BREXIT: LOSING OUR PASSPORT

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The recent vote in the United Kingdom to leave the European Union has raised a number of contingency planning issues for UK-based financial institutions. The exact terms of the deal negotiated between the EU and the UK will be vital to understanding what financial institutions will need to do to prepare for Brexit (by which we mean the UK leaving the EU and moving to a new relationship with the trading bloc). There is therefore still a great deal of uncertainty about which regulations and restrictions UK-based finance institutions will need to cope with after Brexit.

This note aims to look at a worst case scenario, by asking the question: How will your business or your client's businesses be affected if the UK loses all passporting rights to sell services into the EU? This situation would only occur if the UK did not move to an EEA model and instead chose some form of hard Brexit.

Passporting is the exercise of the right available to a firm authorised under one of the EU Single Market directives to carry on activities in another EEA Member State, on the basis of its home state authorisation. The advantage of the current system is that it enables financial institutions to do business across the EU without having to consider whether they need to be licensed in one or more Member States whenever they undertake a cross border transaction. For example, a bank authorised in the UK can use its passporting rights under the CRD IV Directive (*2013/36/EU*) to carry out various banking activities, including lending, in other Member States, without needing to obtain additional licences in those Member States.

While the worst case scenario may not actually occur, asking the question allows financial institutions to better understand the risks they face and how to start guarding against those risks. It is obvious that not all areas of financial activity would be equally affected by a loss of passporting rights. There are some risks that affect all areas. For example, it is possible that travel between the UK and the EU countries may be affected. Will the simple act of going to see clients in continental Europe for face to face meetings be deemed to be an activity that requires licensing in particular Member States? However many of the issues will be specific to individual transactions and specific sectors or practice areas. For certain types of cross border transactions passporting rights may be entirely unimportant. This note aims to identify some of the high and low risk areas.

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Securitisation

UK securitisations are currently subject to the regulatory framework imposed on EU securitisations by the CRR (many of the requirements of which are set to be revised and adopted by the EU's proposed Securitisation Regulation (STS Regulation)). After Brexit, to what extent are UK securitisations likely to qualify as STS securitisations (and eligible for the favourable regulatory capital treatment corresponding to that standard)?

On 30 September 2015, the European Commission published a proposed regulation (the STS Regulation) relating to a European framework for simple, transparent and standardised securitisation as part of wider changes to establish a "Capital Markets Union" in Europe. The Presidency of the Council of Ministers of the European Union has published compromise proposals. In addition, in June 2016, the Rapporteur of the Committee on Economic and Monetary Affairs published a draft report (ECON Report) containing proposed amendments to the proposed STS Regulation.

The overall aim of the STS Regulation is to revive the securitisation markets by addressing the risks in complex and risky securitisations - differentiating those securitisations which are deemed to be "simple, transparent and standardised". The intention is that securitisations which meet the criteria for "simple, transparent and standardised" securitisations will be given a favourable regulatory capital treatment.

One issue that will need to be considered is whether UK securitisations will be able to satisfy the criteria for "simple, transparent and standardised" securitisations after Brexit. The original legislative proposals do not appear to contain any requirements relating to an EU connection, although the ECON Report does. In particular, the ECON Report contains a proposed amendment which would require the originator, sponsor and SPV involved in a "simple, transparent and standardised" securitisation to be established in the EU. Ultimately, it appears that the outcome to this issue will depend on the final terms of the STS Regulation.

It should also be noted that the ECON Report contains additional proposed restrictions which, if adopted, could have a significant impact on UK securitisations following Brexit. These proposed restrictions would not only restrict the ability of a UK firm to be an eligible retainer for European risk retention purposes (by providing that the originator, sponsor or original lender in a securitisation will need to be a "regulated entity") but would also restrict the ability of a UK firm to be an investor in a European securitisation (by providing that only "institutional investors" (which term refers to specific types of EU regulated entities) will be able to invest in securitisations).

If UK securitisations do not fall within the scope of the STS Regulation, are we likely to see a UK equivalent regime, encompassing similar risk retention and investor due diligence requirements?

At this point, it is not clear whether the UK regulators will adopt an equivalent regime to the regime proposed by the STS Regulation.

Can we expect UK securitisation bonds to no longer qualify for use by banks (as investors) and issuers (of retained securitisations) seeking to access the ECB's monetary policy operations?

Brexit may result in UK securitisation bonds no longer meeting the criteria for eligible collateral for the purposes of the Eurosystem monetary policy operations. In particular, the criteria require the securitised assets to be originated by an originator incorporated in the EEA and the obligors of such securitised assets to be incorporated, or, if they are natural persons, resident in the EEA. The criteria also require the securitised assets to be acquired by the SPV under an agreement governed by the law of an EEA Member State. If UK securitisation bonds were no longer suitable for Eurosystem monetary policy operations this would make them a less attractive investment proposition for significant investors.

CLOs

Brexit is likely to result in the UK no longer being subject to (or able to benefit from) the EU Single Market directives (such as MiFID). As such, the regulation of UK collateral managers will come into sharp focus in the months and years ahead, particularly if passporting rights are lost. How might Brexit affect the ability of UK entities to act as collateral managers, and retention holders, in European CLOs (whether under the CRR or the proposed Securitisation Regulation)?

If the UK were no longer within the scope of the EU Single Market directives, notably the Markets in Financial Instruments Directive (MiFID), then it could potentially impact the ability of UK entities to act as collateral managers on European CLOs. This is because European CLO SPVs are generally established in Ireland or The Netherlands, and frequently have a UK collateral manager authorised as an "investment firm" under MiFID. Collateral managers will need to consider what authorisations would be required for non-EU collateral managers to continue to provide collateral management services to the CLO SPV post-Brexit.

Under the current rules, in the case of The Netherlands, a collateral manager needs to be authorised in The Netherlands under MiFID (or passported under MiFID if established in another EEA state). However, in the case of Ireland, if the collateral manager has no head or registered office or branch in Ireland, it would not generally need to be an authorised investment firm in order to provide collateral management services in Ireland.

Brexit may also have an impact on the ability of a UK collateral manager to act as a retention holder under the EU risk retention rules. The most significant EU risk retention requirements are contained in the Capital Requirements Regulation (CRR), which requires the "originator, sponsor or the original lender" of a securitisation to retain at least a 5% net economic interest in the securitisation. These rules are currently the subject of proposed amendments pursuant to the so-called "Securitisation Regulation" as part of wider changes to establish a "Capital Markets Union" in Europe.

Under the CRR, a "sponsor" must be an EU regulated bank (that is, a credit institution) or an "investment firm" as defined in the CRR. The CRR definition of "investment firm", in turn, refers to certain investment firms authorised under MiFID. If, following Brexit, the UK is no longer within the scope of MiFID, then it would appear that a UK collateral manager would not be able to act as a "sponsor" for the purposes of these rules. It may, therefore, be necessary to structure such CLOs with a mechanism that permits the collateral manager to switch to an "originator" structure. In addition, there may be further restrictions imposed on the entities that can act as the "originator, sponsor or original lender" under amendments proposed by the Securitisation Regulation. These provide that the originator, sponsor or original lender in a securitisation will need to be a "regulated entity". Although not explicitly stated, it appears that the intention is that the retention holder will need to be a specified type of EU regulated entity (such as a MiFID investment firm).

How may Brexit impact the ability of non-passported UK investors to participate in European CLOs?

Another proposal with potential impact under the amendments proposed by the Securitisation Regulation is that only "institutional investors" (which term refers to specific types of EU regulated entities) will be able to invest in securitisations under this EU regime. Again, if the amendments proposed by the Securitisation Regulation do indeed end up including such restrictions and a passporting regime is not agreed between the UK and the EU, then UK investors may not be able to invest in EU securitisations following Brexit. It is, however, to be noted that the Securitisation Regulation is still being developed in the EU legislative process.

Nick Shiren (Partner), Cadwalader, Wickersham & Taft LLP