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Securitisation 2023

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UK: Law & Practice
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UK

Law and Practice

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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. The UK then entered a transition period that lasted until 31 December 2020 (the "Transition Period"), 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. Following the expiry of the Transition Period, in accordance with the European Union (Withdrawal) Act 2018 (as amended by the European Union (Withdrawal Agreement) Act 2020) (the "Withdrawal Act"), EU law as directly applicable in the UK at the end of the Transition Period (subject to certain exceptions) was transposed into UK domestic law subject to significant amendments. As part of the transition process, Regulation (EU) 2017/2402 (the "EU Securitisation Regulation") was adopted as part of UK law as "retained EU law", in the form that applied at that time, and was then amended by way of UK statutory instruments, including the Securitisation (Amendment) (EU Exit) Regulations 2019, to ensure that it would operate effectively in the United Kingdom (as so amended, the "UK Securitisation Regulation").

In December 2022, HM Treasury published a policy note together with an illustrative statutory instrument with the draft title "Securitisation Regulation 2023", which demonstrates the UK government's approach will be to repeal the UK Securitisation Regulation as it was adopted in the UK as retained EU law, and instead propose a new approach in lieu of statutory provisions where the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) will make detailed rules going forward. One example of the extent of the devolved powers to the FCA and PRA is the possibility of including a securitisation position as an underlying exposure in a securitisation, provided consultation with the Bank of England occurs before granting permission to the entity requesting the "re-securitisation". Under the EU Securitisation Regulation, the ban on re-securitisations could only be overridden in very limited circumstances where a competent authority grants permission of inclusion of "re-securitisations" for "legitimate purposes" as defined in Article 8(3) of the EU Securitisation Regulation. These reforms form part of a wider set of UK financial services reforms, known as the Edinburgh Reforms, which set out the UK government's ambition to become a competitive global financial centre.

At the time of writing this article, however, the UK Securitisation Regulation applies to securitisations in the UK and follows the EU Securitisation Regulation very closely (subject to amendments), and therefore this article refers to Securitisation Regulation in places where both the EU Securitisation Regulation and UK Securitisation Regulation remain the same.

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 recharacterised 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 (the IA 1986).

True Sale versus 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:

- the purchaser has recourse to the seller for any shortfall if the underlying obligor fails to pay; or
- 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 per-

fection 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.

Consequences of Recharacterisation

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). Consequently, a true sale which is recharacterised as a secured loan would constitute an unregistered security interest of the originator and render the issuer its unsecured creditor as regards the assets forming part of the originator's insolvency estate. 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.

Equitable Assignment

Until the occurrence of the requisite perfection steps, the issuer will only have the benefit of an equitable, rather than a legal, assignment of the assets from the originator. Unless a power of attorney has been granted by the originator to the issuer, for so long as the assignments of any assets are equitable and not legal, the issuer would not be able to take proceedings in the English courts to enforce the assets without the legal owner being joined in such proceedings. If the originator as the legal owner was to go into administration before the issuer's legal title had been perfected by registration, there would be statutory prohibitions under paragraph 43(6) of Schedule B1 to the IA 1986 against joining the originator as the legal owner as a co-defendant in any English insolvency proceeding. Unless the issuer obtained the leave of the court (or in certain circumstances the consent of the administrator) to join the originator as the legal owner and the co-defendant, it would be necessary to perfect the legal assignment of the property, assets and rights comprised in the relevant assets before the issuer could bring any action against any other claimants.

Fixed or Floating Security

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.

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.

Floating charge proceeds are potentially subject to a number of deductions and claims ranking in priority before they are distributed to the floating charge holder. A summary of the potential disadvantages is set out below.

- Floating charges generally rank behind fixed charges.
- 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, HMRC receives 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.
- The costs and expenses of an administration (including the remuneration of the administrator and the costs of continuing to operate the business of the charger while in administration) are generally payable out of floating charge assets, in priority to the claims of the floating charge holder.
- 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. The maximum total limit of such prescribed part is GBP800,000 where the floating charge is created on or after 6 April 2020 or GBP600,000 where the floating charge is created prior to that date.
- 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 where 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, the costs and expenses of the liquidation are generally 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.

If the floating charge falls within the scope of the Financial Collateral Arrangements (No 2) Regulations 2003, some of the disadvantages of taking a floating charge are avoided and certain registration formalities are disapplied. One of the main reasons for taking a floating charge is that a qualifying floating charge holder may appoint an administrator out of court if it is the holder of a qualifying floating charge. The ability to appoint an administrator out of court is a major advantage as acting quickly often helps to minimise concern among suppliers and creditors of the business, and therefore helps to retain value. Under paragraph 14 Schedule B1 to the IA 1986, a person is the holder of a qualifying floating charge if they hold one or more security instruments which together relate to the whole or substantially the whole of the chargor's assets, and at least one of which is a qualifying floating charge. In certain capital markets transactions, such as securitisations, a qualifying floating charge holder may appoint an administrative receiver whose primary responsibility is to protect the interests of the charge holder, instead of an administrator whose main aim is to rescue the company as a going concern. Therefore, in some instances the appointment of an administrative receiver could be more attractive for certain qualifying floating charge holders.

In some circumstances, a qualifying floating charge holder will not be able to enforce its

security without the consent of the court (or administrator), for example:

- if a moratorium is in place because an administrator is already in office;
- if an interim moratorium is in place because formal steps have been taken to appoint an administrator; or
- if there is a standalone moratorium in place under Part A1 of the IA 1986 (which was inserted by the Corporate Insolvency and Governance Act 2020).

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:

- 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
- 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 above confirmations 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:

- the transaction was at an undervalue; and
- 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 the first point here does not apply, the second is rendered irrelevant.

Preference (Section 239, IA 1986)

The court may set aside a transaction as a preference if it is entered into during the six months prior to the onset of an administration or liquidation of the originator (or, where the parties are connected, two years). 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 upon the originator's insolvency, and the originator was influenced into 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 (SPEs)

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).

Substantive 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.

Limited exceptions include:

- where the assets of an entity may be available to meet the liabilities of another entity over which it acts as a shadow director; or
- where the SPE is held to be acting as agent for the originator.

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 Materially Relevant Law

Other relevant laws and regulations include the following.

- 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, and compliance with consumer credit protection laws). This article does not cover the various consumer rights laws and regulations in the UK which may apply to securitisations in respect of specific asset classes.
- 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 these requirements would generally constitute an equi-

table 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 obligor 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 obligor prior to assignment, or that arise in favour of the obligor 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 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 obligor 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 obligor – 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 the obligor regarding transfer or confidentiality obligations that would prohibit their assignment or unduly limit dealing with information.

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 con-

sideration 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, 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, securities are not considered to be results-dependent solely due to being issued on a limited-recourse basis. A further exemption for capital market investments was introduced in 2022 which provides increased flexibility as to the structuring of the debt, including by allowing results-dependent returns. The application of this additional exemption is subject to certain criteria being met, most notably that the SPE must be a "note-issuing company" within the securitisation tax regime and the debt must be a capital market investment.

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, 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 was 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 typically 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

The most frequent issues that arise in connection with accounting rules that apply to securitisations in the UK are:

- the treatment of the transfer of underlying financial assets as true sale for accounting purposes; and
- the related question of whether the SPE is consolidated for accounting purposes into the originator's group.

3.2 Dealing With Legal Issues

Accounting issues relating to securitisation transactions should be addressed by accountants, as the respective analysis falls outside the legal scope. Legal opinions do not generally cover accounting matters, but may include certain qualifications or assumptions that feed into other legal opinions or risk assessments.

4. Laws and Regulations Specifically Relating to Securitisation

4.1 Specific Disclosure Laws or Regulations

Securitisation Regulation

The EU Securitisation Regulation, as amended from time to time, has applied in the EU since 1 January 2019. Following the UK's departure from the EU, the EU Securitisation Regulation does not apply in the UK. Instead, the EU Securitisation Regulation has been enacted as retained direct EU law in the UK by virtue of the opera-

tion of the Withdrawal Act, as amended by the Securitisation (Amendment) (EU Exit) Regulations 2019 (SI 2019/660) (the "UK Securitisation Regulation" and together with the EU Securitisation Regulation, the "Securitisation Regulation").

A "securitisation" is defined in Article 2 of the Securitisation Regulation as a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

- payments in the transaction are dependent upon the performance of the exposure or of the pool of exposures;
- tranching in the form of the contractual subordination of payments determines the distribution of losses during the ongoing life of the transaction; and
- the exposures are not "specialised lending exposures" within the meaning of Article 147(8) of Regulation (EU) No 575/2013 as it forms part of domestic law of the UK by virtue of the Withdrawal Act.

The UK Securitisation Regulation, in broad terms, imposes upon relevant UK-established or UK-regulated persons certain restrictions and obligations similar in nature to those imposed by the EU Securitisation Regulation as at the end of the Transition Period, but such restrictions and obligations are not identical. For instance, under the UK Securitisation Regulation, the UK Financial Conduct Authority (FCA), the UK Prudential Regulation Authority (PRA) and the Pensions Regulator have been designated as the competent authorities, while the EU Securitisation Regulation has designated the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) as the European supervisory authorities.

There is a risk that the UK Securitisation Regulation may subsequently be amended and further diverge from the EU Securitisation Regulation.

Further, while secondary legislation relating to the EU Securitisation Regulation in force at the end of the Transition Period was enacted with certain amendments in the UK, there is a risk of divergence in respect of the content and/or timing of secondary legislation effected after the end of the Transition Period under the respective regimes. In addition, interpretative guidance issued by European supervisory authorities does not form part of UK-retained law and it is uncertain whether guidance from the relevant authorities on each EU and UK Securitisation Regulation will be and remain similar between the respective regimes.

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.

The EU Securitisation Regulation established a framework for simple, transparent and standardised (STS) securitisations. A securitisation which meets the relevant STS criteria can benefit from preferential regulatory treatment including lower regulatory capital charges with respect to the related exposures for bank investors under the Capital Requirements Regulation and for insurance and reinsurance undertakings under Solvency II, and eligibility for certain exposures in specified asset classes as Level 2B high quality liquid assets under the liquidity coverage ratio for banks. Initially, STS designation was only available for traditional true sale securitisations where the originator, sponsor and issuer are established in the EU; however, pursuant to changes effective since April 2021, STS designation is available, subject to fulfilment of relevant conditions, to balance-sheet synthetic securitisations and securitisations of non-performing exposures.

Under the UK Securitisation Regulation, in the case of a securitisation which is not an asset-backed commercial paper (ABCP) programme or transaction, only the originator and sponsor need to be established in the United Kingdom for such securitisation to be capable of being STS. In the case of an ABCP programme or transaction, only the programme sponsor needs to be established in the United Kingdom in order for such ABCP programme or transaction to be capable of being STS. In addition to this flexibility, any 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. There are currently no reciprocal arrangements under the EU Securitisation Regulation regime for recognition of UK STS securitisations. There is also a proposal to extend this temporary recognition of EU STS securitisations until the end of 2024.

Specific Transparency and Disclosure Laws or Regulations

The 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.

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).

For private transactions, this information should be provided directly to the aforementioned entities.

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;
  - (b) the ownership structure;
  - (c) the cash flows;
  - (d) details regarding the exposure character-

istics;
(e) the priority of payments; and
(f) details of the voting rights of noteholders and their relationship with other secured creditors.

These disclosures must be made using the templates provided for in the regulatory technical standards. Following the end of the Transition Period, there is a dual regime of disclosure templates, although the templates are substantially the same in content. There might be instances where disclosure reporting is required under both regimes. In terms of the due diligence requirements imposed on UK investors under the UK Securitisation Regulation and EU investors under the EU Securitisation Regulation, it is unclear whether EU investors can satisfy their due diligence requirements under Article 5 through receipt of the information as required by the UK templates. UK investors, however, should be able to satisfy their due diligence obligations under Article 5 of the UK Securitisation Regulation by receiving information as required by the EU templates, as the UK Securitisation Regulation permits them to rely on receiving transparency information which is "substantially the same" as that contained in the UK transparency regulatory technical standards.

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) (an "MiFID-regulated market") or an exchange-regulated market.

Where an offering document for securities is subject to Regulation (EU) 2017/1129 (the "EU Prospectus Regulation"), it is referred to as a "prospectus", while an offering document falling outside the scope of the EU 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 EU 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.

In December 2022, a policy note was issued along with a draft illustrative statutory instrument confirming HM Treasury's intention to repeal the UK Prospectus Regulation and replace it with a FSMA-based regulatory regime. The overall effect of this move is to delegate a greater degree of rulemaking power to the FCA to make it simpler for a wide range of investors to participate in UK public market offerings.

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 (or equivalent amounts). 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 an 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 an MiFID-regulated market of the London Stock Exchange, 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 United Kingdom Listing Authority's (UKLA) 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.

Environmental, Social and Governance (ESG) Framework

There is an absence of a specific regulatory framework that determines whether or not a transaction can be labelled as an "ESG securitisation" or "sustainable securitisation" in the UK. Instead, a patchwork of ESG legislation, technical standards, guidance and recommendations have been produced, but this array of existing rules is not yet harmonised. A number of key regulatory updates in this space are discussed below, which do or will influence the regulation of sustainable securitisations in the UK.

In the UK government's report titled *Greening Finance: A Roadmap to Sustainable Investing*, published in October 2021, the UK government set out its vision for sustainability and climate change-related policy plans in UK finance. These plans were split into three key initiatives, namely:

- sustainability disclosure requirements (SDR) which would require companies to disclose how they manage ESG-related financial risks and opportunities, and also require investors to disclose information about how such factors were considered in their investment decisions;
- implementing a UK Green Taxonomy to set out criteria for economic activities which can be considered "environmentally sustainable", and which aims to ensure interoperability with the EU Taxonomy Regulation; and

- investor stewardship objectives to hold companies accountable for the feasibility and credibility of their net-zero commitments and their transition strategies to align their business models with a net-zero economy.

The Sustainable Finance Disclosure Regulation (SFDR) is an EU regulation which imposes a series of sustainability-related disclosure requirements on EU asset managers and similar entities marketing financial products in the EU in relation to sustainable investments, sustainability risks and sustainability factors. While securitisations themselves are not included as an "in-scope financial product" under the SFDR, this is the most expansive piece of legislation establishing specific ESG criteria and mandating disclosure requirements on "in-scope EU financial entities" related to sustainable investments. While the UK is yet to publish its own framework sustainable securitisation, it is likely that the FCA and PRA will look to ensure any such recommendations are compatible with other key international initiatives such as the SFDR.

The EU Taxonomy Regulation sets out a classification system to assess the extent to which an economic activity or investment can be considered environmentally sustainable in the EU. While the EU Taxonomy Regulation does not apply to the UK, the UK is set to produce its own classification system in the near future called the Green Taxonomy, which is proposed to be based on the same six environmental objectives as the EU Taxonomy Regulation and the requirement to do no significant harm, but diverge from the EU Taxonomy in relation to the specific disclosure obligations companies face and the technical details of the EU's technical screening criteria. Instead, disclosures under the Green Taxonomy are proposed to form part of the SDR regime.

Under Article 46 of the UK Securitisation Regulation, HM Treasury was required to review the function of the UK Securitisation Regulation and, in its report published on 13 December 2021, concluded that additional environmental disclosure requirements should be added to the Article 7 disclosure templates. HM Treasury has indicated that it does not expect to set up a standalone green securitisation framework in the immediate future, preferring to wait until further progress has been made in the implementation of the UK's SDR regime that is applicable to other financial market participants.

In June 2022, the FCA published a feedback statement:

- endorsing the use of industry standards for ESG-labelled debt instruments developed by the International Capital Markets Association (ICMA) and confirming that it does not intend to develop a compulsory standard for ESG-labelled debt instruments at this time;
- encouraging "second opinion" providers to consider voluntarily applying relevant industry standards such as ICMA Green Bond Principles; and
- endorsing the proposed regulation of ESG data and rating providers (a market that is currently unregulated). Subsequently, in November 2022, the FCA further announced that it will be developing a Code of Conduct for ESG data and ratings providers, which they intend to be in place while regulations are being developed.

The FCA has published a consultation paper on sustainable investment product labels and anti-greenwashing measures, with the proposed measures due to come into effect provisionally from 30 June 2024. The consultation paper proposes, among other things, two levels of disclo-

sure requirements for funds: one for consumers that outline the product's key sustainability-related features, and more detailed disclosures for institutional investors. The recommendations are intended to be compatible with other international initiatives such as the SFDR and similar proposals from SEC.

The ICMA published its Q&A on sustainable securitisations in June 2022 to guide market participants on sustainable securitisation, which is expected to be incorporated into its Green Bond Principles Handbook (although there is no set date yet for its implementation). Also in June 2022, the ICMA updated Appendix 1 to the Green Bond Principles to address "secured green bonds", and confirm that they may be secured on eligible projects or the proceeds may be exclusively used to finance or refinance green projects.

4.3 Credit Risk Retention

Article 6 of the Securitisation Regulation imposes a direct obligation on the originator, sponsor or original lender in respect of a securitisation to 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 meet the following requirements.

- It must 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.
- It must not be 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:

- establishes and manages a securitisation that purchases exposures from third parties; or
- 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.

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.

EU regulatory technical standards on risk retention requirements provide further that:

- where there are multiple originators in a transaction, the retention requirement may be fulfilled by each originator on a pro rata basis by reference to the securitised exposures; or
- the retention requirements may be fulfilled in full by a single originator or original lender provided that either the originator or original lender has established and is managing the securitisation, or the originator or original lender has established the securitisation and has contributed more than 50% of the total

securitised exposures measured by nominal value at origination; and
- for the purpose of assessing whether an entity has been established or operates for the sole purpose of securitising exposures as referred to in Article 6(1) of the EU Securitisation Regulation, account should be taken that the entity has a strategy and capacity to meet payment obligations consistent with a broader business model that involves material support from capital, assets, fees or other sources of income, by virtue of which the entity does not rely on the exposures to be securitised or on any interests retained or any corresponding income from such exposures as its sole or predominant source of income, and the decision-makers have the necessary experience to enable the entity to pursue the established business strategy and adequate corporate governance arrangements (the "Sole Purpose Principles").

The draft EU regulatory technical standards setting out the sole purpose principles is yet to be adopted in any final legislation in the EU, and has not yet been onshored into domestic UK law. As of the date of this article, the UK risk retention technical standards have not yet been developed, but pursuant to the exploratory notes set out in the Withdrawal Act in accordance to which the UK Securitisation Regulation was enacted, any non-binding EU instruments, such as recommendations and opinions, would still be available to assist with the interpretation of retained EU law. The FCA and PRA have also issued guidance confirming that market participants can continue having regard to such materials to the extent they remain relevant after the end of the Transition Period.

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 under Article 5 of the Securitisation Regulation to verify that the aforementioned retention obligation is being fulfilled.

4.4 Periodic Reporting

The 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 in the manner prescribed in the EU reporting templates and/or the UK reporting templates pursuant to regulatory technical standards issued in connection with Article 7 of the Securitisation Regulation.

- 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 the 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.

To the extent compliance with Article 4 of the SFDR is determined to be necessary or elected to be contractually complied with, the relevant reporting entity for SFDR purposes must also publish and maintain on its website a principal adverse sustainability impacts statement (PASIS) on due diligence policies with respect to principal adverse impacts of investment decisions on sustainability factors, taking due account of their size, the nature and scale of their activities and the types of financial products they make available.

4.5 Activities of Rating Agencies

Regulation EC 1060/2009 (as amended) (EU CRA Regulation) established a compulsory registration process for credit rating agencies (RAs) operating in the EU and has been onshored into UK law as part of EU-retained law in accordance with the Withdrawal Act as amended by the Credit Rating Agencies (Amendment etc) (EU Exit) Regulations 2019 (the UK CRA Regulation, and together with the EU CRA Regulation, the “CRA Regulation”). It requires, among other things, that:

- RAs be registered with and supervised by ESMA;
- RAs are independent and appropriately identify, disclose and manage any conflict of interest;
- RAs apply sound quality of rating methodology and ratings;
- EU-registered RAs can endorse ratings issued by non-EU RAs;
- where an issuer or a related third party intends to solicit a credit rating of structured finance instruments, it shall obtain two independent ratings for such instruments; and
- where an issuer or a related third party intends to appoint at least two credit rating agencies to rate the same instrument, the issuer or a related third party shall consider appointing at least one rating agency having less than a 10% market share among agencies capable of rating that instrument.

4.6 Treatment of Securitisation in Financial Entities

Financial entities commonly must 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 (treatment of credit institutions and investment firms differs from that of insurers);
- the type of securitisation and the investor’s role in it (traditional securitisations differ from synthetic securitisations, STS securitisations attract more favourable treatment than non-STS securitisations, and 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/IV 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 changes introduced 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 Capital Requirements Regulation (EU) 575/2013 (the CRR), as amended by CRR Amending Regulation (EU) 2017/2401 (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. The principal EU legislation was effectively incorporated into English law (in so far as it was not already incorporated) at the end of the Transition Period through the Withdrawal Act. 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 was agreed in December 2019 (referred to as Basel IV or Basel 3.1). On 27 October 2021, the European Commission published legislative proposals for amendments to the existing capital requirements rules, in order to implement the updated final Basel III standards. If approved, such proposals will apply within the EU from 1 January 2025 (two years later than initially agreed internationally), with full implementation anticipated by 2032. On 30 November 2022, the PRA published a consultation paper covering parts of the Basel III standards that remain to be implemented in the UK. The PRA's proposals align the UK's implementation of the Basel standards with less divergence than the EU while gold-plating those standards in certain areas. Some of the key proposals include:

- removal of the use of internal models in some areas;
- restrictions on the use of internal models in credit risk for portfolios where there is insufficient loss data to reliably model exposures in certain instances;
- a more risk-sensitive set of standardised approaches for credit, market, operational and CVA risks; and
- introduction of a new "output floor" to be phased in over five years.

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 (RWEA) of the securitised assets.

The originator institution of a securitisation is permitted to exclude underlying exposures from its calculation of RWEAs and, where applicable, relevant loss amounts in the case of the following under Article 244(1) CRR:

- the significant credit risk associated with the underlying exposures has been transferred to third parties; and
- such a reduction in RWEAs, or the reduction in own-funds requirements which the originator achieves by the securitisation, as applicable, is justified by a commensurate transfer of credit risk to third parties, as determined by the relevant competent authorities on a case-by-case basis.

The requirements for establishing whether there has been a significant risk transfer (SRT) are similar whether the transaction is a traditional true sale securitisation or a synthetic securitisation. There are two alternative quantitative tests (Article 244(2), CRR):

- mezzanine test – 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
- first loss test – where 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 RWEAs that would be achieved is not justified by a commensurate transfer of credit 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 mezzanine test or first loss test 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 is currently no definitive guidance in the CRR as onshored to the UK by virtue of the Withdrawal Act as to what constitutes a commensurate transfer of credit risk. For purposes of the EU CRR, the EBA published SRT guidelines on 7 July 2014, which provide guidance on the factors that competent authorities should take into account to determine whether commensurate credit risk transfer has been achieved. More recently, the EBA published a report on 23 November 2020 that includes detailed recommendations on the harmonisation of SRT assessment, including the assessment of structural features, application of quantitative tests and supervisory process for assessing SRT. However, the recommendations in the EBA's report are not legally binding and do not constitute formal regulatory guidance. The PRA also published a supervisory statement in July 2020 on SRT in securitisation, which set out the PRA's expectations of firms seeking SRT treatment.

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).

Solvency II

Insurers and reinsurers established in the UK are subject to the Solvency II regime as onshored as EU retained law by the Withdrawal Act, 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. In December 2022, as part of the Edinburgh Reforms, the UK government announced it will repeal the Solvency II regime as part of its ongoing efforts to repeal key EU insurance prudential regulatory standards which have been onshored as EU retained law, and will instead move towards giving more devolved power from the UK government to the FCA and PRA to oversee the reform of UK domestic legislation related to financial services regulation. The proposed changes by the UK government are aimed at allowing greater flexibility for UK insurers to invest in a wider range of assets, in particular in more structured assets, by reducing the capital requirement thresholds imposed on such insurance firms.

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 in the UK is the UK European Market Infrastructure Regulation on derivatives, central counterparties and trade repositories, as onshored into UK law through the Withdrawal Act (UK EMIR). Under UK 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, certain pension schemes, UK UCITs and alternative investment funds managed by an alternative investment fund manager, while NFCs are all entities taking positions in OTC derivatives other than FCs. FCs and NFCs are further divided into those whose 12-month average consolidated group aggregate positions in derivatives are above certain thresholds (FC+s and NFC+s) or below (Small FC-s and NFC-s).

Parties to an OTC derivative contract are subject to certain obligations under UK EMIR based on their counterparty classification, as well as the type and volume of derivatives they are entering into, 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 those OTC derivatives within such classes in respect of which they have exceeded the relevant thresholds under UK 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 registered under UK EMIR by the working day following their conclusion, modification or termination. Both parties are responsible for trade reporting, although the obligation can be delegated by prior agreement. For trades entered into between an FC and an NFC-, the FC is, however, legally liable and solely responsible for the reporting on behalf of both counterparties.
- Risk mitigation – 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. While all parties are subject to certain risk mitigation techniques, some will apply only to FCs and NFC+s.
- Margin obligation – FCs and NFC+s must engage in the timely, accurate and appropriately segregated exchange of variation margin, and initial margin if an FC or an NFC has a consolidated group average aggregate notional amount of all outstanding derivatives transactions in excess of EUR8 billion. FCs and NFC+s must also conduct mark-to-market valuation of their transactions on a daily basis, reporting them to a registered 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 UK).

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 UK 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 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 that 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:

- the originator for losses arising in connection with the sale of assets; and
- 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:

- a "traditional" securitisation, where the assets are sold to an SPE funded through the issuance of debt securities to investors; and
- 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.

Since April 2021, the UK Securitisation Regulation has applied to synthetic securitisation, which 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.

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 applied 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:

- the higher spread to be received on the (usually low-quality) assets to be securitised; and
- 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. Synthetic securitisations also allow the originator to hedge exposures that are difficult or impossible to assign and therefore cannot be securitised by true sale securitisation, such as revolving credit facilities, SME lending, project finance and trade finance receivables.

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 and therefore the counterparty must maintain a minimum credit rating. Often in funded structures, security is provided by the counterparty over the cash deposit or transactions are structured as a direct issuance of credit linked notes by the originator bank.

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 numerous 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, some 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 recharacterisation 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 three principal structures used for synthetic securitisations:

- the first structure involves the issuance of credit-linked securities by the SPE to investors;
- the second structure involves a direct transfer of credit risk from the originator to investors; and
- the third structure involves a direct issuance of credit-linked securities by the originator.

In the first structure, 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 the second structure, 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 make a payment to the originator under the CDS/financial guarantee.

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

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. The first and third structures are examples of funded structures. In the first structure, 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. The second structure 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. Counterparties to unfunded structures include insurers and EU-level institutions such as the European Investment Bank, while funded structures are the remit of private credit funds.

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. Collateralised loan obligations (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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