HM Treasury and the UK Securitisation Regulation—economical with the actualité?

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Abstract

HM Treasury's December 2021 Report to Parliament on the UK Securitisation Regulation was inaccurate and misleading in its summary of key evidence. Worse, HM Treasury failed to address what effect the large scale regulatory diversion of credit investment may have on the pricing of credit, what market distortions may arise and what can happen if credit is mis-priced and the credit markets are distorted. HM Treasury confirmed in their 9 December 2022 Policy Note that they are holding their position.

Introduction

HM Treasury were required by art.46 of the Securitisation Regulation[1] to report to Parliament by 1 January 2022 on, among other things, the effects of the Securitisation Regulation on the functioning of the securitisation market. HM Treasury duly called for evidence in June 2021 (the Call for Evidence)[2] and reported in December 2021 (the Report).[3]

The Report, a year old at the time of writing, was deeply flawed in two respects. First, the Report misrepresented the evidence received by HM Treasury (as revealed by a Freedom of Information application, discussed below).[4] Second, and more serious, the Report failed to address the distortion of the credit markets resulting from the EU and UK regulatory treatment of securitisation following the 2007–2008 financial crisis (the GFC). A *corrigendum* and an *addendum* are in order, not least so that Parliament, HM Treasury and other government bodies can address the regulation of the UK securitisation market sensibly.

Background

Securitisation in a nutshell

Securitisation is essentially an over-collateralised bond issue. For example, a notional portfolio of £100 million of residential mortgages would typically collateralise about £80 million of top-rated bonds. Securitisation structures can be complex in order to isolate the collateral from originator credit risk and to minimise or eliminate credit, liquidity and market risk. Thus, the desired ratings on the collateralised securities are achieved. Over-collateralisation by lenders is not new, however. Nor is it news that the behaviour of a portfolio of financial assets is qualitatively different to, and much more predictable than, the behaviour of any of the individual financial assets in the portfolio. In other words, securitisation is a simple and predictable financing technique.

The European and UK securitisation markets

The modern securitisation market began in the US in 1970, in the UK in the mid-1980s and, following enabling and facilitating legislation at the national level, on the Continent in the late 1980s and early 1990s. European securitisation issuance reached a peak of €370.9 billion in 2006,[5] which was the last complete calendar year prior to the onset of the GFC. Despite widespread market losses sustained by investors in the sell-off during the GFC, credit losses on rated European securitisation paper were virtually nil.[6]

EU and UK regulation of securitisation

With minor exceptions, the European and UK securitisation markets were unregulated at the EU level until 2009. Since July 2009 the EU have promulgated a vast body of regulations and technical standards relating to securitisation. This post-GFC regulatory regime governs, broadly: (1) risk retention by the business undertaking the securitisation or by its sponsor; (2) "re-securitisation" (a near-total ban on "repackaging" asset-backed bonds); (3) credit-granting criteria in relation to securitised and non-securitised assets; (4) disclosure of information on the securitised assets and the securitisation structure; (5) due diligence by investors; (6) capital and liquidity treatment of securitisation exposures for institutional investors; and (7) extensive special "simple, transparent and standardised" (STS)

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[1] Regulation 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation [2017] OJ L347/35.

[2] HM Treasury, "Review of the Securitisation Regulation: Call for evidence" (June 2021), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1000693/Securitisation_Regulation_Call_for_Evidence_June_2021.pdf* [Accessed 30 December 2022].

[3] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040038/Securitisation_Regulation_Review.pdf*.

[4] Pursuant to a Freedom of Information (FOI) request, to HM Treasury (foirequests@hmtreasury.gov.uk), HM Treasury provided the author with copies of the evidence received, certain commercial information and individual names expurgated, *https://www.gov.uk/make-a-freedom-of-information-request* [Accessed 12 October 2022].

[5] ESF Securitisation Data Report (Winter 2007), *https://www.sifma.org/wp-content/uploads/2017/05/europe-securitisation-data-quarterly-2006-q4.pdf* [Accessed 12 October 2022].

[6] "Securitisation can be a sturdy ally for investors", *Financial Times*, 15 August 2017.

requirements, which are required in order for certain institutions to invest and to achieve reduced regulatory risk weightings.

The regulations are highly detailed and prescriptive. They are continually being amended and expanded, notwithstanding the exemplary performance of European securitisation through the worst financial crisis since the Great Depression. Indeed, EU regulatory technical standards for risk retention have still not been finalised[7] some 13 years after the main regulation was first promulgated.

The entire body of EU regulation pertaining to securitisation, including the Securitisation Regulation, was adopted by the UK following Brexit, with minor adaptive changes.

The EU and UK securitisation markets

The EU and UK securitisation markets have remained moribund since the GFC. Placed European and UK issuance in 2021 were only €84.9 billion and €34.6 billion, respectively,[8] which together amounted to about 32% of 2006 placed issuance (or about 21%, if UK inflation-adjusted[9]). The Financial Conduct Authority[10] and HM Treasury[11] have both stated the obvious fact that securitisation is important to fund the UK economy.

The June 2021 Call for Evidence

The Call for Evidence posed 50 questions on the overall effects of the Securitisation Regulation on: (1) risk retention; (2) disclosure requirements for private securitisations; (3) an STS equivalence regime; (4) environmental disclosure requirements; (5) third-party verification regimes; (6) the role of securitisation special purpose entities; and (7) alternative investment fund managers and extra-territoriality. The Call for Evidence did not ask for comments on capital and liquidity treatment of securitisation exposures which, as noted below, were the subject of extensive market response.

Responses to the Call for Evidence

Identities of respondents not disclosed, so a Freedom of Information request was made

HM Treasury received 21 responses to the Call for Evidence[12] but did not identify or categorise the respondents in the Report. The author made a Freedom of Information request and obtained from HM Treasury copies of all of the responses save his own[13] and that of Association for Financial Markets Europe (AFME)/UK Finance,[14] which are both available online.

The copies of the responses received by the author from HM Treasury appear complete and intact, save that certain commercial information and names of individuals were redacted.

Who responded to the Call for Evidence

The 21 responses came from:

- two banks (Barclays Bank plc and Standard Chartered Bank);
- one rating agency (Fitch Ratings);
- three investors (Insight Investment, M&G and PGGM);
- one university (two academics at the University of Southampton);
- 12 trade associations representing:
  - — investors (Association of British Insurers, Alternative Credit Council and Alternative Investment Management Association *jointly*, International Association of Credit Portfolio Managers (the “IACPM”) and Managed Funds Association);
  - — the structured finance industry (Structured Finance Association, AFME and UK Finance *jointly* and Australian Securitisation Forum); and
  - — originators (Commercial Real Estate Finance Council Europe, Finance & Leasing Association and Loan Market Association (the “LMA”));
- three service providers (European Data Warehouse, STS Verification International and Prime Collateralised Securities (PCS) UK Limited (“PCS”)); and
- one lawyer (the author).

[7] European Banking Authority, EBA/RTS/2022/04 (1 April 2022).
[8] AFME Securitisation Data Report Q1 2022, p.16, *https://www.afme.eu/Publications/Data-Research/Details/AFME-Securitisation-Data-Report-Q1-2022* [Accessed 12 October 2022].
[9] Bank of England, Inflation Calculator, *https://www.bankofengland.co.uk/monetary-policy/inflation/inflation-calculator* [Accessed 12 October 2022].
[10] Financial Conduct Authority, “Securitisation”, *https://www.fca.org.uk/markets/securitisation* [Accessed 12 October 2022].
[11] HM Treasury, “Review of the Securitisation Regulation: Report and call for evidence response” (December 2021), para.1.2
[12] HM Treasury, “Review of the Securitisation Regulation: Report and call for evidence response” (December 2021), para.1.8.
[13] Raines & Co, “Review of the Securitisation Regulation: Call for Evidence” (June 2021), *http://www.rainesandco.com/uploads/6/6/2/1/66213021/2_sept_2021_hm_treasury.pdf* [Accessed 5 January 2023].
[14] AFME/UK Finance, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), *https://www.ukfinance.org.uk/system/files/AFME-UK%20Finance%20Response%20to%20HMT%20Call%20for%20Evidence%20on%20UK%20Sec%20Reg.pdf* [Accessed 5 January 2023].

Highlights from the evidence and the Report

Three issues

It is beyond the scope of this article to summarise the Call for Evidence, the evidence received by HM Treasury and the Report, much less to provide a detailed analysis of them. Nonetheless, it is worth highlighting how the Report treated evidence on three key aspects of the UK securitisation regulatory regime:

- the regulatory burden imposed by the Securitisation Regulation;
- disclosure and reporting requirements under the Securitisation Regulation; and
- the capital and liquidity treatment of securitisation exposures.

The second issue above is part of the first but, since it attracted significant comment from the respondents, it is worth treating it separately. HM Treasury did not call for evidence on the third issue but at least nine respondents commented specifically on it, so HM Treasury addressed it in their Report.

HM Treasury's representation of the evidence in the Report is not accurately or fairly reported.

The regulatory burden imposed by the securitisation regulation

The Report

HM Treasury said:

> "We also note that, while respondents provided suggestions for reforms and noted the Sec Reg may be unduly prescriptive relative to other pieces of regulation, they were generally supportive of it."[15]

The evidence

The respondents were not "generally supportive". The author counted 10 responses that commented negatively on the regulatory burden imposed by the Securitisation Regulation[16] and one response that commented positively.[17]

For example, AFME/UK Finance responded:

> [The benefits of the Securitisation Regulation] "… are outweighed by higher compliance requirements and costs, especially for issuers. In particular, these increased requirements and costs come without a commensurate set of benefits from market development […]
>
> Part of the reason for this is that the Sec Reg, although intended to encourage new investors into the market, has had the opposite effect by increasing the barriers to entry for investors."[18]

Further, from AFME/UK Finance:

> "No other fixed income instrument intended for the wholesale financial markets has either the transparency or due diligence requirements prescribed by primary legislation in anything like the level of detail that the Sec Reg requires."[19]

Finally, from AFME/UK Finance:

> "… the cumulative effect of the Sec Reg appears to the Joint Associations to have been to make securitisation markets shallower and less liquid than they otherwise would be. As a result, they are prone to greater and more exaggerated periods of market stress than the real credit quality of the product or the underlying assets would typically suggest."[20]

Also, by way of illustration, the IACPM stated:

> "… the rules apply a very prescriptive and form-over-substance approach which, while superficially appearing to promote the aims of greater standardisation, transparency, and prudence, has significantly increased the cost and operational burdens of securitisation while simultaneously reducing the benefits."[21]

By way of further illustration, the LMA observed:

> "… the barriers to entry into the securitisation market for both investors and issuers are enormous. Securitisations are now one of the most regulated asset classes in the non-retail finance sector. The amount of information that must be compiled by issuers in order to comply with the transparency requirements of Article 7 and the level of due diligence required to be undertaken by institutional investors under Article 5 have created a very large and costly barrier to taking part in the securitisation market. These barriers coupled with the regulatory capital framework applied to investments in securitisations have made securitisation less attractive when compared with other asset classes such as covered bonds."[22]

[15] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.2.45.
[16] Association of British Insurers, Barclays Bank, IACPM, Commercial Real Estate Finance Council Europe, Insight Investment, LMA, M&G, PCS, AFME/UK Finance and the author.
[17] University of Southampton.
[18] AFME/UK Finance, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.9.
[19] AFME/UK Finance, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.9.
[20] AFME/UK Finance, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.10.
[21] IACPM, Letter on Review of the Securitisation Regulation: Call for Evidence (undated), pp.1–2.
[22] LMA, Letter on Review of the Securitisation Regulation: Call for Evidence (1 September 2021), p.3.

The sole positive comment found by the author came from two academics at the University of Southampton, who said:

> "[The Securitisation Regulation] … has had very positive effects on improving the functioning of the securitisation market, enhancing investor protection and financial stability, and paving the way for securitisation to further contribute to the real economy."[23]

Indeed, the two academics went on to say:

> "… we believe that further macroprudential measures, both for the primary lending market and the secondary securitisation market, should be introduced to guard against the threats that securitisation activities could pose to financial stability in the UK."[24]

A riposte to the academics might be found in the Finance & Leasing Association's answer to HM Treasury's question 12, How could the Sec Reg do more to address the risks that securitisation activity in the UK poses to financial stability?:

> "No UK securitisations defaulted during the GFC. We are therefore concerned by the tone of this question."[25]

The regulatory burden imposed by the Securitisation Regulation transparency requirements

The Report

HM Treasury said:

> "A range of respondents acknowledged the benefits that the Sec Reg has brought to the functioning of the UK securitisation market, many of which were explicit goals of the Sec Reg. Respondents shared that it has so far:
>
> - Improved the transparency of securitisations; …"[26]

That phrasing suggests a generally held view that is supportive of the Securitisation Regulation transparency requirements.

The evidence

The author counted 11 responses that addressed Securitisation Regulation transparency requirements, nine of which were negative.[27]

By way of illustration, AFME/UK Finance said:

> [The Securitisation Regulation diligence and disclosure rules] "… have not in fact created meaningful market safety, nor have they done much to develop the market or increase financing of the real economy at a scale that reflects the potential of the product."[28]

Also by way of illustration, PCS, a non-profit organisation that, among other things, provides STS verifications, said in that context:

> "… the extensive and prescriptive disclosure requirements for originators and due diligence requirements for investors generate costs in time and money that are unique to securitisation as an asset class."[29]

PCS also listed, among the four main impediments to growth of the securitisation market:

> "Excessively prescriptive and detailed disclosure rules, especially for private transactions; …"[30]

Positive comments on the Securitisation Regulation's transparency requirements were given by Standard Chartered Bank and M&G, although M&G's positive words were limited and heavily qualified:

> "It has helped promote transparency by requiring all documents to be shared with investors and managers. It has however introduced a significant level of friction to the purchase process reducing investors ability to take part. It is our view that the Securitisation Regulation as a whole is much more onerous to both issuers and investors as compared with other forms of finance. We observe the on-going shrinking of the UK RMBS market being a direct consequence of this for instance—many issuers no longer access the market or only sporadically and the number of inactive issuers continues to grow."[31]

Capital and liquidity treatment of securitisation exposures

The Report

HM Treasury said:

> "7 respondents provided views on the capital and liquidity treatment of securitisation."[32]

and:

[23] Two academics at the University of Southampton (names redacted), Response to HM Treasury Review of Securitisation Regulation (undated), p.1.
[24] Two academics at the University of Southampton (names redacted), Response to HM Treasury Review of Securitisation Regulation (undated), p.1.
[25] Finance & Leasing Association, Submission, HM Treasury Call for Evidence: Review of the Securitisation Regulation (undated), p.3.
[26] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.2.8.
[27] Association of British Insurers, Barclays Bank, IACPM, Insight Investment, LMA, PGGM, PCS, AFME/UK Finance and the author.
[28] AFME/UK Finance, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.13.
[29] PCS, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.6.
[30] PCS, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.7.
[31] M&G, Letter on Review of the Securitisation Regulation: Call for evidence (2 September 2021), p.2.
[32] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.11.3.

"2 respondents suggested reviewing Solvency II methodologies".[33]

The evidence

The author also counted seven responses providing views on the capital and/or liquidity treatment of securitisation.[34] In addition, the Alternative Credit Council and the Alternative Investment Management Association jointly proposed that CLOs (actively managed corporate loan securitisations) be eligible for STS treatment, which would result in more favourable capital and liquidity treatment. The author counted five (not two) respondents who expressly addressed the need to revisit Solvency II treatment for insurance company investors, as being too onerous.[35]

Was the HM Treasury's Report "economical with the actualité"?

The brief review of the three issues considered above showed HM Treasury to be at best careless and at worst misleading in its Report on the responses on two of these issues. As seen above, HM Treasury's counting of the views—yeas and nays—was incorrect. Observations such as "Both favourable and less favourable views were shared, and respondents didn't unanimously agree on the Sec Reg's impact since its introduction"[36] are vague and misleading on the face of the evidence. On the third issue, the Report carelessly noted, "The respondents unanimously agreed that less stringent capital and liquidity treatment would support the functioning of securitisation markets"[37] (only seven responses addressed the point, albeit unanimously).

This carelessness was exacerbated by HM Treasury according, on the face of the Report, equal weight to each of the 21 responses, including the two joint responses.

The AFME/UK Finance joint 36-page response was supplemented by an 88-page Appendix containing detailed explanations and evidence. It would not be unfair to say that the AFME/UK Finance joint response reflects a considered securitisation industry view. The University of Southampton academics' response was five pages long with a bibliography of six items, three of which were articles by academics from the University of Southampton. So the response from the University of Southampton (two academics) counted the same as the joint response from AFME and UK Finance (more than 170 AFME members and approximately 300 UK Finance members, most being institutions or associations of institutions). The two responses are not made of the same dust.

Similarly, the author's response, submitted in his own name, was counted by HM Treasury the same as each of the responses by the IACPM, which counts more than 135 institutional members,[38] and the LMA, which counts more than 800 members.[39]

Perhaps the most inaccurate and misleading statement in the entire Report was HM Treasury's statement cited above that, whilst there were suggestions for reform, "… the vast majority of respondents conveyed their general support for the Sec Reg".[40] One might fairly ask whether HM Treasury channelled the late Alan Clark, who famously advised Matrix Churchill to be "economical with the actualité" (in emphasising the peaceful use of machine tool exports to Iraq).[41]

Worse yet

HM Treasury made their deeply flawed summary of key evidence worse by their bland, general conclusion regarding the regulatory framework established by Securitisation Regulation:

"… HM Treasury assesses that the Sec Reg remains an important element to the functioning regulation of securitisation in the UK. We remain committed to the ongoing and effective implementation of the Sec Reg and welcome industry support and engagement in this endeavour."[42]

As to disclosure, HM Treasury concluded:

"HM Treasury recognises that work is needed on the disclosure requirements, especially to assess the distinction between different types of securitisations (i.e. whether they are public or private), and to consider whether the disclosure requirements for certain private securitisations are appropriate."[43]

Regarding the capital and liquidity treatment of securitisation exposures, HM Treasury said:

"… HM Treasury does not currently see sufficient evidence to support significant changes to the capital treatment of securitisation, which is consistent with the Basel standards."[44]

[33] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.11.8.
[34] Association of British Insurers, Barclays Bank, the Commercial Real Estate Finance Council Europe, the LMA, PCS, AFME/UK Finance and the author.
[35] Association of British Insurers, Barclays Bank, the LMA, PCS and AFME/UK Finance.
[36] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.2.5.
[37] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.11.4.
[38] International Association of Credit Portfolio Managers, Current Members, *http://iacpm.org/about/current-members/* [Accessed 12 October 2022].
[39] Loan Market Association, List of Members, *https://www.lma.eu.com/membership/list-members* [Accessed 12 October 2022].
[40] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.2.6.
[41] Christopher Elliott, "Matrix Churchill men want legal back-up at enquiry", *The Times*, 17 March 1993, p.7.
[42] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.2.51.
[43] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), p.3.
[44] HM Treasury, "Review of the Securitisation Regulation: Report and call for evidence response" (December 2021), para.11.13.

HM Treasury's conclusions betray a failure to understand what securitisation is and how the securitisation market operates. Still worse, their conclusions demonstrate an unwillingness to address the key evidence:

- the superb credit record of European securitisation during the GFC; and
- in the LMA's words, "… the [regulatory] barriers to entry into the securitisation market for both investors and issuers are enormous".[45]

This evidence points to a substantial body of regulation that is artificially diverting investment – quite possibly hundreds of billions of pounds – from a sound credit.

The large-scale artificially diverted credit investment will go somewhere else. The important questions that HM Treasury failed to address include:

- 1. What effect has this large-scale diversion of credit investment had on the pricing of credit?
- What kinds of market distortions have arisen as a result of this large-scale diversion of credit?
- What do HM Treasury think happens when credit is mis-priced and the credit markets are distorted?

A corrigendum to the Report, with an addendum making HM Treasury's conclusions consistent with the evidence and addressing the questions above, is urgent and overdue.

Doubling down

On 9 December 2022, one year after publication of the Report, HM Treasury published a Policy Note[46] in relation to securitisation and the Financial Services and Markets (FSM) Bill,[47] together with a draft statutory instrument.[48] The FSM Bill will repeal retained EU law on financial services, to be replaced with rules made by financial services regulators under the Financial Services and Markets Act 2000.

The few changes to the current requirements of the Securitisation Regulation contemplated by HM Treasury, such as empowering regulators to allow 'resecuritisation' on a case by case basis, do not depart substantially from the current regulatory framework. Indeed, HM Treasury said in the Policy Note:

> "...in its report on the Sec Reg review, HM Treasury concluded that the requirements in the Sec Reg overall remain an important element of the regulation of securitisation in the UK. Therefore, the majority of these requirements are expected to be maintained in FCA and PRA rules, as appropriate."[49]

Thus, even with the further opportunity presented by the FSM Bill to revisit the current securitisation regulatory framework, HM Treasury continue to advance a fundamentally flawed regulatory scheme, justified by an inaccurate and misleading representation of key evidence received from the market.

One expects better from HM Treasury, especially in a Report to Parliament.

[45] LMA, Letter on Review of the Securitisation Regulation: Call for Evidence (1 September 2021), p.3.
[46] HM Treasury, "The Securitisation Regulation—Illustrative Statutory Instrument: Policy Note" (December 2022).
[47] HL Bill 80 (as brought from the Commons).
[48] The Securitisation Regulations 2023.
[49] HM Treasury, "The Securitisation Regulation—Illustrative Statutory Instrument: Policy Note" (December 2022), para.2.18.