

**HM Treasury**

**Review of the Securitisation  
Regulation:  
Call for Evidence**

**June 2021**

RESPONSE

2 September 2021

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**1. INTRODUCTION**

**i. The author**

1.1 I am a London securitisation lawyer with 30 years' experience as external counsel to arrangers, originators, rating agencies and others operating at the 'senior' end of the market; that is, structuring and documenting large, innovative transactions. I have published widely on legal, tax, regulatory and accounting aspects of securitisation, including on the regulation of UK securitisation following Brexit. I have also taught securitisation to graduate law students in the LL.M. programme at Queen Mary, University of London for 25 years. A brief biography is at:

<http://www.rainesandco.com/marke-raines.html>

**ii. Scope of Response**

1.2 This Response addresses the effect of the Securitisation Regulation on the functioning of the *term securitisation* market, per Article 46(2)(c) of the Securitisation Regulation.

1.3 This Response is not directed at ABCP securitisation, which raises particular bank regulatory considerations. Nor does it address structured investment vehicles, collateralised bond obligations or collateralised debt obligations, which are qualitatively different financial exercises to term securitisation even though they use similar structuring techniques.

1.4 Capitalised terms not otherwise defined in this Response have the meanings given in the Call for Evidence.

**iii. Further reference**

1.5 Detailed analysis of the EU regulation of, or affecting, securitisation in the context of Brexit can be found in two articles I published in late 2018<sup>1</sup> and in 2019.<sup>2</sup>

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<sup>1</sup> *UK regulation of term securitization following a hard Brexit*, Capital Markets Law Journal, Oxford University Press (2018)

<sup>2</sup> *Brexit: Time to Revisit UK Regulation of Term Securitisation*, Journal of International Banking Law and Regulation (2019)

## **2. EVIDENCE**

### **i. UK securitisation largely unregulated prior to the GFC**

2.1 EU-level law did not specifically address securitisation until 2004 when the Prospectus Directive Regulation<sup>3</sup> set out specific disclosure requirements for ABS. Only in 2006 did two EU directives implement the Basel II framework, including rules for (1) the recognition of transfer by credit institutions and investment firms of securitised assets<sup>4</sup> and (2) ratings-based regulatory capital risk weightings for securitisation and other exposures<sup>5</sup> (together, the Capital Requirements Directive or CRD). Implementation of the CRD was incomplete and uneven across the EU when the liquidity crisis began in mid-2007 but the securitisation framework was implemented in the UK by the Financial Services Authority on 1 January 2007.<sup>6</sup>

### **ii. European and UK term securitisation performed exceptionally during the GFC**

2.2 Paragraph 1.4 of the Call for Evidence states that:

*“Securitisation is considered to have played a significant role in the Global Financial Crisis (GFC), due to insufficient transparency of the risk involved and the misalignment between investors’ and manufacturers’ interests.”*

This statement is broad and must be qualified. Significant credit losses arose in relation to US securitisation. The opposite was the case, however, for European and UK term securitisation.

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<sup>3</sup> Regulation No 2004/809/EC.

<sup>4</sup> Directive 2006/48/EC

<sup>5</sup> Directive 2006/49/EC

<sup>6</sup> Prudential Sourcebook for Banks, Building Societies and Investment Firms, Financial Conduct Authority.

2.3 European (including UK) asset-backed securities ('ABS') performed exceptionally during the GFC. In 2014, the European Banking Authority compared the performance of top-rated European ABS products and residential mortgage-backed securities ('RMBS') with the performance of top ratings assigned to corporate issuers including financial institutions and insurance undertakings.<sup>7</sup> They found that:

*“Despite being relatively low during the 2006-2009 time period, the default rate of corporate ratings appears to be substantially higher than the default rate of EU RMBS and ABS products, the latter being close to zero.”<sup>8</sup>*

2.4 Losses were generally confined to commercial mortgage-backed securities transactions ('CMBS') and some lower tranches of certain ABS and CMBS deals.<sup>9</sup> It is important to note that rated European ABS and RMBS suffered no credit losses.<sup>10</sup>

2.5 Indeed, in the seven year period running from mid-2007, when the GFC began, the cumulative default rate for all European structured finance notes rated by Standard & Poor's was, as at mid-2014, only 1.58 per cent (by original balance).<sup>11</sup> This cumulative rate includes not only top-rated RMBS but also CMBS, corporate securitisations and collateralised debt obligations ('CDOs') comprised of ABS.<sup>12</sup>

### **iii. The UK term securitisation market since the GFC**

2.6 Paragraph 2.7 of the Call for Evidence states:

*“Available data indicates a fairly positive picture for the UK securitisation market. Since the GFC, the securitisation market has rebounded: the number of new securitisations issued has increased significantly since 2014, while new issuance volume has risen more gradually in the same period (see Chart A). These trends have more or less continued since 2019, when the*

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<sup>7</sup> EBA Report on Qualifying Securitisation—Response to the Commission's call for advice of January 2014 on long-term financing, 13

<sup>8</sup> *ibid.*

<sup>9</sup> 'Securitisation can be a sturdy ally for investors' *Financial Times* (15 August 2017)

<sup>10</sup> *ibid.*

<sup>11</sup> 'Seven Years On, the Cumulative Default Rate for European Structured Finance Is Only 1.6%', Ratings Direct, Standard & Poor's Ratings Services, 26 August 2014, 2.

<sup>12</sup> *ibid.*, 3.

*UK's securitisation market has had to adapt to the Sec Reg's new provisions, though there has been some decrease during the Covid-19 pandemic."*

2.7 A consideration of only GBP-denominated securitisation issuance over the past eight and a half years does not present an accurate picture of the UK securitisation market since the GFC.

2.8 It would be more illuminating if HM Treasury:

(a) considered issuance by country of collateral, not by currency of issuance;

(b) distinguished between placed and retained issuance; and

(c) compared pre-GFC peak issuance to current issuance.

2.9 Taking these in turn:

(a) the country where the collateral is situated generally indicates the country in which the benefit of the funding is enjoyed, regardless of where the issuance takes place or (since currency swaps are common) the currency of issuance;

(b) following the onset of the GFC, significant amounts of securitisation issuance were retained (purchased) by the originator. The retained issuance reflects purchases of ABS by UK originator banks for use in repo transactions with the Bank of England. As such, retained issuance does not reflect private investor appetite; rather, it represents central bank funding of the assets being securitised;

(c) it is important to measure the difference between peak pre-GFC and current securitisation backed by UK collateral for three reasons. First, peak pre-GFC issuance occurred in a regulated environment but not in an environment where the activity of securitisation was regulated or where a 'securitisation penalty' was imposed on regulated investors who took on securitisation exposures. Second, the Securitisation Regulation, that regulation is only the most recent iteration of a long, complex and continually changing mix of EU regulatory proposals and enactments, to which the European and UK markets have had to adjust, repeatedly, since 2009, beginning with Article 122a of the Banking Consolidation

Directive.<sup>13</sup> Thus the effect of the Securitisation Regulation on the UK securitisation market is difficult, if not impossible, to consider in isolation: see below. Finally, it is the only by measuring the performance of the UK securitisation market from mid-2007 that the recovery of the securitisation market can be determined.

2.10 In 2006, the last complete calendar year before the onset of the GFC, securitisation issuance (all of it placed) backed by UK collateral reached EUR 192bn<sup>14</sup> (GBP 129.3bn<sup>15</sup>). In 2020, total securitisation issuance (placed and retained) backed by UK collateral was only EUR 19.6bn<sup>16</sup> (GBP 17.5bn<sup>17</sup>), per the Securitisation Data Report Q4 2020 published by the Association for Financial Markets in Europe ('AFME'), just over 10% of the pre-GFC level. The 2020 securitisation placed issuance backed by UK collateral, will be lower. That figure is not given in AFME Q4 2020 Report but the Report records total European issuance as EUR 194.7bn of which only EUR 81.5bn, just over 40%, was placed.<sup>18</sup> If, hypothetically, the proportion of 2020 placed securitisation issuance backed by UK collateral was proportionately the same as the Europe-wide figure, that figure would be only GBP 7.3bn, or 5.6% of the 2006 level. Even if all of the 2020 securitisation issuance backed by UK collateral was placed, it would be fair to characterise the UK securitisation market as moribund, as compared to the pre-GFC market.

2.11 It would thus be fair to characterise the UK securitisation market as moribund, as compared to the pre-GFC market.

#### **iv. Regulation of securitisation since the GFC**

2.12 In the 14 years since the onset of the GFC, EU regulation has imposed or proposed the following categories of restrictions on, or adverse regulatory treatment of, securitisation, all of which embraces term securitisation. This post-GFC EU securitisation regulation, virtually all of which has been adopted by the UK post-Brexit, can be grouped under a dozen heads:

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<sup>13</sup> Directive 2006/48/EC, added by Directive 2009/111/EC Article 30

<sup>14</sup> European Securitisation Forum Data Report, Winter 2007 <https://www.sifma.org/resources/research/europe-securitisation-data-quarterly-2006-q4/> accessed 2 September 2021

<sup>15</sup> At 31 December 2006 mid-market 17:00 UTC <https://www.xe.com/currencytables/?from=EUR&date=2006-12-31#table-section> accessed 2 September 2021

<sup>16</sup> AFME Securitisation Data Report Q4 2020 <https://www.afme.eu/Publications/Data-Research/Details/AFME-Securitisation-Data-Report-Q4-2020> accessed 2 September 2021

<sup>17</sup> At 31 December 2020 mid-market 17:00 UTC <https://www.xe.com/currencytables/?from=EUR&date=2020-12-31#table-section> accessed 2 September 2021

<sup>18</sup> AFME Securitisation Data Report Q4 2020

- (a) mandatory retention by originators of a 5 per cent net economic interest in the securitised assets and an obligation on institutional investors to verify the retention;
- (b) an obligation to apply the same credit-granting criteria to securitised and non-securitised assets;
- (c) a ban on resecuritisation;
- (d) extensive disclosure obligations by originators, sponsors and issuing vehicles, in addition to the issuer's usual prospectus and post-issuance reporting obligations;
- (e) extensive securitisation-specific due diligence requirements including:
  - (i) initial due diligence for institutional investors including, inter alios, credit institutions and investment firms, insurance and reinsurance undertakings, alternative investment fund managers (AIFMs) and undertakings for collective investment in transferable securities (UCITS) taking an exposure to a securitisation; and
  - (ii) post-issuance monitoring for such institutional investors, including regular stress tests on the solvency and liquidity of the sponsor of a fully-supported ABCP programme;
- (f) limited exemptions for securitisation vehicle rate swaps from new collateralisation requirements;
- (g) limitations and penalty haircuts on ABS collateral in non-centrally cleared OTC derivative contracts;
- (h) increasing risk weighting of ABS held by credit institutions and investment firms as investments;
- (i) penalty spread risk applicable to ABS held by insurance and reinsurance undertakings as investments;
- (j) limitations and penalty haircuts on the use of ABS to meet liquidity coverage ratios;
- (k) limitations and penalty haircuts for ABS collateral used for credit risk mitigation; and
- (l) more than 100 requirements for a new category of 'simple, transparent and standardised' securitisations that will benefit from more favourable regulatory capital treatment.



The new body of regulation is accompanied by strict administrative sanctions for breach of retention, disclosure, credit-granting and STS requirements with risk-weight penalties for breach of due diligence and other rules. A full analysis of this body of regulation, and the effect of Brexit on UK securitisation, can be found in the first of the two articles cited above.<sup>19</sup>

**v. What the evidence shows**

2.13 The evidence shows two things:

- (a) during the GFC there were no credit losses on rated UK term securitisation (even though there was virtually no EU-level regulation of securitisation at the onset of the GFC and little UK regulation of any consequence); and
- (b) the UK securitisation market, in terms of placed securitisation issuance backed by UK collateral, has remained moribund since 2007.

**3. CONCLUSIONS**

3.1 Certain conclusions can be drawn from the evidence, particularly in light of the legal analysis in *UK regulation of term securitization following a hard Brexit*, cited above.

*False premise*

3.2 First, a proper analysis of the adopted UK regulatory approach to securitisation is that it is premised on term securitisation being a significantly more dangerous financing technique than others, such as asset-based lending or high-yield bonds. In particular, the UK regulatory approach treats term securitisation products as more dangerous than comparably rated vanilla corporate bonds. On the evidence, that is a false premise.

*Distortion of credit markets*

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<sup>19</sup> Note 1 *supra*.

- 3.3 Second, the barriers set up by the UK regulatory approach to securitisation will necessarily divert investment in fixed income securities away from ABS. That money finds a home elsewhere and, theoretically, the increased demand exerts downward pressure on the price of other credits. The pricing of credit varies wildly across markets and over time but a regulatory framework that is based on a false premise and impedes investment in an otherwise sound credit cannot be good for the markets, particularly in times of loose monetary policy.

*Impeding recovery of the UK securitisation market*

- 3.4 Common sense suggests that the continually changing, expanding and highly prescriptive body of post-GFC regulation of securitisation adopted by the UK has impeded the recovery of the UK securitisation market. Investors want a good risk-adjusted return on investments. For a regulated UK investor, it is much harder and ‘costs’ much more to hold a UK term securitisation instrument than it does to hold a comparably rated corporate bond, even though the former proved a better credit than the latter during the worst financial crisis in recent history. Rigorous asset-level due diligence requirements will deter some investors who ordinarily – and quite rightly – would analyse the portfolio characteristics of a homogenous pool of assets, rather than each individual asset. As noted above, there are significant limitations and risk weighting penalties in the case of ABS held by credit institutions and investment firms and spread risk penalties for insurance and reinsurance companies holding securitisation positions.

*Need for wider review*

- 3.5 It is difficult, if not impossible, for HM Treasury to assess the effect of the Securitisation Regulation, in isolation, on the UK securitisation market for reasons given above. HM Treasury, together with other relevant departments and agencies, should as a matter of urgency conduct a wholesale review of the regulation of term securitisation, with a call for comments from interested parties. The review would include, among other instruments, the Securitisation Regulation, the Capital Requirements Regulation and Solvency II. The author has expressed views on the reform of UK securitisation post-Brexit in the two articles cited above.

**MJR**