Brexit – legal consequences for commercial parties

UK covered bonds – a head start on the key considerations and possible implications

Specialist paper No. 5
February 2016

Issue in focus
Since the first UK covered bond transaction in 2003, and following the introduction of the national statutory framework in 2008, a mature covered bond market has developed in the UK. This market has allowed UK banks and building societies to diversify and expand their funding sources, and covered bonds have provided a reliable source of funding throughout periods of market stress. The importance of covered bonds across Europe has been expressly acknowledged by the EU Commission through its Capital Markets Union (CMU) initiative and the corresponding consultation on the development of a new pan-European regulatory framework for a more integrated covered bond market.

Key Considerations and Analysis
Possible unlevel playing field from a regulatory perspective
Covered bonds benefit from preferential regulatory treatment under the current EU framework. Since the introduction of the national statutory framework in 2008, UK regulated covered bonds have been on a level playing field with more traditional EU covered bond products in that they benefit equally from this better treatment. However, Brexit could result in a shift in the current position, meaning that UK covered bonds may once again face a competitive disadvantage, as they did prior to 2008.

In this article we identify certain key considerations for UK covered bonds arising as a result of a vote in favour of Brexit, or Brexit itself, and seek to provide a head start for our clients in considering the possible implications and what they may mean in practice. It should be noted that the post-exit model negotiated and adopted by the UK is a fundamental element of the analysis in this regard and may shape certain outcomes, as we have highlighted below.

This article is one of a series of specialist Allen & Overy papers on Brexit. To read these papers as they become available, please visit www.allenovery.com/brexit.

By way of background, the preferential treatment afforded to covered bonds under the current EU framework is apparent in the adjusted treatment provided on a number of fronts. For example, less restrictive rules apply to EU regulated funds with respect to exposures to covered bonds, reduced capital requirements apply to EU regulated credit institution and insurer investors in respect of covered bond positions and provisions apply to allow covered bonds to be eligible as Level 1 assets for EU regulated credit institutions for liquidity coverage ratio purposes. In addition, some relief is provided (or expected to be provided) from the clearing and margin requirements under the EU Market Infrastructure Regulation (EMIR) for covered bond swaps.
However, in order to benefit from these adjustments, relevant bonds are required in all cases to demonstrate the key features set out in article 52(4) of the EU UCITS Directive, and to also satisfy certain additional requirements (e.g. with respect to the cover pool assets) for specific regulatory purposes. Among other things, article 52(4) of the UCITS Directive requires qualifying bonds to be issued by a credit institution with its registered office in the European Economic Area (EEA). As a result, given that the UK statutory framework requires use of a domestic issuer, Brexit may mean in effect that UK regulated covered bonds are no longer able to satisfy this requirement.

It should be noted that the outcome on this point and the corresponding regulatory treatment that would apply in a Brexit scenario depends in large part on the exit mechanism adopted. For example, if the UK remained part of the EEA, then it would continue to be subject to much of EU law and UK issuers should still satisfy the jurisdiction requirement under article 52(4), whereas other exit options and possible corresponding terms would not involve this.

If UK covered bonds were no longer able to benefit from better regulatory treatment in the hands of relevant EU regulated investors, relative disincentives to investing in UK bonds would likely arise for these investors. While it is possible that the EU authorities may adjust the current EEA issuer requirement (and incidentally the consultation published by the Commission in connection with its CMU workstream seeks feedback on this point), there is no certainty that this will occur.

In addition, it is not clear what regulatory treatment covered bonds would be subject to after Brexit in the hands of UK regulated investors and whether the UK authorities would provide for better treatment for certain covered bonds, including UK regulated covered bonds. In addition to depending on the exit mechanism adopted, the continuing effect of current regulatory requirements would depend on whether the relevant EU law has been implemented in the UK (which is unlikely to be the case where the relevant EU law is derived from a regulation as such measure has direct effect in member states), whether the implementing measures are made by primary or secondary legislation and, if by secondary legislation, whether a relevant savings provision is made.

Lastly, we note that, in the longer-term, Brexit is likely to result in a growing divergence between the regulatory regime which applies in the UK and that which applies in the EU, unless an EEA-based exit route is selected. Given the inherently cross-border nature of the covered bond markets and the fact that certain regulatory requirements and provisions are investor-focused, such divergence may give rise to increasing regulatory considerations for UK covered bonds. In particular, if the EU authorities decide to pursue a new framework for covered bonds as part of the CMU initiative, then, depending on the features identified as part of that framework and the details of any further adjustments in the regulatory treatment of covered bonds, heightened unlevel playing field issues could arise.

Expected general consistency in UK statutory framework

The current UK statutory framework for covered bonds cross-refers to and reflects certain principles derived from the EU regulatory regime. These points of consistency are deliberate and operate in certain respects to facilitate compliance on the part of UK issuers with the requirements applicable for the preferential treatment of regulated covered bonds under such EU regime.

While Brexit may result in a general review of these cross-references, we would expect any corresponding updates or amendments to the UK statutory framework to be relatively contained. This is in part due to our understanding that the current regime is considered by the authorities to function as intended in general and also due to the fact that the requirements for covered bonds which apply at an EU level (including under article 52(4) of the UCITS Directive) are largely principles-based, meaning that the UK authorities were able to exercise significant discretion in setting the terms of the current UK regime. In this regard, we note that the authorities undertook a review of the UK framework within the last five years and concluded that only a handful of changes were required.

Notwithstanding the foregoing and despite (rather than as a result of) Brexit, if the EU authorities pursue the adoption of a new pan-European framework for covered bonds as part of the current CMU workstream and the regulatory treatment of covered bonds in the hands of relevant EU regulated investors is tied to compliance with this, the UK authorities may consider making corresponding adjustments to the national regime if this would result in a level playing field for UK covered bonds.
General consistency in law and basic legal analysis

The structure used in UK covered bond transactions is reflected in the national statutory framework but predates this and is based on securitisation technology in part. As a result, the structure draws on English common law principles. While Brexit would likely result in uncertainty as to some aspects of English law as the precise terms of exit from the EU are negotiated and any necessary domestic legislation is passed, principles of English common law as they apply to support the basic legal analysis in respect of UK covered bond transactions (including concepts related to general contract law, trusts, asset assignments and security) should be largely unaffected. As a result, the UK covered bond structure should continue to function as it has done to date and material concerns related to legal certainty should not arise.

Notwithstanding this, certain cross-border recognition-related legal frameworks may no longer apply. In particular, the Insolvency Regulation (as an EU regulation) would cease to apply to ensure cross-border coordination and recognition of insolvency proceedings within the EU in respect of certain companies (including the cover pool owners used in UK covered bond structures). While the Credit Institutions Winding Up Directive and Bank Recovery and Resolution Directive (as EU directives which have been implemented in the UK) may continue to apply as implemented, this will depend on the exit mechanism selected, whether the relevant implementing measures were made by primary or secondary legislation and, if by secondary legislation, whether a relevant savings provision is made. However, we would not expect material issues to arise as a result of the cessation in application of any of these frameworks, particularly given that UK covered bond structures do not typically involve a relevant cross-border connection.

Possible shifts in issuer and counterparty strength

General concerns have been raised by a number of market analysts that the increased uncertainty arising as a result of the coming Brexit referendum may give rise to financial and economic volatility in the UK, which may in turn result in increased stress for UK market participants and a corresponding reduction in the financial strength of such entities. These analysts also predict significantly higher stress levels for UK institutions, particularly those less domestically oriented, in the event of a vote in favour of Brexit.

In respect of the issuer, the occurrence of certain events such as insolvency may result in an issuer event of default under the bonds and trigger the cover pool owner’s obligations under the note guarantee. Due to certain structural features common across all UK covered bond transactions (including the true sale of the asset pool to the cover pool owner and the note guarantee provided by such entity), an issuer event of default under the bonds may not (in itself) interfere with the continuing operation of the relevant UK covered bond transaction.

In the context of counterparties, the occurrence of certain related events upon a reduction in counterparty strength may give rise to a termination event. The analysis in this regard will turn on the relevant contractual provisions, as will the timelines and the obligations with respect to termination notices and finding a replacement counterparty if relevant.

Common termination events include insolvency-related events, although such termination may not be fully triggered until notice is provided. In general, whether parties can close out or terminate in an insolvency scenario may depend on the type of contract and the laws of the jurisdiction of the relevant insolvency proceedings. Trustees may be reluctant to exercise discretion in relation to contractual rights and remedies that have become exercisable following relevant termination events without direction. A ratings downgrade may also constitute a termination event.

While transactions may anticipate and provide for arrangements intended to mitigate the risk of counterparty default in line with rating agency requirements or otherwise (such as requirements for the positioning of collateral or replacement with a party holding the requisite rating), it is difficult to confirm that all arrangements would operate as intended and/or prove sufficient in a scenario involving wider financial and economic volatility issues. In general, in times of market turmoil, it may prove more difficult (and costly) in practice to find a suitable replacement for a counterparty, and in certain circumstances this may ultimately affect the payments made to bondholders, although inherent features of UK covered bond structures would guard against this.

Lastly, it is worth noting that recent prospectus updates for UK covered bond programmes have included
disclosure intended to flag the uncertainty related to Brexit. This disclosure is necessarily set out in high level terms only in a reflection of the current lack of certainty and the resulting challenges to meaningfully identifying and articulating the corresponding risks for issuers and programmes at this point. Notwithstanding this, we expect consideration to continue to be given to this practice in the context of UK covered bond transactions in the lead up to the referendum.

Possible shifts in cover pool performance or bond pricing and liquidity

As an extension of the financial and economic volatility concerns noted above, certain market analysts have noted that Brexit may affect the UK housing and secured funding markets in particular, thereby possibly giving rise to shifts in the performance of related assets (such as UK residential mortgage loans). Any shifts in this regard may be relevant in the context of UK covered bond transactions, the majority of which are supported by cover pools comprised of such assets, although such bonds also involve a full recourse claim with respect to the issuer.

Various factors are cited by analysts as possibly contributing to the relevant implications of Brexit in this regard for underlying asset portfolios. These factors include (i) the level of geographical diversification (given expected relocation levels from London), (ii) the level of UK non-conforming and buy-to-let assets (given expected reductions in investment in the UK real estate market and the possibility of property value evolution) and (iii) floating rate product concentration levels (given expected increases in interest rates). Certain recent research reports also indicate that Brexit could possibly bring wider spreads and reduced liquidity for UK covered bonds in general, at least in the short- and medium-term.

These asset performance and market-related predictions go beyond the scope of this article and its focus on legal consequences in general. Notwithstanding this, we note that the UK statutory framework for covered bonds includes certain asset coverage requirements including a minimum over-collateralisation requirement. These coverage requirements may function to provide a safeguard in the event of any shift in cover pool performance.

Eurosystem operations access and eligibility implications

Brexit seems unlikely to result in UK covered bonds no longer being eligible collateral for the purposes of the Eurosystem liquidity providing operations. This is because the eligible collateral requirements for bonds (other than asset-backed securities) do not include jurisdiction-related requirements, other than a requirement for the issuer to be established in the EEA or a non-EEA G-10 country (and the UK is of course a G-10 country). This requirement should not restrict the eligibility of bonds (including covered bonds) issued by a UK credit institution issuer post-Brexit regardless of the exit mechanism selected. That said, the reduced haircuts applied in respect of so-called “jumbo covered bonds” under the Eurosystem framework may not be available, although non-jumbo UK covered bond issues should be treated on the same haircut basis as other non-jumbo covered bond issues.

For the sake of completeness, we note that we expect UK covered bonds would remain ineligible for purchase under the Eurosystem’s current covered bond purchase programme (CBPP3). This is already the situation given the requirement under the CBPP3 regime for the issuer to be a euro area credit institution, and further requirements (related to compliance with article 52(4) of the UCITS Directive) are also unlikely to be satisfied in the event of Brexit.

With respect to whether UK institutions would be able to access the Eurosystem operations, this would remain largely in-line with the current position assuming the European Central Bank does not revise the requirements. Under this position, non-euro area established institutions may have access to such operations subject to satisfying certain counterparty criteria related to (i) being subject to at least one form of harmonised EU/EEA supervision in accordance with the CRD regime (or non-harmonised supervision by competent authorities of a comparable standard), (ii) being financially sound and (iii) holding the required reserves with a relevant national central bank. Notwithstanding this, it should be noted that the own-name covered bond carve-out to the close links provisions (which provisions do not determine collateral eligibility per se but instead restrict counterparties with close links to the collateral from positioning and using it themselves) may not be available in respect of UK covered bonds post-Brexit.
What does this mean for you?

Market participants should start considering possible outcomes in relation to Brexit sooner rather than later and this article is intended to provide a head start by highlighting some of the preliminary issues and spaces to watch. Save for that, there is little that market participants can do right now to meaningfully anticipate Brexit in the context of UK covered bond transactions and/or to try to mitigate its potential effect on such arrangements. As the referendum draws closer, we will of course remain focused on what (if anything) may be done on this front and stand ready to assist clients.

As noted above, Brexit should not result in material changes to the English common law building blocks on which UK covered bond structures are based and the national statutory framework (which we would not expect to change significantly as a result of Brexit itself) may function to provide a safeguard in certain respects. We expect market participants to take comfort from these factors. Notwithstanding this, the regulatory position post-Brexit is not clear and UK covered bonds may end up on an unlevel playing field, which may in turn affect incentives to invest in such bonds.

We encourage interested clients to get in touch with any questions and comments. We also encourage clients focusing on Brexit-related issues to refer to the other specialist papers in this series, linked at www.allenovery.com/brexit.
Brexit – legal consequences for commercial parties | UK covered bonds – a head start on the key considerations and possible implications | Specialist paper No 5 | February 2016

Your Allen & Overy contacts

Angela Clist
Partner
Securitisation – London
Contact
Tel +44 20 3088 2437
angela.clist@allenovery.com

Sally Onions
Partner
Securitisation – London
Contact
Tel +44 20 3088 3584
sally.onions@allenovery.com

Nicole Rhodes
PSL Counsel
Securitisation – London
Contact
Tel +44 20 3088 4408
nicole.rhodes@allenovery.com

If you would like to discuss the issues raised in this paper in more detail, please contact Angela Clist, Sally Onions or Nicole Rhodes or your usual Allen & Overy contact.

GLOBAL PRESENCE

Allen & Overy is an international legal practice with approximately 5,000 people, including some 525 partners, working in 44 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:


“Allen & Overy” means “Allen & Overy LLP and/or its affiliated undertakings”. The term partner is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP’s affiliated undertakings. Allen & Overy maintains a database of business contact details in order to develop and improve its services to its clients. The information is not traded with any external bodies or organisations. If any of your details are incorrect or you no longer wish to receive publications from Allen & Overy, please contact corporatepublications@allenovery.com. This note is for general guidance only and does not constitute definitive advice. | ICM 23657098.2

© Allen & Overy LLP 2016 www.allenovery.com