

In Practice

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Brexit: what are the consequences for ECB collateral?

In order to be eligible for use as collateral for Eurosystem credit operations, asset-backed securities must comply with the eligibility criteria set out by the European Central Bank. Following the UK's departure from the EU on 31 January 2020, questions have arisen as to whether UK assets will be eligible during and after the implementation period.

The European Central Bank (ECB) has given no indication that a wall of existing asset-backed securities (ABS) have become ineligible for Eurosystem credit operations since the UK left the European Union (EU) on 31 January 2020. In its 30 January 2020 press release, the ECB welcomed ratification of an orderly UK withdrawal from the EU, but it was silent with respect to continued collateral eligibility. However, the question needs to be asked whether new and existing ABS that have a UK nexus will be eligible for Eurosystem credit operations during the "Implementation Period" (during which EU law continues to apply to and in respect of the UK) and following its completion (IP Completion Date), which is due to occur on 31 December 2020.

The ECB's collateral eligibility criteria, which is set out in its "General Framework"¹ and "Temporary Framework",² imposes geographic restrictions on ABS destined for use as collateral with the Eurosystem. Eligible ABS must be:

- admitted to trading on a regulated market or "acceptable" non-regulated market³ in the European Economic Area (EEA);
- issued in the EEA by an issuer established in the EEA;
- held and settled in member states whose currency is the euro through an account with a national central bank (NCB) of a member state or with an eligible securities settlement system;
- backed by cash-flow generating assets originated by an originator incorporated in the EEA and sold to the issuer by the originator or an intermediary incorporated in the EEA;
- backed by assets governed under the laws of an EEA country, with any related security located in the EEA, and sold under the laws of a member state; and
- backed by assets located in the EEA where the obligors and creditors of the underlying assets are incorporated (or if natural persons, resident at the time of origination) in the EEA.

The last criterion in respect of obligors of underlying assets was amended on 10 May 2019⁴ to include the following:

"Obligors who are natural persons must have been resident in the EEA at the time the cash-flow generating assets were originated."⁵

This language could suggest the addition of a narrow form of grandfathering, since UK obligors would have been EEA residents if

origination occurred before Brexit and, as is suggested below, the IP Completion Date. However, it is also possible, for example, that this change was made as an accommodation to originators who confirm their borrowers' residency at origination but not subsequently, rather than as a means of facilitating the inclusion or grandfathering of ABS backed by third-country assets. Those taking a cautious approach may want to consider carefully the degree of reliance they place on this proviso in the context of Brexit. In addition, no equivalent language applies in the case of the other geographic restrictions.

Aside from references to member states and the euro area, geographic restrictions in the ECB eligibility criteria generally refer to the EEA instead of the EU. On 31 January 2020, the UK also left the EEA by virtue of Art 126 of the treaty creating the EEA (EEA Agreement), which states that the EEA Agreement applies to the territories to which the "Treaty establishing the European Economic Community is applied and under the conditions laid down in that treaty". Notably, the UK continues to be bound by international agreements concluded by the EU (pursuant to Art 129 of the Withdrawal Agreement) during the Implementation Period, which includes the EEA Agreement. As a result, the Implementation Period also applies to the UK's membership of the EEA, and the UK should continue to be considered part of both the EU and the EEA during the Implementation Period for the purposes of applying the ECB's eligibility criteria. This is echoed in the ECB's General Framework, which defines the EEA as "all Member States, regardless of whether or not they have formally acceded to the EEA, together with Iceland, Liechtenstein, and Norway", as well as the EEA/EFTA Separation Agreement, where the Implementation Period under Art 126 of the EU Withdrawal Agreement is incorporated by reference, and the recitals state that the applicable rights and obligations under the EEA Agreement and other international agreements should continue to apply to the UK for the duration of the Implementation Period.

Issuers that are established in the UK and originators and obligors that are incorporated in the UK should thus be deemed to be "established/incorporated in the EEA" during the Implementation Period for the purposes of the General Framework, and likewise the laws of England and Wales, Scotland and Northern Ireland should continue to be considered laws of an EEA country during such period. Arguably eligibility should be unaffected solely as a result of the presence of underlying assets with UK obligors, where the obligors are natural persons that were resident in the UK at the point of origination, provided that the underlying assets were originated before the IP Completion Date.

Satisfying the ECB's eligibility criteria does not guarantee that an NCB will accept any particular assets into the Eurosystem. NCBs exercise wide discretion and act on a case-by-case basis. Consequently, whether any particular existing or new collateral is rejected during the Implementation Period remains to be seen. That being said,

there is a strong argument that ABS transactions with a UK issuer, originator, or underlying obligors should continue to satisfy the ECB's eligibility criteria during the Implementation Period. However, absent an extension to the Implementation Period or changes to the ECB's eligibility criteria, and in the absence of guidance to the contrary, it seems likely that such eligibility will end on the IP Completion Date when the UK is no longer deemed to be a member state or part of the EEA. ■

- 1 Articles 60 to 71 of Guideline (EU) 2015/510 of the European Central Bank, as amended. The most recent unofficial consolidated text of the General Framework was produced on 8 August 2019.
- 2 Article 7 of Guideline (EU) 2014/31 of the European Central Bank, as amended. The most recent consolidated text of the Temporary

Framework was produced on 24 June 2019.

- 3 No UK markets were on the list of acceptable non-regulated markets updated by the ECB on 10 January 2020.
- 4 Guideline (EU) 2019/1032 of the ECB on 10 May 2019.
- 5 Emphasis added.

Biog box

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