying exposures and liabilities of the securitisation; and
  (d) risk retention.

There is also a requirement to promptly make any inside information (for purposes of the Market Abuse Regulation (EU) No 596/2014 (MAR)) relating to the securitisation available to the aforementioned entities, in addition to the public. Even if MAR is not applicable to the notes, the following information must be provided:

- any material breach of obligations under the transaction documents;
- any structural change that could materially impact the performance of the securitisation;
- any change in the risk characteristics of the securitisation or the underlying exposures that could materially impact the performance of the securitisation;
- any material amendment to the transaction documents; and
- in the case of STS securitisations, any loss of STS eligibility.

4.5 Activities of Rating Agencies

The CRA Regulation (Regulation 1060/2009) established a compulsory registration process for credit rating agencies (RAs) operating in the EU. The CRA Regulation also aimed to:

- ensure that RAs avoid and manage appropriately any conflict of interest;
- ensure the quality of rating methodology and ratings;
- increase the transparency of RAs; and
- provide a mechanism by which EU-registered RAs can endorse ratings issued by non-EU RAs.

The CRA Regulation was amended by CRA 2 (Regulation 513/2011), which transferred responsibility for the registration and supervision of RAs to ESMA, and CRA 3.

4.6 Treatment of Securitisation in Financial Entities

Financial entities commonly have to hold a certain amount of regulatory capital or "own funds". Investors in securitisations are generally subject to specific regimes to determine the amount of regulatory capital required to be held in respect of securitisation exposures, which differ from non-securitisation exposures and depend on various factors, including:

- the nature of the financial institution (credit institutions and investment firms' treatment differs from that of insurers);
- the type of securitisation and their role in it (traditional securitisations differ from synthetic securitisations; STS securitisations attract more favourable treatment to non-STS securitisations; liquidity facilities and derivatives provided to securitisations can be treated differently to other exposures);
- the purpose for which it is held (if held with trading intent, it may be held in the trading book, otherwise it would be in the banking book); and
- the financial institution's sophistication (broadly, those using internal ratings-based methodologies have a more risk-sensitive position).

For credit institutions and investment firms, securitisation positions can arise either because they have implemented a securitisation in respect of their assets as originator or sponsor or they have invested in (or have exposures to) another's securitisation (and often both).

Basel III Framework

The Basel Committee on Banking Supervision published a regulatory capital framework in 2006 (the "Basel II framework"), and subsequently approved significant changes to the Basel II framework (referred to as "Basel III"). In particular, the chang-

es refer to new requirements for the capital base (including an increase in the minimum Tier 1 capital requirement), measures to strengthen the capital requirements for counterparty credit exposures and the introduction of a leverage ratio as well as short-term and longer-term standards for funding liquidity (the "Liquidity Coverage Ratio" and "Net Stable Funding Ratio", respectively).

The Basel III framework was incorporated into EU law, primarily through the Capital Requirements Directive and the CRR, as amended by the CRR Amending Regulation (together, CRD IV). A new capital requirements directive (EU) 2019/878 (CRD V), which amends CRD IV, and Regulation (EU) 2019/876 (CRR II), which amends the CRR, entered into force on 27 June 2019. CRR II will generally apply from 28 June 2021 and CRD V was required to be transposed into national legislation in each EU member state by 28 December 2020. CRD V changes are being implemented in UK law principally by amendments to the PRA's rulebook.

A further set of proposals intended to complete the Basel III proposals were agreed in December 2019 (referred to as "Basel IV" or "Basel 3.1"), which will be implemented by January 2023 (with some not being implemented fully until 2028).

The principal EU legislation was effectively incorporated into English law (in so far as it was not already incorporated) as at the end of the Brexit transition period through the Withdrawal Act.

Risk-Weighted Exposure in Securitisations

Prior to implementing a securitisation, the assets to be securitised appear on the bank's balance sheet and have a risk-weighted exposure amount determined for that asset type. While securitisations can be used purely for funding purposes (in which case, the assets may remain on the originator's balance sheet), generally securitisations are used to reduce regulatory capital costs by reducing the risk-weighted exposure amount of the securitised assets.

To reduce the risk-weighted exposure amount, there must be a significant risk transfer (SRT). If there is an SRT, the credit institution or investment firm needs to determine the risk-weighted exposure amount of the securitisation positions it retains in the assets, generally resulting in a lower risk-weighted asset exposure.

The requirements for SRT are similar whether the transaction is a traditional true sale securitisation or a synthetic securitisation. There are two alternative quantitative tests:

(i) the risk-weighted asset exposure amounts of the mezzanine positions in the securitisation held by the originator do not exceed 50% of the risk-weighted exposure amounts of all mezzanine securitisation positions in the securitisation; or

(ii) there are no mezzanine positions, the originator does not retain more than 20% of the exposure value of the first loss tranche and the originator can demonstrate that the exposure value of the first loss tranche exceeds a reasoned estimate of the expected loss on the underlying exposures by a large margin.

If the reduction in the risk-weighted exposure amounts that would be achieved is not justified by a commensurate transfer of risk, the PRA may decide on a case-by-case basis that SRT has not occurred. Conversely, the PRA may allow an originator to recognise SRT, even where neither (i) nor (ii) above is achieved, if the originator can demonstrate that the reduction in own funds requirements achieved by the securitisation is justified by a commensurate transfer of risk to third parties.

There are additional requirements that need to be met to achieve SRT, depending on whether the transaction is a traditional securitisation or a synthetic securitisation (see Articles 244 and 245, CRR).

The EBA published a report on 23 November 2020 that includes detailed recommendations on the harmonisation of SRT assessment. The key focus areas are the assessment of structural features, application of quantitative tests and supervisory process for assessing SRT.

Solvency II

Insurers and reinsurers established in the EU are subject to the Solvency II regime, which consists principally of the Solvency II Directive and the Delegated Regulation supplementing Directive 2009/138/EC (as amended), and, when investing in securitisations, they need to hold capital in respect of those investments in accordance with the Solvency II requirements.

4.7 Use of Derivatives

The SPE may enter into derivatives with a swap provider to hedge the SPE's fluctuating exposures, or otherwise modify or supplement the cash flows of the underlying assets (eg, by transferring interest rate or foreign currency risk to the swap provider).

The primary regulation that applies to over-the-counter (OTC) derivatives is the European Market Infrastructure Regulation (EU) 648/2012, as amended by Regulation (EU) 2019/834 on 17 June 2019 (EMIR). Under EMIR, parties to a derivative are classified as financial counterparties (FCs) or non-financial counterparties (NFCs). FCs are entities such as credit institutions, investment firms, insurers and pension schemes, while

NFCs are all entities taking positions in OTC derivatives other than FCs. FCs and NFCs are further divided into those whose consolidated group aggregate positions in derivatives are above certain thresholds (FC+s and NFC+s) or below (FC - s and NFC - s).

Parties to an OTC derivative contract are subject to certain obligations under EMIR based on their classification, the type of derivative and trade date, as follows.

- Clearing obligation – FC+s need to clear OTC derivatives that fall within classes of derivatives that are subject to mandatory clearing, while NFC+s only need to clear any OTC derivatives within such classes where they have exceeded the relevant thresholds under EMIR. To date, certain interest rate swaps and credit derivatives are subject to the clearing obligation. However, OTC derivatives entered into by NFCs for commercial hedging or treasury activities that are objectively measurable as reducing risks directly in relation to the commercial activity or treasury financing activity of the group do not count towards the relevant thresholds.
- Reporting obligation – all OTC derivatives within scope must be reported to a trade repository by the working day following their trade date. For trades executed prior to 18 June 2020, both parties are responsible for trade reporting, without duplication, although the obligation can be delegated by prior agreement. For trades executed on or after 18 June 2020 (or life-cycle events such as the modification or termination of an existing trade on or after 18 June 2020), the same applies, except between an FC and NFC-, where the FC is now responsible for the reporting obligation.
- Monitoring obligation – parties to OTC derivatives need to have appropriate procedures in place to monitor and mitigate operational and counterparty credit risk, including timely confirmation of transaction terms, portfolio reconciliation, portfolio compression and dispute resolution.
- Mandatory margin – FCs and NFC+s must engage in the timely, accurate and appropriately segregated exchange of collateral (initial and variation margin), and conduct a mark-to-market valuation of their transactions on a daily basis, reporting to a trade repository. Neither FCs nor NFC+s need to exchange mandatory margin where their counterparty is an NFC- (or would be an NFC- if incorporated in the EU).

As a securitisation SPE is most likely to be an NFC-, the clearing obligation and mandatory margin requirements should not apply to swaps entered into between the SPE and swap counterparty.

4.8 Investor Protection

The regulatory framework applicable to securitisations has investor protection as a primary aim; in particular:

- the disclosure requirements under the EU Securitisation Regulation are intended to protect investors by allowing them to undertake due diligence of and monitor securitisations properly;
- the disclosure requirements under the Prospectus Regulation are intended to allow investors to make an informed assessment of the securities they are acquiring;
- MAR is intended to protect investors by preventing insider dealing and market manipulation; and
- MiFID II contains certain requirements intended to protect investors, such as product governance rules and rules around conflicts of interest and allocations, record-keeping and inducements.

4.9 Banks Securitising Financial Assets

No information has been provided in this jurisdiction.

4.10 SPEs or Other Entities

Other than certain tax laws relating to SPEs that are "securitisation companies" (see **2.2 Taxes on SPEs**), there is no specific regime that applies to securitisation SPEs. If the SPE is incorporated in England and Wales and offers the notes on a marketed basis (or to a wide number of funders on a bilateral basis), it may need to be re-registered as a public limited company to comply with the UK Companies Act 2006 (this is a different test from a public offer under the Prospectus Regulation). As a private limited company, its minimum paid-up share capital is GBP1, whereas for a public limited company it is GBP50,000 paid up as to one quarter.

See also **1.2 Special-Purpose Entities**.

4.11 Activities Avoided by SPEs or Other Securitisation Entities

There is no regime under English law comparable to the US Investment Company Act of 1940. However, the possibility that the issuer could be held to be a covered fund for the purposes of the Volcker Rule can be a concern in UK securitisations – particularly if any investor is a US banking entity (or affiliate). Typically, the issuer represents that it is not a covered fund.

4.12 Material Forms of Credit Enhancement

Securitisations are structured using various forms of credit enhancement to give some protection to repayments under the senior notes from losses arising under the assets.

Securitisations involve a subordination of junior notes (and/or a subordinated loan). This tranching of credit risk means that

the junior noteholder suffers the first losses on the portfolio. The junior noteholder is generally the originator (or an affiliate) to fulfil risk retention requirements and because investors expect the originator to have some "skin in the game".

Over-collateralisation (where assets are transferred to the SPE with an aggregate value greater than the consideration paid) and various cash reserves are often utilised to provide further credit enhancement. One method of funding a cash reserve is through excess spread (which is the remaining net interest payments from the underlying assets after all expenses are covered).

4.13 Participation of Government-Sponsored Entities

Unlike in the USA, there are no government-sponsored entities that are active in the UK securitisation market. However, the UK government has disposed of the credit risk of certain assets through securitisations (including Income Contingent Repayment student loans and mortgage loans acquired during the financial crisis). The British Business Bank facilitates SME securitisations, most recently through the Coronavirus Business Interruption Loan Scheme. The Bank of England also allows certain notes in securitisations to be eligible for its bank liquidity schemes.

4.14 Entities Investing in Securitisation

Investors in securitisations include credit institutions, investment funds (including hedge funds, money market funds and funds associated with asset managers and pension providers), and insurance and reinsurance undertakings.

5. Documentation

5.1 Bankruptcy-Remote Transfers

In traditional securitisations, the transfer of assets is generally effected through a sale agreement, which includes provisions under which:

- the assets are transferred by the originator to the issuer;
- the issuer agrees to pay an amount in consideration for the purchased assets;
- conditions precedent to the transfer are established;
- the originator declares a trust in favour of the issuer over the proceeds arising under the assets;
- circumstances in which the issuer has the right to perfect its title to the assets are detailed;
- the originator agrees to repurchase non-compliant receivables or ineligible assets in certain circumstances; and
- the originator provides undertakings, representations and warranties in respect of matters relevant to its role and the assets.

5.2 Principal Warranties

The originator typically provides comprehensive warranties relating to its corporate status (for example, its capacity, power and authority, solvency, and relevant permissions and/or licences, being the "corporate warranties") and the assets being transferred (being the "asset warranties"). Asset warranties generally include confirmations as to the originator's good title to the assets and that the assets comply with the eligibility criteria.

Breach of a corporate warranty would generally lead to a breach for misrepresentation, which, if not remedied, could lead to a default and/or early amortisation of the notes and a claim in damages. Breach of an asset warranty would generally oblige the originator to repurchase the affected assets.

5.3 Principal Perfection Provisions

Under the sale agreement, the parties generally agree that the issuer's title to the assets may only be perfected on the occurrence of certain agreed "perfection events" (see **1.3 Transfer of Financial Assets**).

Once a perfection event has occurred, the issuer (or a nominee on its behalf) can typically take the following steps:

- give notice in its own name to the underlying obligors of the transfer of assets;
- direct the obligors to pay amounts outstanding in respect of the assets directly to the issuer; and
- take such other action as it reasonably considers necessary to recover any amount outstanding in respect of the assets, or to protect or enforce its rights against the obligors.

5.4 Principal Covenants

The key covenants are primarily provided by the issuer and the originator. As discussed in **1.2 Special-Purpose Entities**, the issuer's activities will be limited by comprehensive negative covenants. The issuer will also provide positive covenants (eg, that it will comply with all of its obligations). The originator will provide covenants relating to its corporate status, the transferred assets and its ability to fulfil its role under the transaction documents. Failure to comply with any such covenant would generally lead to early amortisation or default under the notes.

5.5 Principal Servicing Provisions

The servicer is appointed under a servicing agreement entered into with the issuer to service the transferred assets, including:

- collecting payments from underlying obligors and transferring those payments to the issuer's account(s);
- enforcing the obligations of obligors under the underlying contracts;
- maintaining necessary permissions;

- maintaining records in respect of the assets; and
- administering the assets in accordance with the originator's credit and collection policies, and applicable laws.

The servicer typically receives a fee for these services from the issuer (paid out of the agreed priorities of payment). Failure of the servicer to comply with its obligations may lead to its replacement by another servicer and/or early amortisation or default under the notes.

5.6 Principal Defaults

Typical events of default under the notes include:

- non-payment by the issuer of interest on the most senior notes on any payment date and principal on any notes on the final maturity date;
- breach by the issuer of its other obligations under the transaction documents;
- misrepresentation by the issuer under the transaction documents;
- an insolvency event in respect of the issuer; and
- illegality for the issuer and repudiation or termination of the transaction documents.

A default under the notes would generally lead to the most senior class of noteholders having the ability to instruct the note trustee to declare all outstanding amounts under the notes immediately due and payable, and to enforce security.

5.7 Principal Indemnities

The precise indemnities included in each transaction depend on the outcome of negotiations between the parties. The issuer (and the security trustee) may receive indemnities from (i) the originator for losses arising in connection with the sale of assets and (ii) the servicer for losses arising from the servicer's negligence in respect of the performance of the services.

6. Roles and Responsibilities of the Parties

6.1 Issuers

The issuer is generally a bankruptcy-remote SPE. See **1.2 Special-Purpose Entities**.

6.2 Sponsors

The term "sponsor" can be used to refer to the originator (or an affiliate). It generally initiates the securitisation by establishing the initial lending relationship with the underlying obligors or purchasing another party's assets to be securitised, and devises the appropriate structure.

6.3 Underwriters and Placement Agents

The underwriters act as intermediaries between the issuer and investors. They tend to be investment banks and help to market and sell the securities, including book building, providing liquidity support in the secondary market, and underwriting the issuance.

6.4 Servicers

See **5.5 Principal Servicing Provisions**.

6.5 Investors

See **4.14 Entities Investing in Securitisation**.

6.6 Trustees

In traditional securitisations, there are typically two distinct trustee roles:

- the note trustee, who holds the benefits of the covenants and rights in the secured assets on behalf of the noteholders; and
- the security trustee, who holds the security created over the assets and related rights in favour of the secured creditors (including the noteholders).

The same entity typically carries out both functions. Broadly speaking, the trustee ensures that collections are paid to the SPE and that investors receive their share of such amounts in accordance with the contractually agreed priority.

7. Synthetic Securitisation

7.1 Synthetic Securitisation Regulation and Structure

Synthetic Securitisation

A "synthetic securitisation" is assumed to be as defined in the FCA Handbook. This is based on the definition of "securitisation" therein, which includes (i) a "traditional" securitisation, where the assets are sold to an SPE funded through the issuance of debt securities to investors, and (ii) the wider set of transactions that satisfy the requirements that the credit risk associated with a pool of exposures is tranched, payments are dependent upon the performance of the pool of exposures, and the subordination of the tranches determines the distribution of losses during the transaction. This latter structure may involve, but does not require, the issuance of securities, and would be viewed as a synthetic securitisation.

From 1 January 2019, the EU Securitisation Regulation has applied to synthetic securitisation and governs matters such as risk retention, disclosure and due diligence. Article 2(10) of the EU Securitisation Regulation defines a "synthetic securitisation" as a securitisation in which the transfer of risk is achieved

through the use of credit derivatives – typically credit default swaps (CDS) – or financial guarantees, and the securitised exposures remain exposures of the originator. At the time of writing, synthetic securitisations are not eligible for the STS framework; however, as mentioned above, the Commission Proposals of July 2020 propose to extend the existing framework to cover balance sheet synthetic deals.

Article 270 of the CRR, as implemented through the CRR Amending Regulation, extended the differentiated capital treatment applicable to traditional STS securitisations to certain SME synthetic securitisations. It provides for preferential risk-weighting of senior positions in balance sheet synthetic securitisations of SME exposures that satisfy specified requirements.

On 13 November 2020, the Bank of England issued guidance on the PRA's transitional direction in relation to firms' obligations under the CRR, which came into effect at the end of the transition period and apply until 31 March 2022. The guidance confirmed that STS transactions under the UK Securitisation Regulation will be eligible for differentiated capital treatment where the CRR criteria are met and any preferential treatments afforded to EU exposures will continue, including senior positions in SME securitisations as referenced in Article 270 of the CRR.

Engagement of Issuers/Originators

Balance sheet synthetic securitisations involve the transfer of credit risk of assets originated by the originator or its group (ie, the credit risk relates to exposures held on the originator's balance sheet). The primary benefit to the originator is improved credit risk management and regulatory capital treatment.

Arbitrage synthetic securitisations take advantage of the difference between (i) the higher spread to be received on the (usually low-quality) assets to be securitised and (ii) the lower spread that would be payable to investors under the transaction, once tranching and other credit enhancements are incorporated. Unlike balance sheet structures, originators in arbitrage structures do not necessarily have any credit exposure to the assets being securitised, and may use arbitrage structures purely for investment purposes. Since the financial crisis in 2008, the use of arbitrage structures has greatly diminished, not least due to the application of risk retention requirements.

The attraction for originators is that synthetic securitisations can be easier to establish compared to traditional securitisations, as the operational issues associated with the transfer of exposures is avoided and it may not be necessary to establish an SPE.

However, there are drawbacks. As there is no transfer of assets, there is no related funding benefit driving synthetic securitisations (although, depending on the collateralisation structure, funding benefits can be derived). In an unfunded structure, the originator takes full counterparty credit risk as it relies on the payments under the CDS/financial guarantee (not from the collateral) to offset its losses on defaulting assets, which affects the degree of capital relief as well as pricing; often security is provided by the counterparty over the cash deposit and/or the counterparty must maintain a minimum credit rating.

Regulation

Synthetic securitisations are regulated in the same manner as traditional securitisations. In the UK, the primary regulator is the PRA, which is responsible for regulating the required capital allocated for investments in securitised positions. The FCA also has regulatory oversight of a number of aspects of a synthetic securitisation depending on the structure used.

Principal Laws and Regulations

The primary difference between a synthetic securitisation and a traditional securitisation is that there is no title transfer of the exposures from the originator to an SPE or investors. At a regulatory level, the same principal laws apply, although the following considerations are specific to synthetic securitisations.

Derivatives regulations

EMIR needs to be considered where a credit derivative is used to transfer credit risk and may subject the parties to mandatory margin and other risk mitigation requirements. If another instrument is used akin to a derivative (such as a financial guarantee), applicability of EMIR should be considered on a case-by-case basis.

Relevance of other laws

It is not necessary to conduct a true sale analysis as there is no transfer of title and so the impact of insolvency is of less relevance, unless credit risk transfer is in respect of the originator's own obligations. However, counterparty credit risk should be factored in during the structuring phase. In addition, a number of the issues that arise as a result of ownership of the assets by the SPE do not arise in synthetic securitisations (eg, data protection and assignability) as the underlying portfolios tend to be "blind". The SPE or investor will not necessarily have access to data regarding the underlying risk due to issues around confidentiality and bank secrecy regimes.

Verification

Due to confidentiality considerations, the originator may only be able to provide the protection seller with limited information about the underlying exposures, leading to concerns around verification (in terms of the occurrence of a credit event and

quantum of any protection payment). This is normally dealt with through an external verification agent, which is permitted sight of the relevant information.

Insurance re-characterisation risk

Credit risk transfer agreements have many similarities with contracts of insurance. The sale of insurance (or arranging insurance) is a regulated activity in the UK and carrying out a regulated activity without the requisite authorisation is a criminal offence, such that the obligations of the party purchasing the insurance may be unenforceable. As a result, it is important to ensure that the instrument transferring credit risk is distinguishable from a contract of insurance and being sold by an authorised entity or an entity that is not required to be authorised, or that the activity takes place outside the UK. Typically, synthetic securitisations are structured to distinguish themselves from contracts of insurance in two respects:

- the payment obligations are not conditional on the protection buyer sustaining a loss or bearing a risk of loss; and
- the contract does not seek to protect an "insurable interest" of the protection buyer.

The payment obligations fall to be made regardless of whether the protection buyer has actually suffered loss or been exposed to risk of loss.

Principal Structures

There are two principal structures used for synthetic securitisations:

(i) the first involves the issuance of credit-linked securities by the SPE to investors; and
(ii) the second involves a direct transfer of credit risk from the originator to investors.

Recently, a third structure (iii) has started to be used, consisting of a direct issuance of credit-linked securities by the originator.

In structure (i), the originator transfers the credit risk of the securitised assets to an SPE through a CDS/financial guarantee, and the SPE issues securities (credit-linked notes) to investors. Under the CDS/financial guarantee, the originator pays a periodic fee to the SPE, and if there is a default on any securitised exposures, the SPE makes a payment to the originator (funded from the purchase proceeds of the securities). Investors are paid a coupon on their securities, funded from interest earned on the invested purchase proceeds and payments from the originator under the CDS/financial guarantee. At maturity, the investors are repaid their principal on the securities, minus any loss amounts paid to the originator for defaulted assets. In this manner, the investors provide credit protection on the defaulted assets.

In structure (ii), there is no SPE or issuance of securities, and the originator instead enters into a CDS/financial guarantee directly with the investors. If there is a default on any securitised asset, the investors would make payment to the originator under the CDS/financial guarantee.

In structure (iii), there is no SPE and instead the originator issues credit-linked securities to investors, which embed a notional CDS/financial guarantee and payments work otherwise as in structure (i) above.

Synthetic securitisations can be funded or unfunded. Funded structures involve the upfront payment from investors to the originator of the amount of credit protection, so that the originator does not have credit risk on the investors. Structures (i) and (iii) are examples of funded structures. In structure (i), even though the upfront payment is made by investors to the SPE rather than the originator, the SPE usually deposits the funds in an account with the originator and, more importantly, given its bankruptcy remoteness and the security arrangements in favour of the originator, the originator is effectively insured against non-payment by the investors. Structure (ii) would be a funded structure if the investors are required to collateralise their exposure to the originator. In unfunded structures, there is no upfront payment from the investors, so the originator is exposed to the credit risk of the investors, and relies on the investors' ability to pay the default amounts under the CDS/financial guarantee. To achieve effective risk transfer under prudential regulations, the counterparty to an unfunded trade is required to have a minimum rating.

8. Specific Asset Types

8.1 Common Financial Assets

Public and private securitisations are carried out in the UK in relation to a range of asset classes. Public issuances most commonly relate to RMBS and asset-backed securitisations (ABS). The most common ABS relate to credit cards and auto loans, although other asset classes – including personal loans, SME loans, CMBS and trade receivables – are not uncommon. CLO transactions and whole business securitisations are also common.

8.2 Common Structures

The basic structure of a securitisation does not generally change based on the type of underlying asset, although specific commercial and legal factors may result in structural differences at a detailed level.

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Authors

Sanjev Warna-kula-suriya is a partner in the London office of Latham & Watkins and a member of the Finance Practice. He is also chair of the Global Structured Finance and Securitization Practice. He advises private equity sponsors, hedge funds, commercial and investment banks, and corporates on a broad range of innovative capital raising and investment transactions. Mr Warna-kula-suriya advises clients across a wide range of asset classes and structures, including structured finance and securitisation, public and private debt, equity-linked and hybrid capital markets issues, CMBS, cash and synthetic CLOs, OTC and exchange-traded derivatives, and cross-border structured finance.

Kamal Dalal is an associate in the London office of Latham & Watkins, as part of the Derivatives and Structured Finance Practice. She focuses on structured finance and securitisation transactions in relation to a variety of asset classes, including mortgage assets, trade receivables, consumer receivables, and SME or marketplace lending. She also regularly advises clients on OTC derivative transactions and structured hedging solutions.

Latham & Watkins

99 Bishopsgate
London
EC2M 3XF
United Kingdom

Tel: +44 20 7710 1000
Fax: +44 20 7374 4460
Web: www.lw.com

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Trends and Developments

Contributed by:
Sanjev Warna-kula-suriya and Kamal Dalal
Latham & Watkins** **see p.25

Navigating a changing legal and regulatory landscape against the backdrop of the COVID-19 crisis and an uncertain Brexit transition period was the defining feature of 2020 in the context of securitisation and structured finance deals. Unprecedented levels of governmental intervention to minimise the impact of the pandemic on human health and economies have affected securitisation markets in a multitude of ways depending on the underlying asset class and transaction structure.

While in the aftermath of the financial crisis of 2008 and the Eurozone sovereign debt crisis the focus was on embedding structural protections in asset-backed securitisations (ABS) to improve their resilience under stress, the COVID-19 pandemic has presented new challenges for the market not seen in previous crises. The advent of social distancing initiatives and state-imposed lockdowns prompted a record fiscal policy drive to alleviate the economic pressure felt by consumers and businesses. Forbearance measures introduced by governments to prevent widespread defaults, or otherwise demanded by financially distressed borrowers, have had a particularly notable impact on the amortisation profile of underlying portfolios, with the resultant interruption in cash flows eroding the value of the borrowing base as well as threatening portfolio financial covenants, and leading to challenges in obtaining funding for such assets in the medium to long term.

To counterbalance the economic strain born out of the crisis, particularly for small and medium-sized enterprises (SMEs) that have been most affected, the programme for regulatory reform of the EU securitisation regime has been accelerated. Among other recommendations made in 2020, EU authorities focused on improving the regulatory capital treatment of certain securitisation structures, which are seen as a vehicle for improving access to finance and shifting risk from the banks to the non-banking sector.

The UK's departure from the EU on 31 January 2020 led to a transition period (which elapsed on 31 December 2020), during which the UK continued to be treated as an EU member state for most purposes and subject to EU rules. Finally, the EU–UK Trade and Cooperation Agreement was signed on 30 December 2020 and established the principal terms that will govern the UK's relationship with the EU from 1 January 2021. In the securitisation context, questions remain regarding the dual securitisation regime that could emerge in the UK and the EU as regulatory divergences begin to appear, creating potential market fragmentation as well as opportunities for arbitrage.

Impact of COVID-19 on UK Securitisations

Market impact

The COVID-19 pandemic has prompted a collapse in consumer demand and commercial activity. For existing ABS transactions, cash flows have been deteriorating for various reasons, including state-backed "temporary" forbearance schemes, forbearance granted at the behest of underlying obligors, an overall rise in rates of default by underlying obligors (for instance, as a result of lost earnings and wages), sector-specific challenges (in particular, the travel, hospitality and retail sectors) and operational challenges (such as a lack of personnel or limited access to premises). Public ABS volumes have been badly hit in 2020 and the secondary market for trading is relatively quiet. Rated deals have been subject to volatile credit ratings, with rating downgrades occurring with growing frequency.

There has been particular stress on commercial mortgage-backed securitisations (CMBS) and whole-business securitisations exposed to the retail, hospitality and leisure sectors, which have been most directly affected by pandemic-related measures, with a large chunk of their regular revenues lost. In the retail space, many tenants reduced or altogether withheld rental payments to commercial landlords as shops were required to remain closed for the majority of 2020. Hospitality and leisure businesses such as pubs, restaurants and hotels have struggled to stay afloat, with a dramatic decline in occupancy rates and travel severely limited for most of the year. Residential mortgage-backed securitisations (RMBS) have suffered as a result of job losses and depressed wages weighing on borrowers' abilities to discharge their mortgage repayments and lenders' willingness to advance new loans.

In the UK, the Financial Conduct Authority (FCA) introduced a package of forbearance measures in April 2020 for the benefit of UK consumers under motor finance and high-cost credit agreements impacted financially by the pandemic. In addition, the FCA issued guidance in March 2020 expecting mortgage providers to offer payment deferrals of up to three months for borrowers in the mortgage market facing temporary payment difficulties as a result of the pandemic. That guidance was updated in June 2020 to enable struggling borrowers to take a second payment deferral of up to three months and again supplemented in September 2020 to establish tailored support that

firms should provide to affected borrowers. Under the FCA's latest guidance in November 2020, borrowers can now receive a payment deferral under a regulated mortgage contract or regulated home purchase plan of up to six months until 31 July 2021. Moreover, the UK government agreed with UK lenders to accommodate forbearance requests by buy-to-let landlords whose tenants had lost income due to the pandemic.

Notwithstanding these state-backed forbearance initiatives, originators have themselves been under pressure to grant payment holidays to their customers, particularly SMEs, to avoid reputational damage and many landlords in the UK have offered reduced rent or waivers to financially vulnerable customers. Impaired cash flows do not typically relieve the issuer from having to discharge its payment obligations to senior noteholders and cover senior costs and expenses of the structure. For public ABS deals that have sufficient cash reserves built into the structure or liquidity facilities available to mitigate the effects of cash flow reductions, it may be possible to provide payment holidays without triggering a rating downgrade or default. However, as the pandemic wears on, the existing cash reserves will continue to be depleted beyond the stress levels modelled by the rating agencies, increasing the risk of default unless additional liquidity can be made available.

Impact on existing deals

The financial stress caused by COVID-19-related measures has manifested in existing ABS deals in various ways. With increased volatility in the performance of the underlying assets, borrowing base facilities have been particularly vulnerable as financial covenants are prone to be triggered if the number of delinquent or defaulted assets exceeds the pre-agreed thresholds. Debt service coverage ratios and other performance covenants may also be breached as a result of cash flow disruptions. Any such breach may cause the facility to go into early amortisation (or turbo amortisation), bring about a stop-purchase event (whereby sales of new assets are not permitted) or trigger an event of default. Originators would be unable to continue funding their customers and would be forced to wind down their existing portfolios.

Much depends on how forbearance is addressed in the transaction documents. Forbearance-affected assets could be characterised as in arrears, non-performing or merely subject to suspended obligations (during which time no amounts become due and payable). Such characterisation will have a bearing on whether forbearance-affected assets are classified as delinquent or defaulted assets, with corresponding implications for the performance metrics of the transaction.

At a regulatory level, the European Banking Authority (EBA) provided guidance in April 2020 regarding the treatment of assets subject to temporary pandemic-related forbearance. The EBA stated that in order to avoid triggering a forbearance classification in a lender's systems, the forbearance measure must be in respect of the COVID-19 pandemic, apply broadly to financial institutions in a given jurisdiction in respect of a range of obligors (by reference to borrower type, sector, size, etc) regardless of creditworthiness, offer the same conditions to all obligors subject to the forbearance measure, and change only the schedule of payments but no other conditions of the loan.

The FCA has adopted a similar approach, stating that customers' accounts should not be recorded in lenders' systems as being in detrimental arrears if COVID-19-related forbearance is granted. However, the EBA and FCA guidance only applies to credit institutions and investment firms that fall within the scope of the Capital Requirements Regulations (Regulation (EU) No 575/2013) (CRR). In other cases, forbearance-affected assets may be captured by the definitions of delinquent or defaulted assets depending on the contractual position. Moreover, regardless of the regulatory characterisation of assets, if the underlying obligors are unable to meet their payment obligations once the forbearance period elapses, the assets will be characterised as in arrears. In this sense, the regulatory approach simply delays the problem as the obligors' accumulated debt burden grows.

The transaction parties could amend the existing documentation to permit temporary COVID-19-related forbearance (so as to avoid affected assets being classified as delinquent or defaulted) and/or alter the amortisation profile of the deal to enable a more sequential basis of amortisation and shore up additional cash reserves. Alternatively, waivers may be agreed to avoid triggering a breach of covenant or default arising as a result of forbearance-affected assets. Whether this is feasible turns on investor appetite, which will depend on the specific facts of any given transaction, including the duration of the proposed forbearance measures as against the remaining duration of the deal.

Servicing of portfolio assets may also be under strain. The servicer will need to consider whether forbearance measures announced in relation to COVID-19 are permitted under the servicing and collection policy for the transaction. In doing so, the servicer must have regard for its duty of care when carrying out its servicing obligations, including maximising recoveries under the portfolio. Where forbearance is prohibited by the transaction documents but mandated by law or imposed by official guidance as a result of governmental intervention, the servicer may have to make a difficult call. In other cases, forbearance may be contractually permitted subject to certain conditions, such as the satisfaction of overall pool concentration limits or a prohibition on changing the principal amount outstanding or maturity date of the asset. The servicer will need

to consider the impact of granting forbearance on the transaction, including the borrowing base valuation and calculation of financial covenants, against running the risk of early amortisation or default in the absence of forbearance.

In line with the rest of the market, servicers may face financial and operational challenges of their own in performing their obligations, particularly where they are required to liaise with pandemic-affected borrowers, monitor collections, make claims under assets in arrears and resolve liquidity issues, alongside preparing investor reports. If the servicer fails to perform its obligations to the required standard of care, while the lender may be permitted to replace the servicer and appoint a successor or back-up servicer, doing so in an unstable market is likely to be problematic. As such, transaction parties may consider amending the scope of the servicer's duties under existing servicing arrangements.

Other contractual amendments that may be considered include the introduction of additional credit enhancements and/or liquidity measures, amending the scope of force majeure provisions to account for pandemic risk, amending change in law provisions to carve out pandemic-related measures, and/or revising material adverse effect qualifiers.

UK government relief measures

The UK government launched various COVID-19-related measures to support and stimulate the UK economy in 2020, including the Job Retention Scheme, the Self-employment Income Support Scheme, the COVID-19 Corporate Financing Facility, the Coronavirus Business Interruption Loan Scheme (CBILS), the Coronavirus Large Business Interruption Loan Scheme, the Future Fund, the Bounce Back Loans Scheme, the Retail and Hospitality Grant Scheme, business rates holidays, statutory sick pay relief, and certain tax deferrals.

Among these, the CBILS initiative created opportunities for investors in the structured finance market searching for yield, particularly in the non-banking sector. Broadly speaking, the scheme is delivered by the British Business Bank through its accredited lenders, which provide bank lending, overdrafts, invoice finance and asset finance of up of to £5 million to SMEs with a turnover of up to £45 million (on a consolidated group basis) that satisfy the eligibility criteria. For each approved loan, the UK government covers the first 12 months of interest payments and any lender-levied fees on behalf of the borrower, while also providing the lender with a guarantee of 80% of each loan. The borrower remains liable for the entirety of the debt, but the UK government effectively underwrites the lender's credit risk, thereby enhancing its expected return.

In a first-of-its-kind funding structure, Latham & Watkins advised Funding Circle on the establishment of a marketplace lending platform enabling the newly accredited lender to advance CBILS loans to SMEs by deploying capital advanced by investors in the platform. The structure was replicated across the market, enabling challenger banks, fintech providers, pension funds and other investors in the non-banking sector to provide funding to SMEs struggling to access capital during the pandemic.

State of the EU Securitisation Regulation

Regulation (EU) 2017/2402 (the "EU Securitisation Regulation") has applied since 1 January 2019 and is the cornerstone of the EU securitisation regime. The legislation consolidated the pre-existing patchwork of regulations relating to EU securitisations and established the framework for simple, transparent and standardised (STS) securitisations, covering all EU securitisations completed after 1 January 2019 (subject to grandfathering and transitional provisions). In the two years since its application, many of the technical standards and delegated legislation emanating from the EU Securitisation Regulation remained outstanding, but much of that was completed during the course of 2020.

On 3 September 2020, a number of key regulatory technical standards (RTS) and implementing technical standards (ITS) were published in relation to disclosure and reporting requirements, securitisation repositories and STS transaction notifications, which came into force on 23 September 2020. The market is still waiting for the EBA's final draft on RTS on risk retention requirements to be finalised, but the EU securitisation regime is one step closer to being complete.

Moreover, the COVID-19 pandemic has accelerated amendments to the existing regime that have been under consideration for some time. In July 2020, the European Commission (the "Commission") published a package of reform measures known as the "Capital Markets Recovery Package" in response to the economic crisis.

Two key proposals were put forward, with the aim being to improve access to capital, particularly for SMEs. First, the Commission proposed to extend the STS framework to cover balance sheet synthetic securitisations subject to compliance with certain criteria, based on those applicable to traditional STS securitisations but adapted for the synthetic space. This is notable because STS transactions attract preferential regulatory capital treatment and bringing synthetic securitisations in balance sheet form into scope would encourage lending on this basis. Balance sheet synthetic securitisations have made up the bulk of synthetic transactions in Europe since the financial crisis of 2008 and have staged a silent comeback in recent years. As

these structures continue to grow in popularity, policymakers are beginning to recognise their potential as a credit risk and capital management tool that enables financial institutions to free up lending capacity.

Second, the Commission proposed to remove regulatory obstacles to the securitisation of non-performing exposures (NPEs) so as to remove NPEs from banks' balance sheets and improve their regulatory capital positions. While this proposal is welcomed, it remains to be seen whether the amendments would facilitate the use of securitisations by the banks to clean up their balance sheets and transfer NPEs to other market participants. Several planned disposals of NPEs were delayed or suspended in 2020, as the economic crisis curbed investors' willingness to acquire distressed debt that could be further corroded by market forces. Taken together, however, these proposals could have a significant impact on the growth of the securitisation market in 2021. They currently remain subject to deliberations by the European Parliament and the Council.

Another area of recent development relates to the EBA's report of 23 November 2020 on significant risk transfer (SRT) in securitisations under Articles 244(6) and 245(6) of the CRR. Securitisations that qualify for SRT reduce an originator's regulatory capital requirements by enabling the originator to substitute the capital requirements in respect of the positions it holds in the securitisation for its capital requirements in respect of the securitised exposures. The existing SRT framework was seen as being too vague and gave too much discretion to competent authorities, leading to a fragmented approach across EU member states. The recommendations aim to harmonise the different regulatory approaches with the introduction of two new "commensurateness" tests, the identification of structural features that are potentially problematic for SRT assessment together with mitigating safeguards, and a clearer SRT assessment process. They will inform the delegated legislation that the Commission may adopt.

The EU securitisation regime will be subject to a comprehensive review by January 2022, when the Commission will evaluate the effects of the regime (in its then current form) and propose legislative amendments if appropriate. The review will take into account the recommendations of the final report of the High-Level Forum on the Capital Markets Union of 10 June 2020 in relation to disclosure and reporting obligations, investor due diligence requirements, securitisations of legacy portfolios and NPEs, and the development of an STS framework for balance sheet synthetic securitisations, together with changes to securitisation prudential regulation. Some of these recommendations were reflected in the Commission's proposals of July 2020, although it remains to be seen if the remainder will be implemented.

Impact of Brexit on the UK Securitisation Regime

While there may have been some relief that the UK averted a no-deal Brexit with the eleventh-hour approval of the EU–UK Trade and Cooperation Agreement before the end of the transition period, the deal that was struck changed little from a securitisation perspective. The focus for practitioners and market participants relates to the dual regime in securitisation regulations that could emerge in the EU and the UK from 1 January 2021 for a number of reasons.

The European Union (Withdrawal) Act 2018 (the "Withdrawal Act"), together with various statutory instruments, onshores EU laws that are in effect and legally binding as at the end of the transition period, correcting deficiencies as necessary for the UK statute book. That includes the EU Securitisation Regulation and any level 2 legislation in effect as at 31 December 2020, but excludes any EU laws that come into effect from 1 January 2021 onwards, as well as all level 3 guidance and statements by the European supervisory authorities. As further amendments are made to the EU Securitisation Regulation and EU level 2 measures are enacted, it remains to be seen whether the UK authorities will make similar rules under the UK securitisation regime. Onshoring future EU laws is not mandatory and if such laws are not replicated in the UK, the UK and EU securitisation regimes could diverge over time. Regulatory discrepancies between the regimes could give rise to fragmentation in the market, particularly for cross-border UK–EU securitisations.

Indeed, there are a number of existing areas of asymmetry between the regimes. For instance, in order for a transaction to qualify for STS treatment, the EU securitisation regime requires the originator, sponsor and issuer to be established in the EU. Any transaction involving a non-EU originator, sponsor or issuer cannot qualify as an STS securitisation in the EU as there is no third-country equivalence regime for non-EU parties and so it would lose its STS status. By contrast, the UK securitisation regime only requires the originator or sponsor to be established in the UK and does not mention issuers, making the UK STS framework more permissive. In addition, a separate authorisation regime is being established in the UK for UK data repositories that will cease to be authorised by the European Securities and Markets Authority, as the EU Securitisation Regime requires repositories to be located in the EU. More importantly, the UK's designation as a third country under EU financial regulations as of 1 January 2021 will result in the loss of passporting rights under the EU financial services regulations for UK entities conducting cross-border activities (for EU entities seeking to conduct regulated activities in the UK, there is a temporary permissions regime in place) and may have implications for the regulatory capital treatment and/or withholding tax position of any given transaction.

Even in the absence of regulatory differences, issues could arise from the application of existing EU rules in a post-Brexit environment. For instance, risk retention is permitted on a consolidated group basis under the EU Securitisation Regulation; if this form of retention was being relied upon for an existing securitisation structure and the group in question spans both the EU and UK, the structure could cease to be compliant from 1 January 2021. As a general rule, however, these types of Brexit-related challenges are unlikely to arise in transactions that are mainly connected to the EU or the UK only, rather than cross-border deals, with the majority of legacy deals falling into the former category.

LIBOR Discontinuance

The London Inter-Bank Offered Rate (LIBOR) may be relevant to securitisation structures with GBP-denominated floating-rate notes or underlying assets. The FCA's announcement of 21 November 2019 that LIBOR will be discontinued from the end of 2021, which was reiterated in March and April 2020, has triggered a transition process in the market towards a replacement base rate. For UK deals, the replacement rate that the market appears to be converging on is the Sterling Overnight Index Average (SONIA). One area to watch is existing CLO deals where LIBOR discontinuance will affect both the asset side (being the underlying portfolio) and liability side (being amounts payable under the notes), with the potential for basis risk to arise as between these if replacement rate conventions differ.

ESG Considerations

ESG (environmental, social and governance) criteria are becoming more important for investors in the context of capital market transactions, including securitisations. Policymakers have indicated that ESG considerations should be a growing focus from a regulatory perspective in years to come, a trend that appears to have been accelerated by a rise in consciousness and urgency owing to the COVID-19 pandemic. Based on the commitments agreed by the signatories to the UN Paris Agreement of 2015 to limit the increase in global average temperature to 1.5^{o}C above pre-industrial levels and make financial flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development, a host of ESG-related regulations are under discussion or being finalised, which will play a pivotal role in the development of this market.

Final Words

The UK securitisation market is undergoing a period of significant change driven by macroeconomic events and regulatory shift. Alongside the key themes discussed above, additional reporting obligations to HMRC have been introduced under the EU Directive on Administrative Cooperation (DAC 6) in respect of certain cross-border securitisations. Further changes are expected to the Basel securitisation framework, and by extension to the regulatory capital treatment for securitisations, with the Basel III proposals that were agreed by the Basel Committee on Banking Supervision in December 2017 to be implemented by January 2023.

The outlook for 2021 remains fraught with challenges as we grapple with the post-Brexit environment, an economic recession and a continuing pandemic. While progress made in completing and updating the EU securitisation regime is welcomed, it remains to be seen to what extent these changes are replicated into UK law.

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Authors

Sanjev Warna-kula-suriya is a partner in the London office of Latham & Watkins and a member of the Finance Practice. He is also chair of the Global Structured Finance and Securitization Practice. He advises private equity sponsors, hedge funds, commercial and investment banks, and corporates on a broad range of innovative capital raising and investment transactions. Mr Warna-kula-suriya advises clients across a wide range of asset classes and structures, including structured finance and securitisation, public and private debt, equity-linked and hybrid capital markets issues, CMBS, cash and synthetic CLOs, OTC and exchange-traded derivatives, and cross-border structured finance.

Kamal Dalal is an associate in the London office of Latham & Watkins, as part of the Derivatives and Structured Finance Practice. She focuses on structured finance and securitisation transactions in relation to a variety of asset classes, including mortgage assets, trade receivables, consumer receivables, and SME or marketplace lending. She also regularly advises clients on OTC derivative transactions and structured hedging solutions.

Latham & Watkins

99 Bishopsgate
London
EC2M 3XF
United Kingdom

Tel: +44 20 7710 1000
Fax: +44 20 7374 4460
Web: www.lw.com

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