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UK securitization's golden chance

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The UK's new regulatory freedom is, in theory, an opportunity to remove onerous regulations, but divergence from the European Union will bring complications for some deals, and it's not clear whether the government is set to rewrite the rule book in favour of market development

In the 21 months since Brexit, the two once-similar securitization regulations in the EU and UK have begun to diverge. For the UK, this split away could in theory offer the chance to forge a securitization legislation that fits the needs of the country.

In essence, there is no such thing yet as a purely British securitization regulation, according to Merryn Craske, partner at law firm Morgan Lewis. “EU regulations that were in place before the end of the Brexit transition period were adopted as part of UK law and were then amended by way of UK regulations,” she says.

Effectively, EU securitization regulation simply became UK law at 11pm on December 31, 2020 as the UK left the bloc — initially just with some small modifications to the wording. References to the European Securities and Markets Authority (Esma) and the European Banking Authority (EBA) were replaced by the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). It was in effect a find-and-replace “EU” with “UK”.

Since then, however, not all changes have been cosmetic, with two sides each refining and redefining the regulation for their own needs.

“We now have a separate securitization regime in the UK, which is similar to, but not the same as, the EU regime, and the regimes are likely to diverge further,” says Craske.

For instance, the EU and UK have already drifted apart in how they treat deals that comply with the Simple, Transparent and Standardised (STS) quality hallmark introduced by the EU in January 2019, with the EU introducing regulation distinct from the UK in an effort to stimulate the post-Covid recovery.

On one hand, this divergence offers the UK an opportunity “to think about whether the rules put in place under the securitization regulation work and to consider a more practical approach,” says Craske.

Yet for many deals both EU and UK securitization regulations will continue to be relevant. Therefore, as the two regimes continue to move further apart, “it may become harder to comply with both sets of requirements”, says Craske.

For issuers, two divergent regimes can “make issuance more burdensome, complicated, and expensive,” says Cas Bonsema, senior ABS and covered bond analyst at Rabobank, especially if a deal straddles both.

“The UK is more flexible, while the EU is relatively structured,” Bonsema adds. “For UK investors and issuers, this flexibility is nice as it gives a bit more leeway. But on the other hand, this causes further divergence from the EU — it’s a double-edged sword.”

Simple, transparent, and separating

Although the UK has grandfathered EU STS deals until at least the end of 2022, with talk of a further two-year extension, the EU has not extended the same benefit to deals originated in the UK.

“Under the EU regime, the originator, sponsor and SPV must be incorporated in the EU to get the STS label,” says Bonsema. “But under the UK rules, only the originator and sponsor must be based in the UK, while the SPV can be located somewhere else, like Ireland.”

This “flexibility” of location, and the grandfathering of EU STS deals as UK paper under the UK regime, means that a UK investor can continue to get the same preferential regulatory capital treatment for EU STS securitizations. Craske at Morgan Lewis says that the expectation is that “eventually”, there “will be an STS equivalence regime in the UK”.

This is not something extended by the EU to European investors in UK STS deals. Bonsema believes that, although an equivalence agreement in the EU is not off the table, the prospect of the EU pushing for one is unlikely, especially given the frameworks have already diverged on several points.

“There is a high bar needed for equivalence,” he says.

As the UK’s investor base is predominately domestic, there is less of an incentive for the EU to bring in equivalence with the UK, he adds, noting that European bank treasuries are not that active in the UK market. But the investor base for European ABS is already shallow and it is a consistent problem for the market. Any moves that would make it thinner are unlikely to please anyone.

While the UK's STS regime has remained near enough the same since the end of 2020, the EU has moved its programme forward, opening the format to allow synthetic deals and ease the securitization of non-performing exposures as part of its Covid recovery plan.

"Originally it was not possible for synthetic securitizations to be STS," says Craske. "Now this is possible under the EU regime, but this was brought in after the end of the Brexit transition period and so it doesn't apply in the UK. The UK regulators aren't looking to bring this in at this point."

As the two STS regimes forge separate paths, Bonsema doubts that the pair will reconverge anytime soon.

"The EU will not want to budge on topics and will look to do whatever is best for the European market," says the Rabobank analyst. "In my opinion, part of the point of the EU STS and securitization regulation was also to set a gold standard, making the barrier high to grant equivalence to a framework that diverges too much from the EU version."

Opportunity knocks

There is hope that the UK could use the break from Europe to reform and refine its securitization legislation into something that best suits the needs of UK originators and their investors.

During this summer's Conservative Party leadership contest, candidates Liz Truss and Rishi Sunak made repeated promises to slash financial regulation and unleash a wave of post-Brexit investment into the country.

"One of the objectives of the Securitization Regulation was to revitalise the securitization market, in recognition of the important role that securitization can play in the financial markets and the economy," said Craske.

The EU's Securitization Regulation, which created the framework for STS, came into force in January 2019, with the UK transposing it into law at the end of the Brexit withdrawal period two years later.

"However, securitization is not achieving its potential in the UK and Europe and the question is whether the regulations as a whole are too onerous and difficult to comply with," Craske adds.

If new prime minister Liz Truss makes good on her promise to slash regulation, UK Solvency II legislation could be on the chopping block — and there is a belief that changes to this regulation could raise the appeal of investing in ABS for insurers, fuelling its growth as an asset class. UK MP and Brexit opportunities minister Jacob Rees-Mogg claimed in late July that these reforms could unleash £65bn of investment in the UK.

Former UK chancellor Nadhim Zahawi kickstarted the first wave of major post-Brexit reform by introducing the Financial Services and Markets Bill to Parliament earlier this year. This is expected to start the unravelling of decades of European legislation — almost two years after the UK left the EU.

The UK is already conducting a review of its securitization legislation as originally designed by the EU, having published a response to the market's views late last year. This response "was quite measured, with the emphasis on considering areas that might be revisited and clarified," says Craske.

"However, the government is certainly focused at the moment on reviewing retained EU laws and considering whether they work for the UK," she adds.

But the changes are yet to arrive. Just under three months after the UK left the EU, the country was plunged into its first pandemic-era lockdown. War in Europe, a change in government and a free-falling pound have since further drawn the Treasury's attention away from reforming the UK's securitization regime.

Even without those obstacles, there is still great uncertainty as to where the UK government is heading. Liz Truss's honeymoon period is well and truly over following the mini-budget on September 23 and faces the prospect of a general election by the end of 2024. With the opposition Labour Party 17 points ahead in the polls as of September 2022, the Conservative party's chances of re-election are already looking slim.

And there is hardly optimism for a radical post-Brexit overhaul. "In reality, there may still be some caution because of concerns that arose as a result of the [2008] financial crisis," says Craske.

Despite these concerns, the securitization industry in both Europe and the UK has performed well. But Brexit has provided the UK with a "real opportunity" to take a close look at "what is working relatively well and what is unduly restrictive or conservative", Craske adds.

The UK has the chance refine the gold standard of securitization legislation that the EU had drawn up. Whether it gets round to it is a different matter.

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