UK Securitization Reform Opts For Modest Approach, For Now

By **Alix Prentice and Assia Damianova** (September 1, 2023)

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Since leaving the European Union on Jan. 31, 2020, the U.K. has been in a position to choose whether or not to mirror future EU rules and regulations and when to adopt new domestic requirements.

The U.K government had hoped to reach a comprehensive set of mutual decisions on equivalence between the U.K. and the EU, but that has not happened. In the absence of equivalence decisions from the EU, the U.K. is focusing on balancing the sometimes-competing imperatives of maintaining and bolstering international competitiveness.

This focus involves adopting changes to law and regulation — including that onshored from the EU post-Brexit — where it makes sense for the domestic market, and not deviating from convergence with the EU and other jurisdictions in a way that is prohibitively costly for market participants, both in terms of financial cost and opportunity.

The government published a policy statement headed "Building a smarter financial services framework for the U.K." in December 2022,[1] following on from the "Future Regulatory Framework Review: Proposals for Reform," updated a few months earlier, to determine how the U.K. financial services regulatory framework should adapt post-Brexit[2].

Securitization reform is part of the vanguard of this so-called smarter financial services framework, and is part of a much bigger packet of policy measures.

These measures are intended to bring forward reforms identified in HM Treasury's 2021 "Review of the Securitization Regulation"[3] and are being made under the architecture of a draft statutory instrument that itself will be made under the newly enacted and revised Financial Services and Markets Act 2023.

As such, these reforms are a test case not only for the U.K.'s flexing of its independent rule-making powers, but also for the powers that the new act gives to the regulators.

Targeted Adjustments

The aim of this article is to assess how recent consultation papers from the U.K. Prudential Regulation Authority and the U.K. Financial Conduct Authority deal with new securitization rules proposed to replace retained EU law requirements currently set out in the provisions of the Financial Services and Markets Act 2000 (Securitization) Regulations 2018; the Risk Retention Technical Standards; and the Disclosure Technical Standards.

The PRA consultation paper, published on July 27, and the FCA consultation paper, published on Aug. 7, are to be read together, with the near-final statutory instrument for the new securitization regulations to repeal the U.K. Securitization Regulation. This includes all related statutory instruments and technical standards, or near

final statutory instruments, which bring in a layer of complexity due to the three overlapping sets of rules.

While the consultation papers mainly both restate retained EU law and preserve current requirements when retained EU law is transferred to the PRA Rulebook and the FCA Handbook, there are some targeted adjustments being proposed.

Scope of the PRA and FCA rules

The PRA consultation paper applies to PRA-authorized persons established in the U.K. — including insurers, qualifying parent undertakings and financial institutions that are subsidiaries of these firms. It does not apply to non-U.K. firms with U.K. branches.

Under the Financial Services and Markets Act, a new designated activities regime gives the FCA powers to make rules covering designated activities carried out by authorized and unauthorized firms.

The near final statutory instruments specify that acting as an originator, sponsor, original lender or securitization special purpose entity is a designated activity within the scope of the designated activities regime, regardless of whether the activity is being carried on by an authorized firm.

Due-Diligence Requirements for Institutional Investors

The U.K. regulators are proposing a more principles-based and proportionate approach when replacing the requirements for verification by institutional investors of disclosures by both U.K. and non-U.K. manufacturers.

This will be achieved by requiring investors to verify that manufacturers have made sufficient information available to enable assessment of the risks, and by requiring that information to include at least certain types of information at certain times but without the level of detail currently included in the retained EU legislation.

Note that, regardless of the new scope of obligations on institutional investors to verify the information set out below, the obligations of originators, sponsors and securitization special purpose entities to make certain prescribed disclosures remain as before.

Delegation of Due Diligence

The U.K. regulators propose a useful clarification of the enforcement position of a managing party delegate for failure to fulfill delegated due diligence obligations. Provided that the managing party is subject to equivalent due diligence rules, the delegating party will not be responsible for a failure to comply with those obligations.

Nonperforming Exposures

The U.K. regulators are proposing to allow the calculation of the risk retention requirements in the U.K. Securitization Regulation for nonperforming exposures to be assessed at their net value — the nonrefundable purchase price discount.

This will align the U.K. rules with the EU approach under the capital markets recovery package,[6] which, among other things, includes measures removing some of the practical hurdles to securitizing portfolios of nonperforming exposures, and in the calculation for the

retention requirement permitted calculation of the net value of the assets after taking into account any nonrefundable purchase price discount.

Making Information Available Before Pricing

U.K. regulators are proposing to clarify the requirement in U.K. Securitization Regulation Article 7(1) for manufacturers to make certain information available before pricing, to align it with the requirement in Article 22(5) for the information for simple transparent and standardized securitizations to be made available before pricing at least in draft or initial form, with final documentation available to investors no later than 15 days after closing.

Resecuritizations

The current position under Article 8(2) of the Securitization Regulation allows the PRA power to give permission to manufacture resecuritizations when this can be said to be for a legitimate purpose including:

- Facilitating winding-up of a regulated firm;
- Ensuring the viability as a going concern of a regulated firm; and
- Preservation of investors' interests when the underlying exposures are nonperforming.

The U.K. government intends to use Section 34 of the Financial Services and Markets Act to switch on a new power for the PRA under Section 138BA of the act to disapply or modify its rules.

The PRA consultation paper therefore appends a proposed statement of practice on the PRA's approach to using this power in relation to resecuritizations, which is broadly in line with its current remit. The FCA takes a similar approach but does not offer a policy statement similar to that of the PRA.

The impact of any potential discrepancy here would be felt if a permission from both U.K. regulators is needed.

Synthetic Securitizations

By contrast with the EU, at this time the U.K. regulators have not signaled any particular intention to introduce an equivalent simple transparent and standardized framework for on-balance-sheet synthetic securitizations, so it appears that this will remain solely a feature of the EU regime in the near term.

Risk Retention

In the EU, the final draft regulatory technical standards specify the requirements for originators, sponsors and original lenders in relation to risk retention and on July 7,

the European Commission adopted the final text of the risk retention standards.

The U.K. regulators' broad approval of the standards and the current retention rules suggests that the risk retention standards adopted in the U.K. at the near future will not contain any material differences.

Geographical Scope

The FCA proposes to limit expressly the application of the FCA rules to entities, including manufacturers, established in the U.K., apart from the definition of institutional investors because its scope is set out in the near final statutory instrument.

Established will mean constituted under U.K. law with a head office, or, if it has one, a registered office in the U.K.

Disclosure Templates and Transparency Requirements

Disclosure and reporting requirements are a cornerstone of both the EU and U.K. securitization frameworks involving considerable compliance burdens. The question for the U.K. is therefore whether there are opportunities in divergence to alleviate some of that compliance burden.

While the EU and U.K. template-based reporting requirements are, for now, sufficiently similar to satisfy the Article 5(1)(f) obligation when investing in an EU transaction, this will be tested when either jurisdiction makes any material amendments to its respective reporting requirements or templates.

With that in mind, the U.K. regulators have flagged that they will be working to review and consult on changes in the disclosure requirements. Two potential areas for review have been identified.

First, to be considered as public, the U.K. Securitization Regulation requires securitizations to be listed on a U.K. regulated market. However, a number of U.K. securitizations have sought admission to regulated markets elsewhere — mostly in the EU.

Further, some U.K. securitizations with characteristics akin to public transactions are not captured by the definition because they are listed on nonregulated markets, such as Euronext's Global Exchange Market, which is a multilateral trading facility in Ireland, and continue to be largely listed there.

Second, current reporting requirements, especially for private transactions, may not always be proportionate, and the information reported is not always useful to investors. This is partly because the legal definition of a securitization is broad and includes transactions that go beyond well understood securitization transactions, such as traditional residential mortgage-backed securities.

The FCA consultation paper is proposing to expand the current description of public securitizations to cover securitizations that are public in substance, i.e., what the market would recognize as a publicly distributed and traded transaction:

- The public securitization description would cover securitizations that are subject to primary listings, i.e., listings a manufacturer has requested, on U.K. regulated markets or appropriate equivalent non-U.K. venues. This would only apply to U.K.

securitizations where the originator, sponsor or securitization special purpose entity is located in the U.K.

- The public securitization description would cover primary admissions to trading on an appropriate U.K. multilateral trading facility and similar non-U.K. venues where there is at least one U.K. manufacturer.

- The public securitization description would also include securitizations where there is at least one U.K. manufacturer and where a public announcement or other general communication is made to a wide audience of potential investors, intended to solicit orders or expressions of interest as part of the primary marketing of the securitization.

The U.K. regulators are considering whether the disclosure templates for private securitizations could be made more proportionate or principles-based, while still supporting the provision of sufficient information to investors and the FCA will look to consult on proposals to amend the disclosure templates in a later consultation.

Conclusion

While the U.K. is no longer part of the EU, it did exercise significant influence on the Single Rulebook developments to harmonize European banking supervision law at regulatory level.[7]

This legacy may last for some time in the EU regulatory framework. In the short term, the loosening of financial services regulation may be dictated by a search for immediate competitiveness without substantive divergence, hence the relatively modest adjustments proposed for the new Securitization Regulations.

In the medium to long term, further divergence is to be expected, considering the powers that regulators and supervisors are mandated to assume in the EU and the U.K. and their different regulatory and supervisory models and agendas.

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[1] https://www.gov.uk/government/publications/building-a-smarter-financial-services-framework-for-the-uk.

[2] The FRF is being delivered through the Financial Services and Markets Bill and will,

amongst other measures, repeal retained EU law and replace it with a new framework tailored for the UK.

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040038/Securitisation_Regulation_Review.pdf.

[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2023/july/securitisation.

[5] https://www.fca.org.uk/publication/consultation/cp23-17.pdf.

[6] https://www.consilium.europa.eu/en/press/press-releases/2021/02/15/capital-markets-recovery-package-council-adopts-first-set-of-measures-to-help-companies-access-funding/

[7] https://www.eba.europa.eu/regulation-and-policy/single-rulebook.