ALLEN & OVERY

Brexit – legal consequences for commercial parties

Securitisation – a head start on the key considerations and possible implications

July 2016

Issue in focus

Notwithstanding that the EU ABS markets are significantly impaired compared to pre-financial crisis levels, securitisation remains an important funding tool and risk-transfer mechanism for institutions established in the UK and elsewhere. This importance has been expressly acknowledged by the EU Commission in the context of its Capital Markets Union (**CMU**) initiative and the corresponding proposals to revive the markets through the introduction of a revised regulatory framework for securitisation. Early indications from the EU authorities suggest that this initiative is intended to remain on track notwithstanding the referendum result and possible competing priorities, although it remains to be seen how the political negotiation process proceeds from here.

In this article we identify certain key considerations for securitisations arising as a result of the recent referendum and 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 sought to highlight below.

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

Key Considerations and Analysis

Possible shifts in counterparty strength

The recent referendum has resulted in a level of financial and economic volatility in the UK. General concerns have been raised by a number of market analysts that the increased uncertainty arising as a result of the recent referendum and Brexit itself may give rise to further volatility, which may in turn result in increased stress for UK market participants and a corresponding reduction in the financial strength of such entities. Some analysts have also predicted higher stress levels for UK institutions, particularly those less domestically oriented, as a result of Brexit and events leading up to it.

While securitisations are structured to mitigate possible risks arising in connection with the occurrence of a material event in respect of a transaction counterparty, perfect protection is elusive and considerations may arise in particular in certain scenarios involving heightened levels of general economic stress and a corresponding (unanticipated) reduction in the credit of a key counterparty.

In particular, the occurrence of certain related events upon a reduction in counterparty strength may give rise to a termination event in respect of the relevant counterparty.

The analysis in this regard will turn on the relevant contractual provisions in respect of the securitisation in question, 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 by the issuer with the consent of the trustee or by the trustee. In general, whether parties can close out or terminate on insolvency 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 from noteholders. A ratings downgrade may also constitute a termination event (requiring the positioning of collateral or replacement with a party with the requisite rating, which may be difficult) or, in the case of a seller downgrade, an event triggering the obligation to establish a reserve fund and/or a "stop sale" event (effectively making the asset pool static).

While transactions may anticipate and provide for back-up servicing arrangements (through the full positioning of a back-up servicer or the appointment of a back-up servicer facilitator) and/or other arrangements intended to mitigate the risk of counterparty default (in line with rating agency requirements or otherwise), it is difficult to confirm 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 securitisation issuer's ability to meet its payment obligations in respect of the ABS.

It is also worth noting that not all counterparties may be replaced. Leaving aside the activities that the originator or seller may perform in its other capacities in the context of an ABS deal (e.g. as servicer, cash manager, swap provider and/or account bank), the occurrence of certain events in respect of the originator or seller may have an impact on its ability to perform its obligations as seller and this is not a role likely to be undertaken by another party. For example, the seller may be unable to repurchase assets which breach the representations and warranties set out in the asset sale agreement. While securitisations are structured to provide for the ring-fencing of the securitised assets and the legal analysis will typically confirm that this should not be compromised by an insolvency event in respect of the originator, certain aspects of transactions may not play out as intended if the seller is no longer able to perform.

Possible shifts in asset performance or ABS pricing and liquidity

Certain market analysts have noted that Brexit and events leading up to it 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 ABS backed by such assets. While the cashflows in securitisations will be modelled to take into account expected stresses and default levels, extended periods of economic uncertainty and/or heightened volatility can challenge the assumptions applied.

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).

These asset performance and market-related predictions go beyond the scope of this article and its focus on legal consequences in general. However, it is worth noting that the prospectuses for a number of recent UK ABS transactions have included risk factor wording intended to flag the uncertainty in this regard. This risk 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 at this point. We expect consideration to continue to be given to this practice in the context of UK securitisations on a case-by-case basis (particularly for transactions with a connection to the UK housing and secured funding markets).

Possible credit rating actions and eligibility implications

Times of financial and economic volatility and any corresponding reduction in counterparty strength and/or

underlying asset performance may result in a rating downgrade.

In certain circumstances, counterparty-related events and/or material asset performance changes may result in rating action in respect of the ABS. This will depend on the nature of the event (and the party involved) or the change, as the case may be, and the potential for the note payments to be affected. Due to the protections inherent to securitisations, these types of events should be limited but cannot be ruled out entirely. A rating downgrade may give rise to a number of implications, some of which may be investor specific and others of broader relevance. For example, a downgrade may have an impact on whether the relevant ABS are eligible collateral for central bank liquidity operations and/or on the regulatory treatment of the securities, such as on whether the ABS are eligible assets for liquidity coverage ratio (**LCR**) purposes (as noted below, Brexit would give rise to other LCR eligibility considerations for certain UK ABS).

Thus far, the main credit rating agencies have taken only limited rating action in respect of UK ABS post-referendum and this has been focused on transactions considered to have significant direct exposure to the UK rating or to the commercial real estate market in London. This follows from the rating action taken by certain credit rating agencies in respect of the UK itself and the Bank of England post-referendum. In particular, Standard & Poor's and Fitch Ratings downgraded the long-term ratings of such entities from AAA to AA (with negative outlook) and from AA+ to AA (with negative outlook), respectively. While these actions have not yet had a general impact across UK ABS ratings, any further downgrade action in respect of the UK may have potential implications for UK ABS ratings given the ratings cap typically applied by the main rating agencies to ABS by reference to the sovereign rating level.

General consistency in common contractual provisions

Contractual arrangements in respect of UK securitisations typically refer to English law as the governing law. This selection reflects wider commercial practice and the perceived certainty, stability and predictability of such law and the English courts. Questions have been raised with respect to whether Brexit would make a choice of English law less attractive in a securitisation context or more generally.

We consider that it is highly unlikely that Brexit would have any substantive impact on the enforceability of English governing law clauses (in the English courts or elsewhere) and the reasons for choosing English law are for the most part entirely unconnected to the UK's membership in the EU and would be unaffected by any departure. As a result, a choice of English law to govern both contractual and non-contractual obligations is a sound one and will remain so. For further consideration of this issue, please refer to our specialist paper on this topic, linked here.

General consistency in law and basic legal analysis

Usual UK securitisation structures are based on a number of English common law principles. While Brexit will result in uncertainty as to some aspects of English law while 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 securitisations (including concepts related to general contract law, trusts, asset assignments and security) should be largely unaffected. As a result, common UK securitisation structures should continue to work as they have done to date and material concerns related to legal certainty should not arise.

Notwithstanding the foregoing, we note that certain cross-border recognition-related legal frameworks may no longer apply, such as the Rome I and Rome II Regulations related to choice of law rules in connection with contractual and non-contractual obligations. In this regard, it seems likely to us that the English courts will continue to respect a choice of English law (including post-Brexit) and, so far as other Member State courts are concerned, the rules in Rome I and II would be applied in essentially the same way to a choice of English law whether the UK is a Member State or not.

The Insolvency Regulation (as an EU regulation) would also cease to apply to ensure cross-border co-ordination and recognition of insolvency proceedings within the EU in respect of certain companies (including common securitisation vehicles) but related principles and provisions as implemented under English law may continue to apply. Similarly, 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 although this will depend on the post-exit

model negotiated, whether the relevant implementing measures were made by primary or secondary legislation and, if by secondary legislation, whether a relevant savings provision is made.

As a bottom line, it is difficult to anticipate all aspects of English law post-Brexit at this point except to the extent derived from common law principles. Importantly, the preservation of these principles will provide continuity in the legal analysis relevant to UK securitisations on many fronts. The cessation in application of any cross-border recognition-related legal frameworks is unlikely to present insurmountable issues for UK securitisations but may result in the need for further legal analysis and thereby give rise to increased legal costs, particularly for transactions involving a cross-border element.

Regulatory horizon uncertainty

Notwithstanding the expected general consistency in English law as described above, the position from a regulatory perspective is less clear. This is because a substantial amount of UK regulation related to securitisation is based on EU law and so would be potentially affected to a greater degree.

In particular, the question of whether any applicable regulatory requirements would remain in effect depends in large part on the post-exit model negotiated and adopted. For example, if the UK remained part of the European Economic Area (**EEA**), then it would remain bound by much of EU law, whereas other post-exit models and possible corresponding terms would not necessarily involve this. The effect of current regulatory requirements would also depend in part on whether the relevant EU law has been implemented in the UK (which is less likely 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.

Affected areas to note from a securitisation perspective may include the prudential-related regulatory frameworks applicable to credit institutions, alternative investment fund managers and insurers in connection with securitisations, including the current risk retention and investor due diligence requirements. It is not clear whether and to what extent these regulatory requirements would continue to apply in the UK, although it would be surprising if the UK authorities did not take steps to ensure appropriate "skin in the game" requirements were carried over in one form or another. In any event, given that relevant EU-regulated investors in the remaining Member States would continue to be subject to the requirements, presumably UK originators and sponsors would continue to be incentivised to retain the required interest and to make the necessary disclosures in accordance with the EU requirements.

Notwithstanding the incentives in this regard, however, it should be noted that technical issues may arise with respect to the ability of certain UK regulated entities to qualify as an eligible retainer as sponsor for the purposes of the EU retention requirements post-Brexit. The relevant issues arise under the sponsor definition which requires, among other things, the entity to be either a credit institution or an investment firm and eligible firms for this purpose are restricted to certain EU regulated entities under the EU Capital Requirements Regulation (**CRR**). This requisite EU connection would be problematic for certain UK entities post-Brexit, including for UK CLO managers, although the outcome in this regard will depend on the post-exit model adopted. Unfortunately, if a post-exit model is adopted which results in the UK being in the position of a third country entity (as opposed to an EEA state), then even the availability of equivalence under the coming MiFID II regime will not fully address the issue as such equivalence is not available under the CRR.

As a result of this uncertainty, some UK entities which would otherwise retain as sponsor have decided to retain as an originator instead (e.g. certain UK CLO managers). This involves certain additional steps to satisfy the requirements for originator retainers, including acquiring a portion of the assets to be securitised, and brings with it some increased regulatory risk as part of the retention analysis. There has also been some discussion among market participants of building provisions into transactions to facilitate a switch by relevant sponsors to retention in an originator capacity at a later stage if necessary, although the efficacy of this under the current rules is not without doubt and it is not clear that market participants will pursue this in advance of further information being available with respect to how Brexit may play out. It is unfortunate that the prospect of future technical non-compliance as a result of Brexit is pushing market participants to consider and possibly adopt more creative retention compliance strategies. Please see below for discussion of certain further considerations that may arise with respect to the ability of certain UK entities to act as retainer post-

Brexit as a result of certain proposed changes to the retention requirements.

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 post-exit model is negotiated. Given the inherently cross-border nature of the securitisation markets and the fact that certain regulatory requirements are investor focused, such divergence may present heightened regulatory considerations and compliance challenges for UK ABS.

Qualifying securitisation/STS label uncertainty and proposed third country restrictions

As noted above, the EU Commission is currently seeking to revive the securitisation markets as part of its CMU initiative and, to this aim, has published legislative proposals for a new regulatory regime for securitisations. While questions have been raised with respect to whether the EU authorities will pursue the establishment of the new regime given the referendum result and a possible corresponding shift in priorities, early indications from each of the Commission and Council support the view that there is continuing momentum with respect to the initiative. Notwithstanding this it remains to be seen how the political negotiation process plays out going forward and the reduction in the degree of influence of the UK with respect to the development of the proposals is cause for some concern in general.

A key pillar of the proposed new regime is the introduction of a common set of criteria to identify "qualifying securitisations" or so-called simple, transparent and standardised (**STS**) securitisations. This work is supported by market participants in general given that the STS initiative represents an opportunity for more balanced EU regulatory treatment for at least a portion of the market. If structured properly, the hope is that the framework will make securitisation more attractive for both issuers and investors.

The framework is proposed to be introduced through new EU regulations including a proposed STS securitisation regulation (which includes, among other things, the STS criteria) and a regulation amending the CRR to provide for better regulatory capital treatment for STS securitisation positions in the hands of credit institution investors. It is intended that the STS criteria and further adjustments to the regulatory treatment of ABS will also be made in due course to the LCR regime and to the regulatory capital requirements applicable to insurers under the Solvency II regime. It has also been suggested that the STS criteria could be used as a reference point in the future for more flexible treatment for certain ABS under the coming EU money market fund regulation and EU bank structural reform regulation.

A key consideration in respect of Brexit from a securitisation perspective is whether a departure from the EU would mean that UK securitisations could not satisfy the STS criteria and, as a result, could not benefit from any better regulatory treatment provided. While the original legislative proposals do not require an EU connection, each of the general approach document agreed by Council in late 2015 and the draft report published by the Committee on Economic and Monetary Affairs (**ECON**) of Parliament in June 2016 (the **draft ECON report**) includes a restriction in this regard. If this more restrictive approach is pursued, then it appears that after Brexit, UK securitisations would be unable to qualify as STS (and unable to benefit from any corresponding better regulatory treatment) unless the UK remains within the EEA and the relevant regulation is specified to have EEA relevance. This outcome may give rise to new regulatory disincentives for certain EU-regulated investors to invest in UK securitisations.

It should also be noted that the draft ECON report includes certain other proposals that would be highly problematic if pursued, and which would present possible heightened issues for UK market participants post-Brexit. The provisions in question would restrict originators and sponsors (for EU risk retention and other purposes) to regulated entities and, based on one interpretation of the relevant provisions, to EU regulated entities. As discussed above, similar issues already arise under the current sponsor definition, but the draft ECON report proposals would extend this issue such that it would also arise in the context of originators. If pursued, the restriction would remove the ability to adopt the 'originator switch' approach described above to address the sponsor definition concerns.

Worryingly, the draft ECON report also includes a proposed restriction on investors in EU securitisations, potentially limiting such entities to EU regulated institutional investors. The rationale for such a restriction seems flawed and would operate, if pursued and depending on the post-Brexit position, to restrict UK regulated entities from investing in EU securitisations. There are various advocacy efforts underway to discourage the pursuit of the problematic provisions

included within the draft ECON report and we encourage interested clients to get involved. Given the loss of practical influence on the part of the UK in EU discussions, including in relation to the CMU-securitisation workstream (and this is consistent with the recent resignation of Commissioner Lord Hill from the EU Commission), these advocacy efforts are key.

As a related matter, it is not clear what regulatory treatment securitisation positions will be subject to after Brexit in the hands of UK regulated investors and whether the UK authorities will pursue better treatment for STS arrangements (or its own version thereof if UK transactions are automatically ineligible under the EU standard).

Lastly, it should be noted that the current LCR requirements relating to Type 2B securitisations restrict permitted underlying asset types to EU Member State originated assets in most cases. In particular, this restriction applies in the context of SME loans, auto loans and leases, consumer loans and credit card receivables. As a result, Brexit could result in certain UK ABS no longer qualifying as eligible assets for current LCR purposes. While it is intended that the STS criteria once finalised will replace the Type 2B securitisation provisions, this may take some time to implement and, as noted above, the STS criteria may include restrictions on non-EU originated transactions in any event.

Eurosystem operations access and eligibility implications

Brexit seems likely to result in UK securitisation positions no longer being eligible collateral for the purposes of the Eurosystem liquidity providing operations.

The potential issues in this regard arise as a result of certain Eurosystem requirements which apply in the context of ABS which refer to an EEA or EU connection. In particular, requirements are applied for the ABS issuer to be established in the EEA, for the cashflow-generating assets to be originated in the EEA and sold to the issuer SPV by an EEA seller and for the obligors to be incorporated or resident in the EEA. The framework also requires the acquisition of the assets to be governed by the law of an EU Member State. Given the importance certain investors place on Eurosystem eligibility, the inability of UK ABS to satisfy the eligible collateral requirements post-Brexit may give rise to new disincentives to invest in such transactions, particularly relative to other ABS.

With respect to whether UK institutions would be able to access the Eurosystem operations, this seems likely to remain 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/CRR 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.

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 market participants can do right now to meaningfully anticipate Brexit in the context of UK ABS transactions and/or to try to mitigate its potential effect on such arrangements. We remain focused on the relevant issues and stand ready to assist clients as more information becomes available.

As noted above, Brexit should not result in material changes to the English common law building blocks on which usual UK securitisation structures are based and we expect market participants to take comfort from this. In contrast, the regulatory position is not clear and concerns arise as to how UK arrangements may fare post-Brexit, and how that outcome may affect incentives to invest in UK securitisation transactions.

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.

Your Allen & Overy contacts

Salim Nathoo
Partner and Head of Securitisation
Securitisation – London

Contact

Tel +44 20 3088 3838
salim.nathoo@allenovery.com

Tim Conduit
Partner
Securitisation – London

Contact

Tel +44 20 3088 2066
tim.conduit@allenovery.com

Christian Lambie
Partner
Securitisation – London

Contact

Tel +44 20 3088 2472
christian.lambie@allenovery.com

Angela Clist
Partner
Securitisation – London

Contact

Tel +44 20 3088 2437
angela.clist@allenovery.com

Vanessa Hardman
Partner
Securitisation – London

Contact

Tel +44 20 3088 4362
vanessa.hardman@allenovery.com

Lucy Oddy
Partner
Securitisation – London

Contact

Tel +44 20 3088 4454
lucy.oddy@allenovery.com

Sally Onions
Partner
Securitisation – London

Contact

Tel +44 20 3088 3584
sally.onions@allenovery.com

Franz Ranero
Partner
Derivatives and Structured Finance – London

Contact

Tel +44 20 3088 2424
franz.ranero@allenovery.com

Nicole Rhodes
PSL Counsel
Securitisation – London

Contact

Tel +44 20 3088 4408
nicole.rhodes@allenovery.com

Tom Constance
Senior Associate
Securitisation – London

Contact

Tel +44 20 3088 2930
tom.constance@allenovery.com

If you would like to discuss the issues raised in this paper in more detail, please contact any of the above contacts or your usual Allen & Overy contact.