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# BREXIT UPDATE: IMPLICATIONS FOR SECURITISATIONS

A Brexit milestone was reached on 31 January 2020, when the UK ceased to be a member of the EU on entry into force of the long-awaited Withdrawal Agreement. However, the immediate implications of this exit were minimised due to the transition period, under which the UK is treated as a member of the EU for most purposes until 31 December 2020. The end of the transition period therefore means the UK and the EU face another "no-deal" scenario unless a comprehensive trade deal is agreed before the end of 2020. With attention diverted by COVID-19, political progress on a UK-EU trade deal has been slow and, at time of writing, many are questioning whether a deal will be concluded by the end of the year.

In last year's annual publication, Testing the New Foundations, we included an article that looked at potential Brexit-related consequences on securitisation markets. We revisit these consequences below, including the impact of the dual UK-EU regulatory regime that would be created by a no-deal scenario at the end of the transition period.

### Key issues

- The UK ceased to be a member of the EU on 31 January 2020, though the transition period minimises the impact of departure until the end of 2020.
- No comprehensive deal on financial services regulation is expected and this will result in the creation of a dual UK-EU securitisation regulatory regime.
- The potential implications of this dual regime include confusion caused by the onshoring of EU law into UK law, regulatory divergence and consequences from the UK becoming a third country under EU law from 1 January 2021.

## The story so far

Last year's article summarised the key milestones from the referendum in June 2016 to the then-expected Brexit date of 31 October 2019. Since that time, a further (and final) extension to the Article 50 notice period was agreed by the UK and EU to 31 January 2020. Buoyed by his new majority in Parliament following December's general election, Prime Minister Boris Johnson reached agreement with the EU on a somewhat modified withdrawal deal, which was subsequently ratified by the Houses of Parliament. This led to the UK's departure from the EU at 11pm GMT on 31 January 2020, over three and half years after the referendum.

Under the terms of this withdrawal agreement between the UK and the EU (the "**Withdrawal Agreement**"), the transition (or implementation) period came into effect at the time the UK ceased to be a member of the EU and lasts until 31 December 2020. The terms of the Withdrawal Agreement were given effect in domestic law in the UK through the European Union

(Withdrawal Agreement) Act 2020 (the "**Withdrawal Agreement Act**"). Though the UK has not been a member of the EU since 31 January 2020, during the transition period the UK is treated under both UK and EU law as if it was still a member for most purposes (though not allowing the UK the voice or the vote in any of the EU institutions that it had as a Member State). This means that EU law continues to apply in the UK and, as such, there has been little in the way of legal change relevant to the securitisation markets during the transition period.

The Withdrawal Agreement only deals with the UK's departure from the EU and is silent on the future relationship between the UK and the EU. The short, nonbinding, Political Declaration that accompanied the Withdrawal Agreement set out in very broad terms the plans for the future relationship, but a full "trade deal" is required if the UK and the EU are to trade on anything other than WTO terms (or, as the Prime Minister prefers to put it, on the same basis as Australia) post-2020. The global COVID-19 pandemic has undoubtedly diverted the focus away from Brexit negotiations and preparations. At time of writing, both sides are reporting little progress in the negotiations, and the atmosphere of the talks between the two sides has been further impacted by the UK government's recent draft Internal Market Bill, which, if passed and brought into force, would place the UK in breach of the Withdrawal Agreement.

In this context, many political commentators are predicting that a full deal on trade and services is unlikely to be reached before the end of the transition period, particularly given that the practical deadline for a deal to be agreed is widely said to be the end of October rather than the end of the year – indeed, the Prime Minister has put the deadline even earlier, at 15 October, saying that the both parties should "move on" if there is no deal by that date. The consequence of this, a "no-trade-deal Brexit", would be essentially the same as the "no-deal Brexit" market participants have been planning for during the last few years.

It is important to note however that neither the UK nor the EU is currently seeking a special agreement on market access for financial services that would resemble anything like membership of the EU's single market. Therefore even if a free trade agreement is concluded by the end of the transition period, it is expected that the UK will be treated as a third country for the purposes of EU financial services regulation (and vice versa) from 1 January 2021.

## The UK's no-deal preparations

In last year's Brexit article we looked at the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**"), which provides the UK legal framework for Brexit and aims to ensure continuity in law in the UK following Brexit. The Withdrawal Act will be equally relevant at the end of the transition period, as will the vast number of statutory instruments ("**SIs**") which seek to correct the deficiencies arising from Brexit in the EU law that will be "onshored" into UK law by virtue of the Withdrawal Act. Several hundred of these correcting SIs have already been made, though the provisions amending retained EU law will only enter into force at end of transition period.

The most relevant SI to the securitisation market is the Securitisation (Amendment) (EU Exit) Regulations 2019 (the "**Securitisation SI**"), which amends the EU Securitisation Regulation as brought into UK law by the Withdrawal Act. As with the other SIs made under the Withdrawal Act, the

Securitisation SI is intended to correct deficiencies in the onshored Securitisation Regulation arising as a result of Brexit and the end of the transition period and not – in general – to create new policy positions. Amendments include replacing references to ESMA and the EBA with references to the FCA and PRA, respectively. The result is that the UK will have its own securitisation regime under the onshored version of the Securitisation Regulation (the "**UKSR**") which will be separate but virtually identical regime to the EU's Securitisation Regulation (the "**EUSR**").

Several issues with the Securitisation SI have been identified, which could create legal and operational uncertainties for market participants. Industry bodies, with the support of law firms including Clifford Chance, provided comments to HM Treasury, which drafted the Securitisation SI, but the concerns expressed seem so far not to have been reflected in any amendments to the proposed approach. Other issues are simply the result of the existence of a separate (if very similar) EU and UK securitisation regimes, to which the market would need to adjust. We consider these issues and implications further below.

## Implications of a dual securitisation regime

Absent other agreements between the UK and the EU, the entry into force of the UKSR at end of transition period would create a dual securitisation regime. The implications of this are discussed in detail in last year's Brexit article but an updated summary is set out below:

### 1) "Frozen" EU law

The Withdrawal Act onshores EU law that is legally binding at end of transition period and will not cover legislation which is published or planned but not yet applicable. This means that any of the level 2 rules made under the EUSR which are not applicable prior to 31 December 2020 would not be automatically onshored into UK law. At the time of writing, most of the significant level 2 measures under the EUSR have been made. Notably, the technical standards relating to disclosure, securitisation repositories and STS notifications were published on 3 September 2020. It seems unlikely, however, that the risk retention RTS will be applicable by 31 December 2020, meaning it would not be onshored and a significant piece of the EUSR regime would be missing from the UKSR regime. Though powers are given to UK authorities to make similar rules, they are not mandatory and there is no guarantee they would be exercised to make similar or identical rules. If any EU level 2 measures are not swiftly replicated in full in UK law, a divergence will develop between the EUSR and UKSR regimes.

Further, the onshoring under the Withdrawal Act does not cover level 3 measures, such as guidelines and Q&As from the supervisory authorities, as these are not legally binding. However, the PRA has indicated in its Statement of Policy on the Interpretation of EU Guidelines and Recommendations[1] that it expects firms to continue to make every effort to comply with the existing EU Guidelines and Recommendations set out in Appendices 1 to 3 of the Statement of Policy – including several sets of guidelines relating to securitisations – to the extent that they remain relevant after the end of the transition period. The PRA expects firms to interpret these in light of Brexit and relevant onshoring changes as well as any relevant transitional relief that may

[1] The PRA Statement of Policy is available at: https://www.bankofengland.co.uk/-/media/boe/files/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop-april-2019.pdf?la=en&hash=B3E75B199112645E67DA7DCC96BB12D68074F4AD

be available. Therefore, it will not always be straightforward to interpret these existing guidelines, which may lead to uncertainties or differences of interpretation. Further, the PRA will not expect firms to comply with EU guidelines that do not start to apply until after the end of the transition period, which could again lead to divergence between the EUSR and UKSR regimes.

**2) Onshoring confusion**

The task of onshoring thousands upon thousands of pages of EU law has, unsurprising, resulted in inconsistencies in how the various Brexit SIs refer to legislation. There are often several SIs that onshore (and amend) a particular piece of legislation and it is not always clear what version they're onshoring or amending. Similarly, the SIs will sometimes refer to the ongoing EU version of a piece of legislation, sometimes to the "frozen" version as it applies at the end of the transition period and sometimes to the continuing version as it applies in the UK. Despite efforts to correct these inconsistencies, it is likely that these problems will persist.

More of these issues have been created by the delay in onshoring from "exit day" to the end of the transition period (or "**IP completion day**"). This is because there are hundreds or thousands of references in onshoring SIs (drafted and made prior to exit day) to "exit day" and time periods defined by reference to "exit day". Many of these were appropriately amended by the Withdrawal Agreement Act which sets out[2] that any provision in an onshoring SI "which provides, by reference to exit day (however expressed), for all or part of that or any other subordinate legislation to come into force immediately before exit day, on exit day or at any time after exit day is to be read instead as providing for the subordinate legislation or (as the case may be) the part to come into force immediately before IP completion day, on IP completion day or (as the case may be) at the time concerned after IP completion day". The issue arises because many of the references to exit day in such SIs were not about subordinate legislation coming into force, and therefore were unaffected by the blanket amendment.

For example, the UKSR (as amended by the Securitisation SI) is currently expected to provide that EU STS securitisations can still be treated as STS in the UK for a period of two years following exit day. Because this provision isn't about when any particular bit of subordinate legislation comes into force, the reference to exit day is unaffected by the blanket change. Therefore, as it currently stands, the two years will begin to run (unhelpfully) from 31 January 2020 instead of 31 December 2020 – effectively eliminating 11 months' worth of the 2-year transitional measure. This is just one example out of hundreds of references to "exit day" that will need to be manually checked and adjusted where appropriate with further amending SIs. These amending SIs, however, tend to be omnibus instruments that amend many pieces of legislation at once, meaning the changes to a particular EU regulation might be scattered over several SIs, with no consolidated version of the final resulting regulation readily available.

**3) Geographic scope**

The EUSR contains a requirement for each of the originator, sponsor and issuer to be established within the EU in order for transactions to qualify as 'simple, transparent and standardised' ("**STS**"). The UKSR equivalent of this provision only requires that the originator or sponsor are established in the

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[2] Schedule 5, paragraph 1 of the Withdrawal Agreement Act.

UK, and does not mention issuers (or securitisation special purpose vehicles). In this regard, the STS regime under the UKSR would be more permissive than the regime under the EUSR.

**4) Risk retention on a consolidated basis**

Under both the EUSR and UKSR, retention is permitted on a consolidated basis within a financial group, meaning one group company can retain in relation to the securitised exposures of the whole financial group on a consolidated basis. This could become problematic for a group that spans the UK and the EU. For example, an EU originator that relies on a UK parent company holding the relevant exposures to fulfil its risk retention obligations would cease to be compliant under the EUSR following a no-deal Brexit. A no-trade-deal Brexit could, therefore, lead to existing transactions where risk retention is held on a consolidated basis ceasing to be compliant upon the UK's exit from the EU.

**5) Data repositories and STS**

The EUSR requires filings to be made to a data repository, authorised and regulated by ESMA, in respect of public securitisations (that is, ones requiring a Prospectus Regulation-compliant prospectus). Existing UK data repositories would cease to be authorised by ESMA upon a no-trade-deal Brexit, as the EUSR requires repositories to be located in the EU. Similarly under the UKSR, a separate authorisation regime would need to be developed for UK data repositories. Following a recent FCA announcement[3], it is expected that the FCA will be working towards authorising UK repositories in advance of the end of the transition period, with final authorisation taking effect on or soon after IP completion day.

A new list of UK STS notifications will need to be established under the UKSR as well. Indeed, the need for this raises the issue of whether UK STS deals (which will lose their EU STS status on IP completion day) will briefly cease to be STS anywhere until the FCA is set up to accept notifications of STS status. There are a number of ways this could be sensibly addressed, but it is not yet clear whether (and if so, how) it will be. By contrast, the transitional measures for EU STS transactions mean that they will continue seamlessly to be treated as STS in the UK until the end of the transitional relief provided for in the Securitisation SI.

**6) Licensing and passporting**

In the event of a no-trade-deal Brexit, EU-wide passporting permissions would no longer be available to entities conducting regulated activities across the UK-EU border. Such cross-border activities would therefore require careful analysis to determine the regulatory obstacles, required licences and applicable exemptions.

For EU entities seeking to conduct regulated activities in the UK, the UK has produced a temporary permissions regime ("**TPR**"), which would allow EU entities that currently rely on passporting rights to continue their activities in the UK for up to three years after the end of the transition period. The position is more complicated for UK entities seeking to provide financial services on a cross-border basis into the EU27. Without the benefit of passporting, firms will

[3] The FCA announcement is available at: https://www.gov.uk/government/publications/securitisation-repository-application-arrangements-under-the-uk-securitisation-regulation/securitisation-repository-registration-arrangements-under-the-uk-securitisation-regulation

need to carry out country-by-country and product-by-product analysis to assess whether they will be able to continue to carry on this business.

For most transactions, it will be for the affected counterparties to ensure business continuity and the ability to fulfil their obligations for the life of the transaction. To mitigate the risk of disruption, transaction documentation should include robust replacement language allowing the replacement of any counterparty whose ability to perform its role is adversely affected by Brexit.

**7) Risk retention for third country sponsors**

Prior to the application of the EUSR, sponsors were defined in the CRR as investment firms regulated under the Markets in Financial Instruments Directive 2014/65/EU ("**MiFID II**"). However, the definition of sponsors in the EUSR refers to investment firms "as defined in" MiFID II, which extends to any investment firm with no geographical limit. Market participants have sought clarification from the European Supervisory Authorities to confirm that this is intended to be interpreted as broadly as it appears on its face but, at time of writing, such clarification has not been provided.

It seems unlikely at this stage that clarification will be provided prior to IP completion day, and this could pose an issue for risk retaining UK sponsors following a no-trade-deal Brexit which will cease to be MiFID II regulated entities once the UK becomes a third country. On structures where a collateral manager fulfils the risk retention requirement as sponsor, there may not be another obvious MiFID II-regulated entity for such retention to be transferred to. This may require a switch to retaining as originator, but such switches carry their own risks which will need to be carefully considered.

**8) Ratings**

Credit rating agencies may be concerned about the potential impact of any counterparty issues on transactions (as discussed above in relation to licensing) and, in practice, we expect closer monitoring by agencies on complex cross-border securitisation structures in the event of a no-trade-deal Brexit.

**9) Listing and ECB eligibility**

If the UK ceases to be an EEA country, the Main Market of the London Stock Exchange ("**LSE**") will no longer qualify as an EEA regulated market and therefore it will cease to be an "acceptable market" in accordance with the ECB's eligibility criteria. To date, the ECB has given no indication of any special concessions or grandfathering arrangements with respect to the LSE's Main Market. However, on 1 April 2019, the LSE announced that, in order to continue to satisfy the ECB "acceptable markets" criterion following a no-deal Brexit, issuers of existing and new bonds listed on LSE's Main Market will be automatically admitted to MTS BondVision Europe without the need for the issuer to take any action, subject to the securities meeting the MTS admission criteria. MTS BondVision Europe is an "acceptable market" in the EU according to the ECB eligibility criteria.

This, however, is unlikely to preserve the ECB eligibility of securitisations listed on the LSE, as the ECB eligibility criteria require the obligors of the underlying assets to be in the EEA, any property collateralising those underlying assets to be located in the EEA and certain transaction parties to be established in the EEA as part of the eligibility criteria.

### 10) Prospectuses and passporting

Another consequence of the UK becoming a third country is the loss of passporting under the EU Prospectus Regulation ("**EU PR**"). The SI which onshores the EU PR provides that the UK FCA would continue to accept prospectuses (and any supplements) approved by EEA competent authorities prior to the end of the transition period for the remainder of the prospectuses' 12-month "life" and that it will also continue to accept EU IFRS. Conversely, neither the European Commission nor ESMA have yet given any equivalent assurances in relation to prospectuses approved by the UK FCA before the end of 2020. That said, the loss of passporting will have limited consequences for securitisation issuers in relation to prospectuses which fall within the public offer exemption under the EU PR for wholesale debt.

### 11) Documentary issues

Other issues arising from a no-trade-deal Brexit, which may require addressing in transaction documents, include:

- A contractual recognition of bail-in clause may be required to be included in certain contracts under Article 55 of the EU Bank Recovery and Resolution Directive or the UK's own bail-in regime.
- References to EEA investors in capital markets legending and selling restrictions will need to be adjusted to reflect the fact that the UK is a third country and no longer within the EEA.
- Consideration may need to be given to adapting jurisdiction clauses in contracts upon the accession by the UK to the Hague Convention following a no-trade-deal Brexit. Counterparties would need to consider whether to incorporate an exclusive jurisdiction clause in order to benefit from the Hague Convention or to retain the benefits of the flexibility offered by a more typical asymmetric jurisdiction clause.

### 12) Other practical implications

There are of course many other potential implications of Brexit and particularly a no-trade-deal Brexit. From 2021, the UK's designation as a third country under EU law could have an impact on withholding tax analysis and on regulatory capital requirements, which may require transaction-by-transaction analysis. Further, the securitisation market is subject to wider macro-economic effects, though such effects are unlikely to affect collateral performance of existing transactions beyond accepted thresholds unless conditions result in the sovereign or bank ratings downgrades. Any downgrade of the UK's sovereign credit rating would be a particular concern for covered bond transactions and other transactions with specific ties to the credit ratings of sovereigns or banks.

## Conclusion

With the possibility of a no-trade-deal Brexit looming, the uncertainties of Brexit persist despite the UK's formal withdrawal from the EU in January 2020. As such, market participants will need to continue both with their preparations and with their engagement and advocacy with regulators. These regulators, along with politicians, will ultimately determine how the creation of a dual regulatory regime across the EU and the UK will impact the securitisation markets beyond 2020. Brexit-related issues are far more likely to arise on cross-border deals, so the fact that the bulk of legacy transactions are functionally domestic (i.e. mainly connected to only one jurisdiction) will provide natural protection from many of the potential implications.

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