New Landscapes

Practical evaluations of new regulations impacting structured debt transactions

CLIFFORD CHANCE

Introduction

Market professionals consider that securitisation issuance in Europe in calendar year 2011 is likely to reach €100-€150 billion (excluding central bank liquidity trades). This is up from approximately €90 billion in 2010 and underlines a recovery in the securitisation market. However, at the peak of the market in 2006, issuance amounted to some €450 billion. Even allowing for some types of investors permanently leaving the market (for example leveraged buyers such as SIVs) it is questionable whether a market size of €150 billion is sufficient for securitisation to fill the funding gap for European banks seeking to fund real economy assets. In this context the impact of regulation creates a significant hurdle for both originators and investors to overcome and can be a material disincentive. Consequently understanding regulation and making it workable and appropriate is probably the most urgent task facing securitisation professionals in the new world of securitisation.

This latest publication in our series exploring the re-emerging securitisation market considers new regulations in Europe and the US that impact securitisation and issues that have emerged in the implementation of that regulation. We also include an opinion piece proposing a new schematic for regulating financial products that can fall within the current Basel II/CRD definition of securitisation. We hope our readers will find this publication interesting and thought-provoking.

Unfortunately we have not reached the end of new regulations affecting securitisation. The next wave of regulation will emerge from the broad macro-regulatory provisions of the Basel III/CRD IV proposals relating to bank regulation. Each of the four key proposed ratios – the regulatory capital ratios of the Tier 1 Capital Ratio and the Leverage Ratio and the liquidity ratios of the Liquidity Coverage Ratio and the Stable Net Funding Ratio - will affect securitisation to some extent. Both for originators and investors these effects may include some positive features as well as a number of negative features. Consequently, it is crucial that over the coming months these proposals are subject to consideration, consultation and hopefully amendment through constructive engagement with regulators by the securitisation industry. New regulation will be a way of life for securitisation for some time yet!

Kevin Ingram
On behalf of the
International Structured Debt Group
London, June 2011

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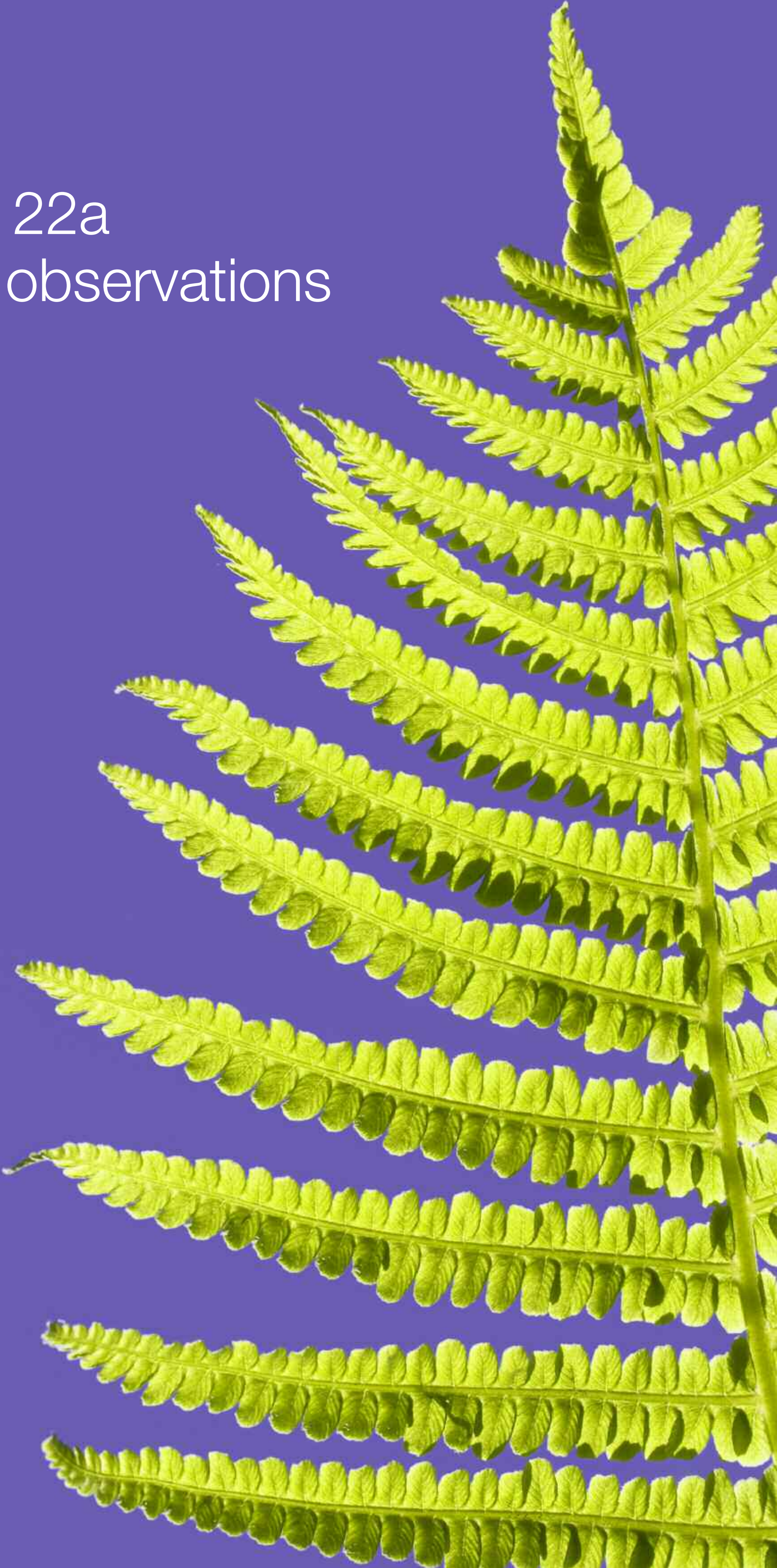
1. Article 122a – early observations



Article 122a has been in force with regard to new securitisations since the beginning of the year and, as predicted, despite there being limited obligations for originators included in the legislation it has been the originators who have had to ensure compliance in order to successfully attract investors. In our experience, notwithstanding initial teething problems, transactions are coming to market which reflect the new regulations although given the variety of approaches seen, it is too early to say there is a clear market standard.

Article 122a of the Capital Requirements Directive[1] ("CRD") contains requirements for the disclosure of a retention of a 5% exposure to the credit risk of the securitisation by the originator, sponsor or original lender. In addition there are due diligence requirements for those credit institutions investing in the notes. The aim of these measures, according to the EU Parliament, is to align the interests of originators and investors.

Investor credit institutions are required to be able to demonstrate a comprehensive understanding of, and to have formal policies and procedures for analysing and recording: (i) information disclosed by originators as to the interest they are to maintain; (ii) the risk characteristics of the securitisation positions and their underlying exposures; (iii) the prior performance of the originator or sponsor in securitising that asset class; (iv) statements by the originators as to their due diligence on the pool and any collateral; (v) methodologies by which the collateral is valued, and the policies of the originator to ensure the independence of the valuer; and (vi) the structural features of the securitisation which could impact the performance of the securitisation position it holds. Investors must also monitor performance of their securitisation positions as a whole, including the diversification, default rates and loan to value ratios of their entire portfolios.

There are no primary obligations on originators to actually retain the 5% exposure; it is left to investors to ensure that they do not invest in a securitisation unless the originator has made the required disclosures.

Guidelines

The Committee of European Banking Supervisors ("CEBS") (now the European Banking Authority ("EBA")) released guidelines (the "Guidelines") on the implementation of Article 122a in accordance with Paragraph 10 of Article 122a on 31 December 2010, with the intention of providing more detailed guidance on the practical implementation of the rules. Helpfully, the Guidelines provide certain clarifications in response to questions highlighted in consultation with industry over the course of 2010.

The Guidelines are not wholly prescriptive; CEBS recognised that given the range of assets and structures which exist in the European market, it would be difficult to provide detailed guidelines to cover every eventuality. CEBS indicated that it would be minded to recommend that the Commission allow market practice, rather than further detailed legislation, to dictate the manner by which this new legislation is implemented. It is also anticipated that the Guidelines will evolve over time and become an iterative set of guidelines.

Will investors be penalised for events outside their control?

A key concern of investors during the consultation phase arose from the imbalance in penalties for non-compliance with Article 122a; namely that investors are required to ensure that the originator, sponsor or original lender has disclosed that it will retain a 5% net economic interest and continues to do so for the life of the bonds but investors are penalised for investing in bonds where such retention requirements are not met. Importantly, CEBS has clarified that investors will not be penalised where originators are negligent in initial or ongoing compliance with the disclosed method of retention of a net economic interest.

Paragraphs 30 and 31 of the Guidelines are of interest and provide some comfort in this regard by explicitly stating that:

"the investing credit institution has still fulfilled its obligation should such originator, sponsor or original lender fail to act in the manner it disclosed (for instance, by not retaining such an interest, or due to unforeseen corporate actions and events, contrary to what it previously communicated) and the credit institution is not deemed to have been responsible for negligence or omission in the fulfilment of its due diligence obligations."

Whilst paragraph 31 goes on to clarify that the investor is not required to sell the securitisation position, it is still not clear how credit institutions intending to sell securities on the secondary market will deal with the fact that securities may be rendered illiquid by the negligence or failure of an originator to comply with the requirement to retain a net economic interest in the securitisation. Tellingly, paragraph 31 goes on to warn investors that reckless disregard of an originator's historic failure to comply with its disclosed retention undertaking may attract a sanction.

[1] Comprising Directive 2006/48/EC and Directive 2006/49/EC, which were amended by Directive 2009/111/EC (CRD 2).

Who is the originator?

The term "originator" is defined to include both the entity which originates the exposure to be securitised or an entity which purchases loans and then securitises them. A sponsor is required to be a credit institution which manages an asset-backed conduit programme or other securitisation scheme that purchases exposures from third party entities. Original lender is not defined but, with some exceptions, will commonly be the same entity as the originator. However, the Guidelines recognise that it is not always apparent if any entity within the securitisation fulfils the role of "original lender", "originator" or "sponsor". In such circumstances, the parties should consider whether the transaction is a "securitisation" for the purposes of the directive (as to which see our article "There's no business like whole business"[2] which argues that whole business securitisations should not be treated as securitisation transactions for the purposes of Article 122a). However, there are many securitisation transactions which fit squarely within the definition of "securitisation" where it is difficult or otherwise problematic to identify an originator, sponsor or original lender. In recognising this, CEBS has introduced an element of flexibility in the definition of originator in paragraph 26 of the Guidelines which are of particular interest for CLO and CMBS structures.

Essentially, the retention requirements can be met through a third party entity whose interests are "optimally" aligned with those of the investors. The non-exhaustive examples provided are an asset manager in a managed CLO type transaction or a subordinated lender in a securitisation where such investor was involved in structuring and selecting the exposures to be securitised (such as a B-lender in a CMBS transaction). As expressed in paragraph 26:

"the retention requirements can be met through a third party entity whose interests are "optimally" aligned with those of the investors"

"CEBS is aware that it is possible that such an entity could fulfil the retention requirement by means of an SPV that is established to act as "originator" (for instance, by purchasing the exposures to be securitised), with such an SPV consequently meeting the definition of the term "originator" under the Directive......where such arrangements are entered into, the primary consideration should be that retention is ultimately met by an entity with which alignment of interest is optimally achieved, and that this is not a mechanism for re-distributing the technically "retained" exposure to other investors."

The inclusion of this interpretation is to be welcomed but leaves residual difficulties; for CLO managers with limited balance sheets, there is the difficulty of funding the 5% held by the so-called originator SPV and for CMBS transactions, the originator SPV could only hold the most junior piece of the securitisation or comply with one of the other retention methods specified below. Unlike the specific CMBS retention provisions set out in US legislation, the retention requirement could not be met through holding the junior tranche of a loan where the senior loan is securitised, as the 5% net economic interest must relate to the securitised exposure, i.e. the senior loan, so this may lead to differences in structuring of the "B-piece" between US and European CMBS transactions.

Retention of net economic interest

The four prescribed methods for the originator, sponsor or original lender to retain a net economic interest pursuant to Article 122a are set out in the box below:

(a) retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors (in other words, a "vertical slice" of the securitisation);

(b) in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures (in other words, a *pari passu* share of the pool);

(c) retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination (this refers to the number of exposures in the pool from which the randomly selected exposures are drawn, not the number of exposures drawn from such pool); or

(d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5% of the nominal value of the securitised exposures.

[2] See page 7.

In every case, the retained interest must be kept for the life of the notes, and should not be hedged or subject to any other credit risk mitigation. The Guidelines make it clear that the primary consideration as to whether the retained interest is deemed to have been "subject to any credit risk mitigation" is whether alignment of interest is optimally achieved. A situation in which the entity which fits the definition of "originator, sponsor or original lender" (e.g. an intermediate SPV) is funded by, and has its credit risk assumed by, another entity which does not fit this definition should not be classified as being "subject to credit risk mitigation" in breach of Paragraph 1 of Article 122a, as this ultimately ensures the "alignment of interest" intention of Article 122a is fulfilled.

The Guidelines contain detailed guidance regarding each of the four retention methods and introduce some helpful flexibility in meeting the retention requirements.

Vertical slice

Whilst the vertical slice (method (a)) is often viewed as the simplest type of retention, namely a 5% holding in the notes of each class issued, the Guidelines have interpreted this method to include a **5% retention of each of the securitised exposures**, that is, the originator may choose to securitise 95% of each underlying loan provided that the credit risk retained with respect to such underlying assets always ranks *pari passu* with, or is subordinated to, the credit risk that has been securitised with respect to those assets. This additional route may be helpful in the context of balance sheet CLOs or CMBS transactions.

Pari passu share

The *pari passu* share (method (b)) is used where there are revolving exposures. This is likely to be the method used by credit card and residential mortgage master trusts but most master trusts are grandfathered at present.

On-balance sheet

It had been thought that method (c) would provide a simple way for an originator to ensure the 5% retention requirement is fulfilled as it is highly unlikely that most originators will securitise all eligible assets. However the Guidelines state that the randomly selected 5% of exposures must be a static pool, which has meant that this form of retention is not as flexible as originally expected. Administratively it is seen as being difficult for an originator to track the particular exposures which make up their 5% and clearly this reduces flexibility for treasury teams.

First-loss tranche

The first-loss tranche described in method (d) may be a subordinated note, a reserve account, an equity interest, a preference share interest or a deferred purchase price element. If the retention is by way of a reserve account it is important that this account is funded at the outset (and going forwards) to cover 5% of the exposures, and that it is capable of absorbing principal losses rather than being, for example, a liquidity reserve. In the current market, in which investors often buy only the highest rated tranches, originators have found it most convenient to retain 5% of exposures through subordinated notes. However, notwithstanding the fact that it is current market practice for originators to retain junior tranches of notes, care should be taken in sizing the relevant junior class as a commitment to retain the subordinated notes in circumstances in which the junior tranche is in excess of 5% of the transaction may be overly restrictive for the originator.

In addition the Guidelines state that, providing it complies with the other requirements, a letter of credit, guarantee or other similar credit support mechanism provided by the sponsor, originator or original lender may be a permissible form of retention. Overcollateralisation of the liabilities of a securitisation is also mentioned in the Guidelines as a method of retention comparable to the four methods set out in (a) to (d) in the box.

Loan-level data disclosure

Paragraph 7 of Article 122a requires sponsors and originators to give investors readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures. The Guidelines clarify that this will typically mean that "loan-level" data will be required, although in securitisations with a large number of highly granular exposures it may be appropriate to disclose data on a collective basis. However, the Guidelines are not prescriptive on an asset class basis. In practice it is likely to be the case that where, for example, mortgage loans are the securitised asset then the data will need to be loan-level, whereas collective data may suffice for a credit card receivables securitisation. However, there is a level of uncertainty for certain asset classes, particularly in those asset classes where no market standard loan level data template has been developed.

In deals in which loan-level data disclosure has been required the information has generally been made available via websites, on a quarterly basis or in line with interest payment dates, in order to fulfil the requirement for investing credit institutions to demonstrate their ongoing understanding of the exposures they have invested in. Historic data will be left available on such websites, to allow the investors to track any changes in the exposures that have occurred over time. The disclosure of loan-level data has given rise to practical and compliance issues for originating banks – see our article "Disclosure, transparency and the provision of data – where are we and what are the issues?" for more on this subject[3].

Article 122a in practice

In recent securitisations the disclosure requirements of Article 122a have been met through a prominent statement regarding the 5% retention together with a statement in the transaction summary (as required by the Bank of England pro forma transaction summary). Most transactions have also included a specific risk factor. Examples of each of these are provided below.

Extract from the transaction overview section of a prospectus:

"Retention of net economic interest

Pursuant to Article 122a of Directive 2006/48/EC (as amended by Directive 2009/111/EC) referred to as the CRD, the Seller will retain, on an ongoing basis, a net economic interest of at least 5% in the nominal value of the securitisation. Article 122a of the CRD became effective on 1 January 2011. Please refer to the Sections entitled "Article 122a of the Capital Requirements Directive" and "Regulatory Initiatives may result in increased regulatory capital requirements and/or decreased liquidity in respect of the Notes" for further information."

Prominent disclosure statement from a prospectus:

"Article 122a of the Capital Requirements Directive

Retention statement

The Seller will, on an ongoing basis, retain a material net economic interest of at least 5 per cent. in the securitisation in accordance with Article 122a of Directive 2006/48/EC (as amended by Directive 2009/111/EC), referred to as the Capital Requirements Directive. As at the Closing Date, such interest will comprise an interest in the first loss tranche within the meaning of Article 122a(1)(d). Such retention requirement will be satisfied on the Closing Date by the Seller holding the [*most junior class of*] Notes. The Seller will confirm its ongoing retention of the net economic interest described above in the Monthly Investor Reports and any change to the manner in which such interest is held will be notified to Noteholders. The Seller has provided a corresponding undertaking with respect to the interest to be retained by it to [*the Lead Managers in the Subscription Agreement / to the Trustee in the asset sale agreement*].

Investors to assess compliance

Each prospective investor that is required to comply with Article 122a (as implemented in each Member State of the European Economic Area) is required to independently assess and determine the sufficiency of the information described above and in this Prospectus generally for the purposes of complying with Article 122a and none of the Issuer, the Arranger, the Lead Managers or the Transaction Parties makes any representation that the information described above or in this Prospectus is sufficient in all circumstances for such purposes. Prospective investors who are uncertain as to the requirements under Article 122a which apply to them in respect of their relevant jurisdiction, should seek guidance from their regulator."

Risk factor from a prospectus:

"Regulatory initiatives may result in increased regulatory capital requirements and/or decreased liquidity in respect of the Notes

In Europe, the U.S. and elsewhere there is increased political and regulatory scrutiny of the asset-backed securities industry. This has resulted in a raft of measures for increased regulation which are currently at various stages of implementation and which may have an adverse impact on the regulatory capital charge to certain investors in securitisation exposures and may thereby affect the liquidity of asset-backed securities. Investors in the Notes are responsible for analysing their own regulatory position and none of the Issuer, the Lead Managers, the Arrangers or the Seller makes any representation to any prospective investor or purchaser of the Notes regarding the regulatory capital treatment of their investment on the Closing Date or at any time in the future."

[3] See page 23.

A relatively short and generalised risk factor has been used in some deals although we have seen a preference by some issuers for a lengthier version. In our view, a very detailed risk factor is inadvisable, as it could be seen to place too much emphasis on Article 122a over and above other regulatory regimes, such as the Solvency II Directive (Directive 2009/138/EC). Moreover, the key point is that investors should have regard to their own regulatory position; issuers should not be encouraged to advise investors on the level of compliance required.

With regard to disclosure of the 5% retention, the Guidelines have made it clear that it is not sufficient to simply disclose that the retention requirement has been met. It is also necessary to disclose the form the retention will take, the way it has been calculated and its equivalence of measurement to the most appropriate one of the four methods described above.

In addition to these new sections in prospectuses there have been several changes necessary to the transaction documents, and these have been dealt with in a variety of ways. In some cases arrangers/managers have required originators to give undertakings to them in subscription agreements stating that the originator will maintain the 5% retention of exposures mentioned above, but in other cases this is covered by an undertaking in the asset sale agreement, given by the originator to the trustee. Generally originators have decided upon one of these two approaches and then opted to keep the same approach for further deals, for the sake of conformity.

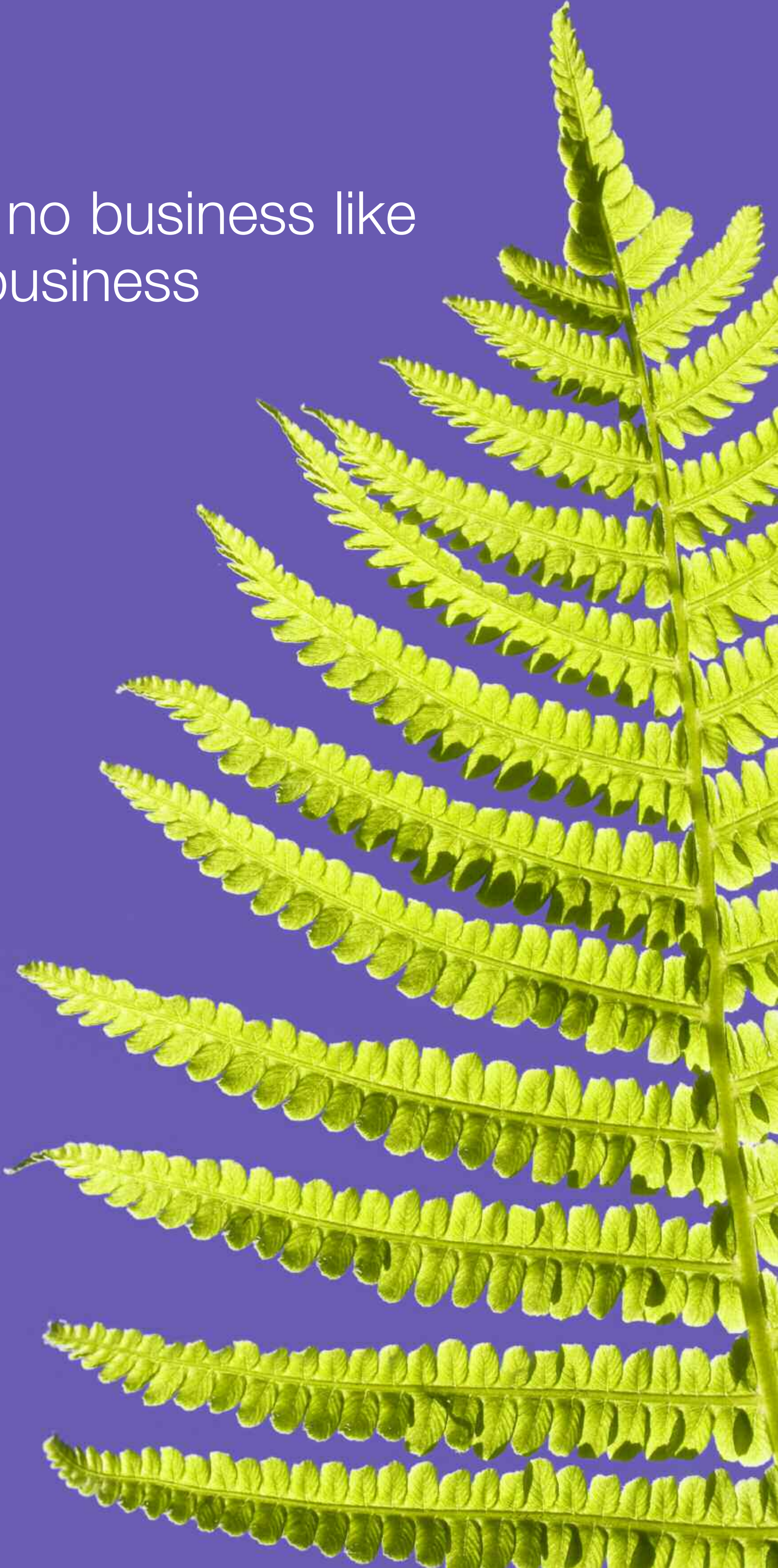
With regard to disclosure, originators are well advised not to provide extensive representations or undertakings which go beyond their obligations under Paragraph 7 of Article 122a. As it is somewhat unclear as to the precise nature of the disclosure obligations, originators should avoid open-ended undertakings to provide information requested by the trustee or noteholders, for example.

Conclusion

With the help of the Guidelines, which have in general allowed a degree of pragmatic flexibility in the implementation of the new rules, Article 122a has been smoothly integrated into the processes and documents of recent deals. Market practice is gradually being established, particularly in relation to RMBS deals, although it is more unclear, and still developing, with regard to other structures where there has been less issuance.

It is still hoped that the creation of increasingly complex regulatory frameworks and burdensome overlapping regimes will be avoided by aligning the regimes relating to investors other than credit institutions, for example insurance firms and pensions funds, with the requirements of Article 122a as well as harmonising the similar but non-identical regimes introduced outside of Europe.

2. There’s no business like whole business

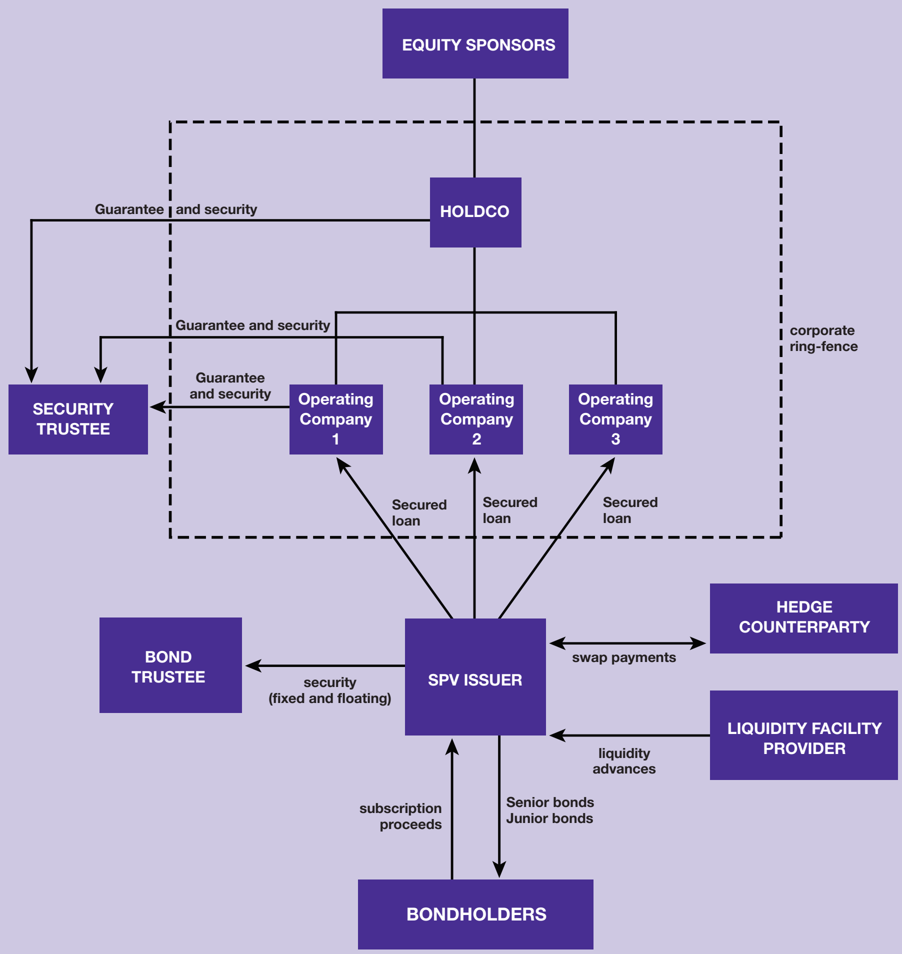


When is a “whole business securitisation” not a “securitisation”? This is a question that has been vexing issuers, arrangers, investors and their respective legal advisers with respect to the application of Article 122a of the Capital Requirements Directive (“CRD”) to a number of programmes and transactions commonly badged as “whole business securitisations”.

A brief history of whole business securitisation

Whole business securitisation or, as it is commonly referred to, WBS has been a useful funding tool over the last 12 years or so for a number of private equity firms, infrastructure investors and equity sponsors looking to refinance in the capital markets corporate acquisitions and/or capital expenditure originally financed in the bank market. Indeed, the market for corporate securitisation has proven to be reasonably robust since the financial crisis, with a number of corporates continuing to access the capital markets to refinance acquisition debt and/or to fund their capex programmes, in spite of the challenges experienced for the more traditional asset classes such as RMBS and CMBS. This goes to show that securitisation is (and always has been) more a combination of funding techniques than a single homogenous product. It is important to bear this in mind when considering the application of Article 122a of the CRD to WBS.

The business supporting a WBS will typically have steady, predictable cashflows and high barriers to entry. This allied with a strong covenant package, corporate ring-fencing and fixed and floating charge security has enabled certain companies in the UK to raise long dated investment grade debt a notch or two higher than their corporate family rating (see the box below for a short description of a paradigm whole business securitisation).



- Unlike traditional securitisations, there is no repackaging of a pool of existing income producing assets. Rather than fund the purchase of an exposure to a pool of assets, the proceeds of the bonds are used by the SPV Issuer to make loans on full recourse terms to operating companies within the corporate ring-fence. These loans are cross-collateralised through guarantees and security provided by each company in the corporate ring-fence.
- As there is no transfer of ownership of the income producing assets (i.e. the operating business) of the corporate ring-fence, in the event of default, the sole remedy of the SPV Issuer/Bondholders is to enforce the guarantees and security and, in particular, to appoint an administrative receiver to the companies in the corporate ring-fence.

These corporate securitisations have involved a multitude of different businesses, from highly regulated utilities to pubs, from football stadia to funeral homes. These transactions range on the one side from the "securitisation" of a corporate group's entire business (as has generally been the case in the UK water sector), through the "securitisation" of the business of a sub-group within a larger corporate group (such as BAA's securitisation of its (regulated) London airports distinct from its regional UK airports) to, at the other end of the spectrum, the "securitisation" of a ring-fenced portfolio of trading assets (as has been seen in the UK pub sector).

Transactions such as those referred to above were happily called securitisations in a market which historically viewed securitisations as favourable both from a regulatory capital and credit perspective. This was the case despite the legal structuring and the motivations behind the transactions invariably being quite different.

How similar is WBS to traditional securitisation?

It is true (and the clue is in the branding) that WBS does share a number of common features with more traditional asset backed securitisations. These similarities are, however, principally on the funding side. They include the use of a "bankruptcy remote" special purpose vehicle to raise the bond proceeds, liquidity facilities being made available to the SPV issuer to ensure timely payment of interest (and any scheduled amortisation) on the bonds, rating agency compliant hedging and standard limited recourse provisions and non-petition covenants with respect to the SPV issuer.

"WBS transactions were happily called securitisations in a market which historically viewed securitisations as favourable from a regulatory capital and credit perspective"

However, so called "whole business securitisations" differ significantly at the asset level and it is these differences which raise significant doubt and uncertainty with respect to the application of Article 122a of the CRD. Unlike traditional asset backed securitisations, the proceeds of the bonds raised by the SPV issuer are not used to acquire a portfolio of income producing assets which have been originated by a third party. Instead, the proceeds of the bonds are used to fund a full recourse loan to the company or companies within the defined group (the "ring-fenced group") secured over the entire assets, revenues and undertaking of the companies within the ring-fenced group (through a combination of fixed and floating charge security). So in contrast to traditional "true sale" securitisations where the credit risk associated with the income producing assets has been divorced from the credit risk of the originator, in a paradigm "whole business securitisation" the debtor and servicer are one and the same. Bondholders remain reliant on the underlying business continuing to operate as a going concern whether under the stewardship of the board of directors of the relevant companies within the ring-fenced group or, following an event of default and security enforcement, the administrative receiver appointed to the underlying business.

It's all in the definition

Given that "whole business securitisation" can be viewed as nothing more than secured corporate (on-balance sheet) debt, one might reasonably wonder what on earth Article 122a and, in particular, the risk retention and diligence provisions, have to do with it? The problem lies exclusively with the term "securitisation" and the meaning given to it in Article 4(36) of the CRD which defines securitisations as transactions:

"whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of the tranches determines the distribution of losses during the ongoing life of the transaction or scheme."

The breadth of the definition of securitisation in Article 4(36) of the CRD gives rise to the concern that, in the absence of any meaningful guidance, a secured corporate debt transaction such as one constituted under a paradigm "whole business securitisation" might fall, on a purely literal interpretation, to be treated as a securitisation for the purposes of Article 122a of the CRD on the basis that (i) payments under the bonds issued under the transaction are dependent upon the performance of the secured loans advanced by the SPV issuer to the relevant companies within the ring-fenced group out of the proceeds of bonds (and so the secured loans are an exposure or pool of exposures within the ambit of limb (a) of the definition) and (ii) the tranching of the exposure to those secured intercompany loans through the issue of senior (class A) and junior (class B) bonds would meet the test for tranched debt under limb (b) of the definition.

A literal interpretation is anomalous and does not bear scrutiny

If a literal approach to the application of Article 122a were to be favoured, then it would likely capture a whole host of private bank funded transactions which had never previously been considered to be, or marketed as, securitisations. Furthermore, if the literal analysis in the preceding paragraph were to be the correct application of Article 4(36) of the CRD to a paradigm "whole business securitisation" then it throws up some anomalies. First of all, the risk retention requirements in Article 122a presuppose that there is an originator, original lender or sponsor which is able to satisfy the retention requirements. However, none of the parties participating in a paradigm "whole business securitisation" satisfy the definitions of originator or sponsor in the CRD or can be said to be an original lender (within its accepted meaning).

However, if one was still to take the view that the transaction constituted by a paradigm "whole business securitisation" is a securitisation for the purpose of Article 122a, then there are practical limitations to discharging the risk retention and diligence requirements. The Guidelines to Article 122a of the Capital Requirements Directive dated 31 December 2010 and issued by the Committee of European Banking Supervisors (the "Guidelines") state that in the absence of any definable originator, sponsor or original lender (and assuming the transaction is a securitisation), it should be ensured that there is retention by whatever party would most appropriately fulfil this role outside of the specific constrains of these definitions "while taking into account of the fact that the intent of the provisions of Article 122a is to align the interests of those of originators, sponsors and original lenders". Retaining 5% of the bonds (whether through a vertical slice of the bonds or the most junior class) makes no sense and does nothing to align the interests of investors with "those of that party to the transaction that is transferring a proportion of the risks and rewards of the underlying exposures or positions to investors" (conceivably the SPV issuer or more likely the companies within the ring-fenced group). If those companies were to retain 5% of the bonds (whether through a vertical slice or the most junior class of bonds), such retention would not expose those companies to any greater risks or incentives. In fact, they would simply be borrowing 5% less debt.

Furthermore, in terms of additional diligence to be undertaken by investors, it is difficult to conceive of any additional diligence that would assist an investor's investment decision beyond the detailed financial and business disclosure typically included as a matter of course in any WBS prospectus.

Common sense favours a purposive approach

The anomalous situation that a narrow literal interpretation of Article 4(36) gives rise to strongly suggests that much more would be gained by applying a more purposive approach to determining whether Article 122a should apply to paradigm WBS transactions. When one considers the policy reasons behind the introduction of Article 122a, the principles and objectives espoused in the Guidelines and the natural alignment of interests that already exists between the debtor and the investors, it becomes difficult to make any compelling case for requiring the application of Article 122a to WBS (even more so in the context of a regulator determining that it should apply a penal capital weighting to investors for a failure to comply with the requirements of Article 122a) and much easier to argue against a narrower literal interpretation of Article 4(36).

So if one were to apply a purposive approach to the issue then it must be wrong to treat the secured loans made by the SPV issuer to the companies within the ring-fenced group as exposures or pools of exposure as they represent nothing more than a straight pass-through of liabilities of the bonds issued and related hedging provided under the WBS transaction (i.e. they are all part of the same scheme). The existence of these secured loans under the transaction is contingent on the issue of bonds and they are simply a mirror image of the funding under the bonds and related hedging (and so should be considered as liabilities, not assets). Furthermore, bondholders under a paradigm WBS transaction have, through the SPV issuer, a full recourse claim to the companies within the ring-fenced group as principal debtors under the secured loans and/or as guarantors of those loans. In that sense, the exposure of an investor in the bonds is no different to the exposure of an investor holding a

"One might reasonably wonder what on earth Article 122a has to do with WBS?"

> "When one considers the policy reasons behind the introduction of Article 122a....it becomes difficult to make any compelling case for requiring the application of Article 122a to WBS"

full recourse corporate debt claim of those companies. Insofar as dependency is concerned, the dependency is essentially identical to any other full recourse corporate debt obligation: namely debt payments have as a legal and contractual matter to be made regardless of performance. To suggest that a full recourse obligation gives rise to dependency would undermine the principles of limited liability and separate legal personality which form the cornerstone of capital raising in the modern era.

If one reaches the conclusion that the secured loans advanced by an SPV issuer in a paradigm WBS are not exposures or a pool of exposures for the purpose of limb (a) of Article 4(36), then it matters not whether the tranching and subordination arrangements in a paradigm WBS fall within limb (b) of the definition. We note that on a narrow literal interpretation of limb (b), the tranching and subordination arrangements in a paradigm WBS would fall outside limb (b) on the basis that the subordination of the tranches do not determine the distribution of losses "during the ongoing life of the transaction or scheme". Rather losses are determined only at final maturity after all of the security granted by the SPV issuer has been realised. However, as a literal interpretation would likely also rule out many traditional securitisations with senior and junior classes of bonds for the same reason (where issuers, arrangers and investors would recognise without question the requirement for Article 122a to apply), we are not particularly persuaded by this argument and instead prefer to argue against the application of Article 122a by reason of the full recourse nature of the investment.

So what is a regulator to do?

We would expect regulators to reject a narrow literal interpretation and instead to take a reasoned and principles based approach to the application of Article 122a, recognising that the full recourse nature of the funding automatically aligns the interests of investors with the debtor and that WBS as a product can be easily distinguished from other traditional asset backed products that have suffered from the risks associated with an "originate to distribute" model. Such a model has no relevance to WBS which is an issuer led product. This should enable regulators to avoid applying a narrow literal based interpretation to Article 4(36) of the CRD in favour of the more purposive approach outlined above. Indeed, whilst the Guidelines provide no guidance on the application of Article 4(36), it is worth noting that paragraph 25 of the Guidelines acknowledges that there may be circumstances where it is not possible to identify any party to the transaction that fits any of the roles of "originator", "original lender" or "sponsor". In this circumstance the Guidelines provide that it should first be ensured that the transaction fulfils the definition of a securitisation "as it is possible that the inability to identify an "originator", "original lender" or "sponsor" of the transaction could be a result of the transaction not fulfilling such definition." We believe that this should be the right result for most, if not all, WBS transactions.

The market precedents so far

The approach to the application of Article 122a to new WBS transactions or the updating of existing WBS programmes is broadly consistent with the thrust of the argument set out in this article. In the prospectus for the "whole business securitisation" of Gatwick Airport, Gatwick Funding Limited, the SPV issuer, asserts in a risk factor related to the CRD that it is "of the opinion that the Bonds do not constitute an exposure to a "securitisation position" for the purposes of Article 122a of the CRD. The Issuer is therefore of the opinion that the requirements of Article 122a should not apply to an investment in the Bonds." However, the statement is caveated by a statement that requested guidance on the sorts of structures captured by the definition of securitisation in Article 4(36) of the CRD has not been forthcoming and "therefore some uncertainty remains as to which transactions are subject to Article 122a of the CRD." Whilst no opinions as to the application of Article 122a have been expressed by issuers in updates to the base prospectus under existing WBS programmes published in 2011 (see for instance BAA Funding Limited and Southern Water Services Finance Limited), there is no suggestion

> "To suggest that a full recourse obligation gives rise to a dependency would undermine the principles of limited liability and separate legal personality...."

either in those updates that Article 122a should apply. Indeed in the case of the WBS programmes in the highly regulated utilities sector such as water and gas distribution, it would be hard to apply Article 122a even on a literal interpretation of Article 4(36) of the CRD as investors in those transactions benefit directly from a full recourse guarantee from the licensed operating company. Even if Article 122a were to be applied to paradigm WBS transactions (e.g. outside the highly regulated utilities), WBS programmes which existed before 1 January 2011 are in any event grandfathered until 31 December 2014 (see paragraph 8 of Article 122a).

We expect that the market will take confidence over time from a consistency of approach to the application of Article 122a in the context of transactions which have traditionally been categorised as whole business securitisations. We would hope that this confidence will be reinforced by further guidance from CEBS (or rather its successor the European Banking Authority (EBA)) to the relevance of WBS in this context or, if not, will be bolstered from the tacit approval given to a purposive approach that may be derived over time from regulators approving the capital treatment applied by investors to their investments in WBS (on the basis that these are not investments in, or exposures to, a "securitisation" for the purposes of Article 122a of the CRD).

Why does any of this matter?

The definition of securitisation as set out in Article 4(36) of CRD is the same definition that applies for determining the application of the "sf" identifier for the purpose of Article 8a of EU Regulation on Credit Rating Agencies (Regulation (EC) No 1060/2009) (the "CRA Regulation") to securitisation transactions and the possible triggering of the additional information sharing requirements under Article 8a of the CRA Regulation (if such proposed requirements are implemented). As with Article 122a in the context of issuers, arrangers and investors, rating agencies have had to interpret the rules in the absence of guidance as to whether secured corporate transactions traditionally badged as WBS are "sf" instruments and, if so, whether they should be subject to Article 8a and the US equivalent in SEC Rule 17g-5. Perhaps unsurprisingly, this has resulted in a far from consistent approach from the rating agencies to date. If securities issued under WBS transactions are marked with the sf identifier, then there is a risk that UK issuers who have sought to diversify their funding through issuing in the capital markets may eventually be able to access only a more limited investor base. There may also be an additional cost to these UK issuers in terms of additional administration required to obtain public ratings. Accordingly it is hoped that as the market evolves and issuers, arrangers and investors continue to reject the application of Article 122a to WBS transactions, the sf identifier and the provisions of Article 8a and SEC Rule 17g-5 will not apply to bonds issued under all or a substantial number of WBS transactions.

3. Effect of new regulations on traditional ABCP conduits and their future role

Bank sponsors have traditionally attracted originators of assets such as trade receivables and auto loans to their ABCP conduits[1] which tended to offer sub-LIBOR rates by financing themselves with short term paper issued to sophisticated investors. Due to the fact ABCP conduits typically benefit from a range of credit and liquidity support from their bank sponsor, investors have relied on the credit quality of the bank sponsor when making their investment decisions and the rating agencies base the rating of the ABCP predominately on the bank sponsors rather than the underlying assets.

Existing playing field

From an ABCP market investor's perspective, the bank sponsor, which structures the underlying transactions, has a significant share of the risk in the underlying transactions (through liquidity and/or programme wide enhancement) so there is already an alignment of risk between the investor and the person putting the underlying transaction together. In terms of the underlying data an investor would see in relation to the diverse asset pools that usually sit in ABCP conduits, this has historically been driven by Rule 2a-7 as a significant amount of ABCP investors are US money market funds.

Not surprisingly therefore, given this pre-existing alignment of risk and an existing disclosure regime which already protect ABCP investors, it is the way new regulation impacts the bank sponsors, rather than ABCP investors, that is affecting the ABCP market.

CRD II - Article 122a

Scope

In the response to their consultation paper 40, CEBS made it clear that they see an ABCP conduit as a "securitisation" (within the meaning of the Capital Requirements Directive) scheme in its own right separate from each underlying transaction and this position is adopted in the CEBS rules on interpretation of Article 122a. This means, for the purposes of Article 122a, that there is a need to consider the exposure of each regulated party both to each underlying transaction and the ABCP conduit itself to ensure compliance with retention and disclosure requirements for that regulated party.

Underlying transactions

In a typical transaction structured for an ABCP conduit, the only EU credit institution likely to have a securitisation exposure to the underlying transaction is the bank sponsor as liquidity and/or credit enhancement provider. Of course, if there was syndication of the liquidity then other syndicate providers would also have exposures but such syndication is increasingly unusual in our experience.

Article 122a provides that, from 1 January 2011, such bank sponsors need to ensure the 5% retention requirement and the enhanced due diligence and disclosure requirements are complied with. We expect the retention requirement to be met through the discount mechanic (floored at 5%) in most transactions, or, in the jurisdictions where such discounts would threaten the true sale analysis, through a subordinated loan, or other credit enhancement provided by the originator or another group company to the ABCP conduit or an SPV in the structure (again, floored at 5%). In other words, the originator would retain the first loss of at least 5% as permitted under Article 122a, paragraph 1(d). We do not expect the due diligence conducted at the transaction level to be significantly different to that already conducted as part of the origination process pre-Article 122a.

ABCP conduit

When Article 122a becomes applicable at the conduit level in an ABCP conduit, we expect the retention to be made by the bank sponsor in the form of liquidity facilities or, if the liquidity facilities cover less than 100% of the credit risk, the programme wide enhancement (which is often sized as at least 5%). At this level in the structure, we would expect the investors to conduct a thorough review of the conduit documents and how the conduit works operationally but not necessarily diligence the underlying transactions in any detail. In particular, we would not expect ABCP investors to be requesting receivable-by-receivable data on any underlying transaction funded through the conduit.

Grandfathering

Where an underlying transaction which has a revolving pool of assets (for instance, where receivables are sold to an SPV on a weekly basis) closed prior to 1 January 2011 and did not comply with Article 122a it will be grandfathered until 31 December 2014. If any assets are added to that pool after 31 December 2014 Article 122a would apply and anyone with exposure at the transaction level would need to ensure compliance.

An ABCP conduit that existed prior to 1 January 2011 is an "existing" securitisation for the purposes of Article 122a so, even if the pools of assets within it revolve (e.g., originators and their assets are added or removed), it should be grandfathered and the retention and due diligence requirements of Article

[1] The scope of this article excludes arbitrage vehicles that fund themselves through commercial paper.

122a would not apply to ABCP conduit level investors until after 31 December 2014. After 31 December 2014, adding just one new transaction to an ABCP conduit would make the whole of the ABCP conduit subject to Article 122a (see paragraph 135 of the CEBS guidelines to Article 122a).

CRD III - "re-securitisation"

Although CEBS have not yet provided guidance on the point, given their interpretation of Article 122a (outlined above), whereby an ABCP conduit is seen as a "securitisation" in its own right, it is hard to argue on this logic that an EU credit institution investing in ABCP would not be holding a "re-securitisation" position. Such a conclusion would make it costly for EU credit institutions to hold ABCP, perhaps even too costly. This would be unfortunate as the "re-securitisation" provision was intended primarily to affect investors in structures such as SIVs and CDO2s which are inherently more complex and where the mismatch between the tenor of the funding and the underlying assets is not covered by a liquidity facility.

The implementation date of the "re-securitisation" provisions of CRD III has been postponed until 31 December 2011 and, in the coming months, we expect there to be more engagement with the ABCP industry on the extent to which the "re-securitisation" provisions of CRD III will apply to ABCP conduits. It is to be hoped this will result in it being clarified that traditional ABCP conduits are not re-securitisations.

The FSA released Consultation Paper 11/9 in May 2011 which provides guidance based on the current CRD III text and suggests that fully supported ABCP programmes would not be re-securitisations. However, this guidance is predicated on the assumption that there will be no change to the current CRD III text.

CRD IV - liquidity coverage requirement

If implemented as currently contemplated, the liquidity coverage requirement proposed in Basel III and CRD IV, which would require credit institutions to hold high quality liquid assets against their liquidity needs (assuming a severe liquidity stress scenario) for the next 30 days, would significantly increase the cost of credit institutions providing liquidity facilities to conduits given the inherent short term nature of the commercial paper they issue.

Large exposures

Bank sponsors which have exposures to ABCP conduits through liquidity facilities or liquidity asset purchase agreements have often calculated their large exposures on the basis that they have an exposure to the underlying assets that the particular liquidity facility or liquidity asset purchase agreement applies to and not an exposure to the ABCP conduit that benefits from the liquidity facility or liquidity asset purchase agreement. On 10 December 2009 CEBS published guidelines on the interpretation of the European large exposure rules and they make it clear that where there is exposure to a scheme that has underlying assets, there is a judgment the bank sponsor needs to make as to whether they calculate their exposure to the scheme, to the underlying assets or to both. Additionally, even though liquidity facilities or liquidity asset purchase agreements may be provided to different SPVs, provided those SPVs are all part of the same scheme and funded through a single entity issuing into the ABCP market, regulatory authorities are likely to aggregate those liquidity facilities or liquidity asset purchase agreements for the purpose of calculating a bank sponsor's large exposure. This is because a market event (such as loss of confidence in a particular ABCP conduit) could result in all the liquidity facilities and liquidity asset purchase agreements being exercised simultaneously.

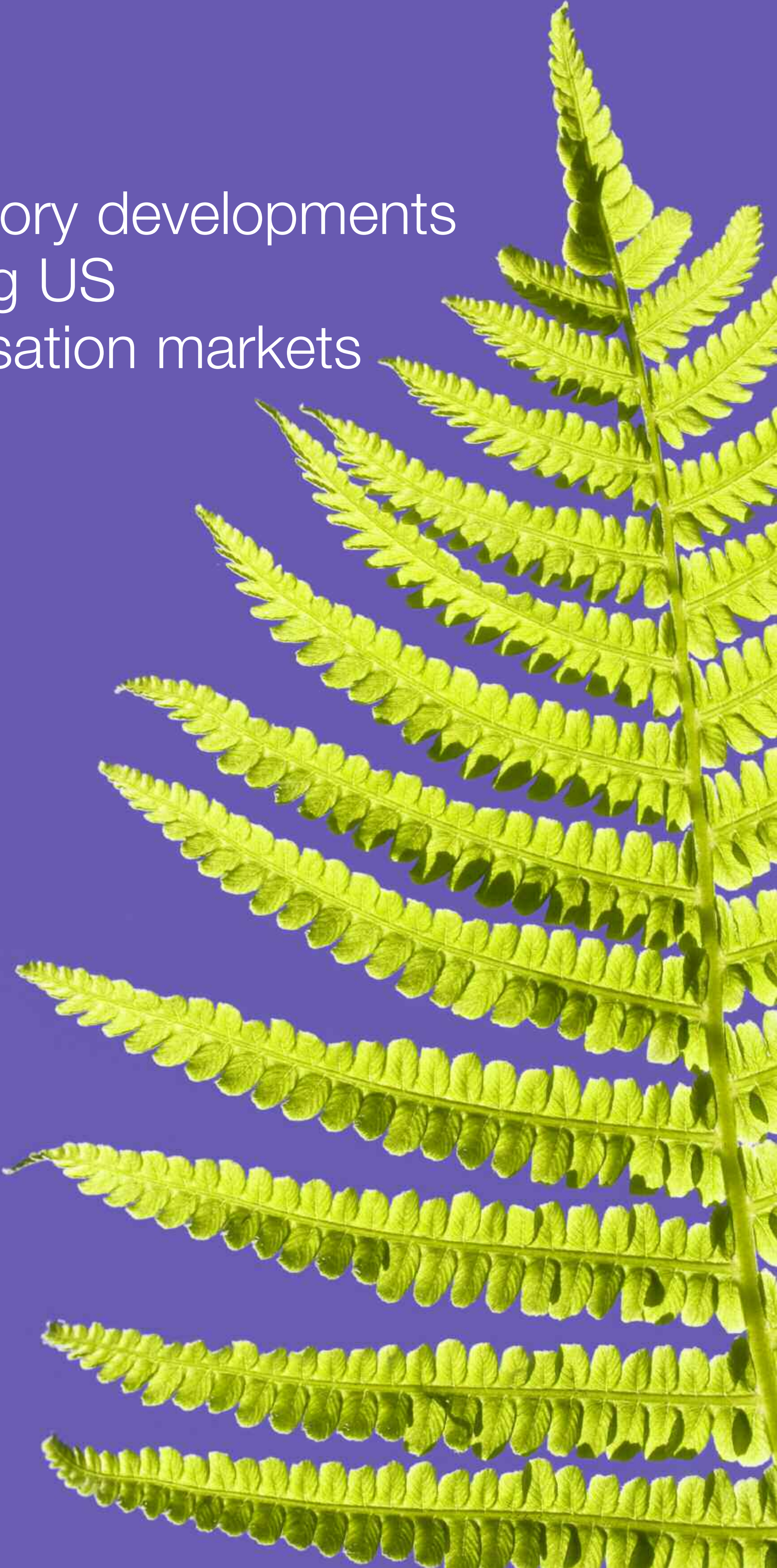
In practice, this means that when a bank is discussing a range of funding options with an originator, it needs to bear in mind that if it offers conduit capacity to the originator it will need to aggregate the exposure to the asset pool with all other exposures in the conduit in order to see if it exceeds its large exposure threshold whereas were it to fund the originator directly, it would only need to look at that particular originator's asset pool.

The future role of ABCP conduits

So, as we have seen, it is the bank sponsor which needs to ensure that the originator holds a retention and discloses relevant data; it is likely to be the bank sponsor which needs to itself hold a retention for EU credit institution ABCP investors from January 2015; it is the bank sponsor which will need to hold very liquid assets against its exposure to the ABCP conduit and it is the bank sponsor which will need to manage its exposure to the conduit to its large exposure threshold.

The growing body of regulation is increasing the cost of setting up and running ABCP conduits for bank sponsors. This cost will, to some extent at least, be passed by those sponsors on to the originators but that increases the pricing, making ABCP conduits as a source of funding less competitive. Nevertheless, following the dearth in new conduit originations during the credit crunch and the stringent criteria bank sponsors now need to meet in order to be allocated a portion of their bank's balance sheet to support a transaction in conjunction with the cost constraints outlined above, we understand demand for ABCP is outstripping supply. Although pricing may not be as competitive for originators as it used to be, ABCP conduits still provide them with access to a reliable funding source with a steady investor base that, in any case, is backstopped by a highly rated financial institution. Where an originator wants to ensure they have diverse funding sources, if its business model fits in with an ABCP conduit, it is a useful tool in that originator's funding portfolio.

4. Regulatory developments affecting US securitisation markets



On 21 July 2010, President Barack Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacting sweeping reforms of U.S. securities markets. Title IX of the Dodd-Frank Act includes several provisions targeted at the securitisation industry[1] and ratings agencies[2] ("NRSROs").

Introduction

In recent months, the U.S. Securities Exchange Commission ("SEC"), together at times with other U.S. federal agencies, has issued a number of rules and has also proposed rules to implement various of these requirements. The SEC remains under significant political pressure to reform the capital markets, and this has resulted in rule-making which has had a tendency to be very broad in scope and highly inclusive in terms of disclosure. In addition, the pace with which the SEC has proposed new rules has been quite rapid by historical standards. In the latter half of 2010, after the enactment of the Dodd-Frank Act, the SEC issued as many rules as it had per year for each of the three prior years, and its rule-making for 2011 has continued at this accelerated pace. This has raised the concern that hastily enacted SEC rules might make public securitisation prohibitively expensive or administratively burdensome and could force issuers into private markets or to abandon the product entirely.

Recent rules proposed or enacted by the SEC have addressed a number of securitisation reforms, including those provisions of the Dodd-Frank Act targeted at enhanced disclosure of asset-backed securities ("ABS"), risk retention requirements, prohibitions on conflicts of interest, due diligence review of securitised assets by issuers, repurchase request disclosure by issuers and repurchase mechanics disclosure by NRSROs. These regulations have been further underscored by changes to the FDIC's so-called "safe harbour", which affords true sale treatment for transfers by U.S. banks to the bankruptcy remote vehicles used in securitisation financing. The changes to the safe harbour are now tied to a number of conditions requiring enhanced disclosure and risk retention by banks wishing to undertake securitisations.

Enhanced disclosure for ABS

Section 942 of the Dodd-Frank Act directed the SEC to adopt new regulations affecting the level of disclosure required for ABS. By the time the Dodd-Frank Act was enacted, however, the SEC had already begun the process of reforming ABS disclosure. In early 2010, the SEC proposed sweeping reforms to Regulation AB, the regulatory provisions which govern offerings of asset-backed securities. The reforms (known as "Reg AB II") included new disclosure requirements for loan-level reporting of ABS, risk retention requirements for "shelf" (programme) offerings, electronic reporting requirements, and an extension of certain disclosure requirements to previously exempted private offerings of ABS.

The proposals in Reg AB II represented a new level of securities disclosure and would require the filing with the SEC of asset data files as well as a waterfall computer program which gives effect to the flow of funds provisions of the transaction.

Other proposals in Reg AB II would affect the timing of shelf registrations by requiring an issuer to make a draft prospectus available within five days of an offering, and 48 hours prior to purchase by an investor. Market observers have warned that this timing delay, together with the increased asset-level disclosures proposed by the SEC in Reg AB II, could have a discouraging effect on public (and even private) offerings of ABS.

One of the more controversial proposals in Reg AB II was that all of the enhanced disclosure requirements would also be made to apply to private offerings of ABS. This would pose a particular dilemma for non-U.S. issuers selling in private markets and could significantly reduce the scope of the private market. Under Reg AB II, sellers of "structured finance products", which include both registered and private assets, synthetic ABS, CDOs and CBOs, would be required to grant purchasers the right to obtain from the issuer all of the disclosure that would otherwise be required in a publicly registered transaction. While there is significant opposition to extending asset-level disclosure and other of the potential new requirements to private issuers in the US, it remains to be seen what final position the SEC will take on this issue. The implementation of the final Reg AB II is also complicated by the overlapping provisions with the Dodd-Frank Act, and it remains to be seen how the SEC will harmonise the various Dodd-Frank requirements with its original disclosure proposal.

Risk retention

The idea of risk retention has been championed by regulators and investors as a means to prevent conflicts of interest and ensure that issuers do not securitise defective assets. This "skin in

[1] See Dodd-Frank Act sections 941-946.
[2] See Dodd-Frank Act sections 931-939.

the game" requirement was codified by Section 941 of the Dodd-Frank Act (now Section 15G of the Securities Exchange Act of 1934, as amended). In March 2011, the SEC issued a proposed rule which would require "securitisers" to maintain a 5% interest in the credit risk of the assets. The SEC has proposed a number of means of structuring this 5% interest, such as a vertical slice of each asset class or horizontal first-loss interest in the securitisation. In U.S. parlance, "securitiser" includes both the entity depositing assets into a securitisation vehicle as well as the transaction sponsor (if different). As the SEC noted, "Section 15G does not appear to distinguish between transactions that are registered with the Commission under the Securities Act of 1933…and those that are exempt from registration under the Securities Act." Risk retention requirements would therefore apply in both public and private transactions in the U.S. (with a very limited safe harbour for non-U.S. transactions selling only a small portion into the U.S.).

Section 15G does, however, include an exemption from the risk retention requirements for "qualified residential mortgages" ("QRMs"). Where the assets in the asset pool meet the requirements of a QRM, an issuer would be wholly exempt from the risk retention requirement. The SEC has indicated that QRMs would be evaluated on the basis of quantitative benchmarks, such as debt-to-income and loan-to-value ratios, as well as qualitative benchmarks, such as a borrower's credit history and the type of mortgage involved. Similar exemptions were also provided for "qualified" commercial mortgage loans, commercial loans and auto loans. Because of the broad application of risk retention requirements, the QRM

"In March 2011, the SEC issued a proposed rule which would require "securitisers" to maintain a 5% interest in the credit risk of the assets. The SEC has proposed a number of means of structuring this 5% interest, such as a vertical slice of each asset class or horizontal first-loss interest in the securitisation"

exception will likely have significant impact on U.S. ABS markets, and we would expect that issuers will increasingly seek out assets for securitisation which accord with this definition. Finally, it is still unclear how the implementation of the Section 15G risk retention requirements will differ from European Union requirements under Article 122a of the Capital Requirements Directive. As the SEC finalises its approach to risk retention, we would expect that a cross-border approach which combines standards of both the EU and U.S. regimes will emerge as an effective model for non-U.S. issuances of ABS.

Due diligence review of assets

Section 945 of the Dodd-Frank Act requires an issuer of ABS to perform a due diligence review of the assets in a portfolio. The SEC has implemented this provision by issuing Rule 193, which was finalised in January of 2011. Rule 193 would require issuers in a publicly registered transaction to perform a due diligence review of the assets included in the asset pool and to disclose the nature of such review in the prospectus. The SEC has adopted a minimum standard of review for such due diligence which would require the issuer to provide "reasonable assurance" that the prospectus disclosure is accurate. While this provision would not affect non-U.S. issuers selling in private markets, participants in private transactions would be required to disclose any findings of a third-party due diligence report obtained by the issuer or underwriter, irrespective of whether such securities were registered under U.S. securities laws.

Conflicts of interest

Dodd-Frank Act Section 621 adds a new section (Section 27A) to the Securities Act of 1933 which prohibits an issuer, underwriter or sponsor of ABS from engaging in a transaction that would give rise to a "material conflict of interest with respect to any investor." This provision was implemented to prevent parties from profiting from securitisations which are supposedly "designed to fail." Although a final rule by the SEC on conflicts of interest was due by 15 April 2011, the SEC has not yet even issued their proposed rule. This has left a significant amount of uncertainty in the market, as it is common for underwriters in securitisation transactions to have a number of potential conflicts of interest (for example, being a counterparty to a hedging arrangement), many of which are relatively harmless and provide significant benefits to the securitisation. In November 2010, industry trade groups filed a comment letter with the SEC outlining this tension within the regulation, and it remains to be seen how the SEC will attempt to distinguish relatively "harmless" conflicts with the kind of conflicts of interest Section 27A appears intended to address.

Repurchase request disclosure

In January 2011, the SEC adopted Rule 15Ga-1 requiring securitisers to disclose detailed information on filled and unfilled repurchase requests. The policy behind this requirement is that increased disclosures as to the quality of assets sold into a securitisation by a particular issuer would enable investors to better assess the health of a particular issuer of ABS.

The scope of Rule 15Ga-1 is generally expansive. Because the Rule uses the wider definition of ABS added by the Dodd-Frank Act (known as "Exchange Act-ABS"), it covers offerings of both registered and unregistered securities. The SEC has also taken an expansive approach as to the application of the Rule to non-US securitisers. Under that approach, "if securitisers of Exchange Act-ABS are subject to [the SEC's] jurisdiction, then securitisers are required to provide the disclosures required by Rule 15Ga-1."

The SEC has created a new form for these repurchase disclosures—Form ABS-15G, which is required to be attached to a securitiser's periodic reports. For a private issuer, the Form ABS-15G must be attached to an issuer's quarterly reports or provided upon demand by an investor, and in a registered Regulation AB transaction, the Form must be attached to a prospectus and periodic Form 10-D reports.

The proposed SEC rule would require a securitiser to provide information on any purchase requests across asset classes and "issuing entities" for the past three years. If a securitiser is unable to obtain or can only find partial information on historical repurchase requests within the three-year look-back period, the securitiser may instead disclose that it has requested but was unable to obtain certain information as to investor demands and that the disclosures included in the Form do not contain all investor demands.

Rule 15Ga-1 filings are required as of February 14, 2012, which report must include information on repurchase requests on outstanding ABS sold into the U.S. for the calendar years of 2009, 2010 and 2011. After this initial filing, securitisers will be required to file the Form ABS-15G on a quarterly basis in respect of all outstanding ABS sold into the U.S. over the past five years. A securitiser that has not received any repurchase requests may satisfy the filing requirements by merely checking a box on the Form ABS-15G and filing once, annually. These contradictory look-back periods for historical repurchase data have created further uncertainty, and it remains to be seen how the market will react to the request for such data. Given these developments, non-U.S. institutions involved in securitisation of ABS in the United States, including in both public and private transactions, should consider reviewing their policies and procedures for reporting and tracking repurchase requests with respect to ABS.

NRSRO reporting on repurchase requests

As part of the repurchase request reporting, the SEC also adopted Rule 17g-7, which requires NRSROs to include in a credit report relating to ABS a description of representations, warranties, and enforcement mechanisms available to investors in a rated ABS, and a description of how these representations and warranties differ from issuances of similar securities. The meaning of "similar securities" has been the subject of some uncertainty.

> "Nothing in the text of [Dodd-Frank] Section 943(1) would support drawing any such distinctions [excluding foreign issuers] in connection with reports issued by NRSROs subject to Commission oversight"

NRSRO reporting would be required for non-US securities, and the SEC specifically noted that "nothing in the text of [Dodd-Frank] Section 943(1) would support drawing any such distinctions [excluding foreign issuers] in connection with reports issued by NRSROs subject to Commission oversight." As a result, non-U.S. issuers in private markets would be subject to enhanced repurchase reporting by NRSROs.

While several commentators to the Rule had recommended that the SEC allow NRSROs to comply with the reporting

> "If securitisers of Exchange Act-ABS are subject to [the SEC's] jurisdiction, then securitisers are required to provide the disclosures required by Rule 15Ga-1"

requirement by incorporating information by reference to a transaction's offering documents, this proposal was rejected by the SEC. As a result, all required information must be presented in an NRSRO credit report itself. Rule 17g-7 becomes effective on September 28, 2011 and applies to any credit report issued by a NRSRO thereafter.

FDIC safe harbour

In the event that a bank in the U.S. becomes insolvent, the Federal Deposit Insurance Corporation (the "FDIC"), the federal insurer for depository institutions in the United States, is generally appointed receiver or conservator of the insolvent bank. This raises particular concerns for investors in securitised vehicles sponsored by U.S. banks, because the FDIC has the power to repudiate contracts and recover assets and cash flows that belong to the bank. Since 2000, this risk had been mitigated by a "safe harbour" adopted by the FDIC under which the FDIC generally agreed not to interfere with securitisations so long as the sponsor bank treated the securitisation transaction as a "sale" for generally accepted accounting purposes (and a few other easy-to-satisfy conditions were met).

In 2009, the Financial Accounting Standards Board in the U.S. promulgated new rules under which, in most cases, banks would no longer be able to obtain accounting sale treatment to securitisation transactions, which in turn called into question the availability of the FDIC safe harbour. Rather than simply addressing the uncertainty created by the new accounting position, the FDIC adopted a rule in September 2010 which completely overhauled the conditions of the safe harbour by requiring compliance with extensive market reforms, including disclosure and risk retention. These requirements became effective for most new bank transactions on 1 January 2011. Since that date, very few U.S. banks have chosen to comply with the requirements of the new FDIC safe harbour and have elected instead to avoid securitisation.

Other provisions

The Dodd-Frank Act includes several other provisions which may affect securitisations, such as the much talked-about "Volcker Rule" (Dodd-Frank Act Section 619), which broadly prohibits banks from engaging in proprietary trading. The language of the rule prohibits a bank from owning any hedge fund or private equity fund and, in its haste, Congress defined these as any entity that relies on a Section 3(c)(1) or (7) exemption under the U.S. Investment Company Act of 1940. The problem is that many securitisation vehicles rely on these same exemptions. While the Dodd-Frank provision notes that "nothing in this section shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law", the contradiction created by the definition of hedge fund or private equity fund must ultimately be resolved by the rule-making process. Industry trade groups have recently been focusing particular advocacy on this issue.

In order to reduce conflicts of interest in the securities ratings process, the Dodd-Frank Act also required that securities laws no longer use ratings by nationally recognized statistical rating organizations ("NRSROs") as a benchmark for regulatory compliance. As a result, in April 2011, the SEC changed the Exchange Act definition of "mortgage-related security". Mortgage-related securities are securities that may readily be sold into secondary markets by avoiding certain U.S. state investment laws. The old definition required that the security "is rated in one of the two highest rating categories by at least one [NRSRO]." The new rule removes the ratings agency reference and instead requires that the security entail a "minimal amount of credit risk", a new standard the SEC has created (but not defined) that requires due diligence and compliance with a bank's internal policies and procedures. The industry's response to this prescribed "minimal amount of credit risk" will therefore have a significant effect on the marketability of ABS.

Conclusion

While securitisation markets in the U.S. remain subject to considerable change, a new regulatory framework for capital markets is emerging. This framework combines robust disclosure requirements for ABS with risk retention requirements, prohibitions on conflicts of interest, due diligence review of securitised assets by issuers, repurchase request disclosure by issuers and repurchase mechanics disclosure by NRSROs. While these requirements in some cases have lead to uncertainty, they provide a general picture of the regulatory regime emerging in the U.S. The success of this emerging model will depend on its ability to balance stability with economic growth, and ultimately on how market forces react to the new requirements.

5. Disclosure, transparency and the provision of data – where are we and what are the issues?

The European Central Bank and the Bank of England are both well on their way to implementing their revised eligibility requirements for asset-backed securities. Each requires greater levels of disclosure and transparency and in particular the provision of loan-by-loan data to investors. The ECB has boldly stated that its aim was the restoration of investor confidence in the securitisation markets and, ultimately, the re-opening of these markets. Will these measures help to achieve that?

Introduction to the various initiatives

Market focus during 2010 and the early part of 2011 was all about loan-by-loan disclosure and greater transparency in ABS transactions. In December 2010 the European Central Bank (the ECB) announced that it would make loan-by-loan disclosure a requirement for asset-backed securities (ABS), in order for such ABS to be eligible for the Eurosystem collateral framework, starting with residential mortgage-backed securities (RMBS). A similar proposal was announced in the UK by the Bank of England through an initial market notice in July 2010 and with more detailed guidance in a further market notice in November 2010. In addition, Article 122a of the Capital Requirements Directive came into effect on 1 January 2011 (for new transactions) and comes into effect on 31 December 2014 for existing transactions where new exposures are added or substituted after that date. Among other things, Article 122a imposes various due diligence requirements on credit institutions investing in asset-backed securities, is a further driver towards increased disclosure and transparency in ABS and thus also relevant to this discussion. Last but certainly not least, the Securities and Exchange Commission (SEC) is in the process of implementing wide-ranging reforms across the Atlantic. The current state of play with the SEC reforms is considered in detail in "Regulatory developments affecting US securitisation markets"[1].

The challenge ahead

The key challenge for all implementing parties stems from the fact that, although these measures are essentially all driving towards the same result - increasing the level of transparency in ABS transactions and providing detailed loan-by-loan information to investors on an ongoing basis – they remain separate measures imposed by different parties. On the face of it, a raft of similar, but not identical, measures, all being implemented with similar, but not the same, timeframes, and all aiming at roughly the same outcome is hardly a recipe for confidence in the securitisation market; rather the opposite. If there is to be any move towards the goal, repeatedly stated by the ECB, of restoring investor confidence in the securitisation markets, the final position must be as clear and harmonised as possible, and as comprehensible as possible to market participants. If this is to happen the various measures need to be implemented consistently, which means both consistent with each other and consistent with the existing regulatory and legal framework. In assessing how successfully this has been done up until now, and what needs to be considered in the future, we will begin by looking at the separate ECB and Bank of England initiatives as well as, briefly, the relevant requirements of Article 122a before going on to discuss what in our view are the chief problem areas.

The ECB – the current state of play

Following a positive response from the public consultation that took place during the early part of 2010, the ECB from April 2010 onwards began to work on its requirements for loan-by-loan disclosure and towards the latter half of 2010 consulted with various senior market participants on preparing appropriate data templates for each asset class. This led to the announcement on 16 December 2010 that it would make loan-by-loan disclosure a requirement for ABS to be eligible for the Eurosystem collateral framework. RMBS would be the first asset class that would be subject to the eligibility requirement; the remaining asset classes would follow.

The ECB stated that it would require the loan-by-loan data to be provided at least quarterly on an interest payment date (or within a month of the interest payment date) and to be submitted on the

"If there is to be any move towards the goal…of restoring investor confidence in the securitisation markets, the final position must be as clear and harmonised as possible, and as comprehensible as possible to market participants"

[1] See page 17.

standardised templates that were prepared in consultation with senior market participants during the latter half of 2010 (with each asset class having its own template). These standardised templates for RMBS were finalised earlier this year and recently the finalised templates for CMBS and SME were published on the ECB's website.

When it made this announcement, the ECB stated that it was working towards a timeline of approximately 18 months from the date of the announcement. Part of the reason for this timeline was the need to work out exactly how, practically, this data was to be made available. The ECB made it clear from the outset that it favoured some sort of pan-jurisdictional data warehouse: in the initial announcement in December 2010, it stated that it was encouraging market participants to establish the necessary data-handling infrastructure to capture the loan level data and stated that it would "encourage market participants to establish the necessary data handling infrastructure". It is noteworthy that the language very much reflects the fact that the ECB as an organisation is not able itself to procure this but rather acts as the facilitator for what will need to be a market-led initiative.

More recently the ECB has made it clearer exactly what sort of data-handling infrastructure it envisaged. On 1 April 2011, it duly announced that it "recognised the need to establish a data warehouse for the processing, verification and transmission of ABS loan-level data" (the ABS data warehouse) and in a press release on 28 April 2011 announced that it was "encouraging" market participants to this end, with a working group set up to oversee the tender process and select an appropriate constructor. Again, note the language used: the ECB's constitutional position, and the laws governing its role, mean that it cannot play any active part in the process; it is involved as a catalyst only but it nevertheless evidently sees the storage of the loan-by-loan data in the ABS data warehouse as an integral part of its eligibility requirements.

"The ECB…evidently sees the storage of the loan-by-loan data in the ABS data warehouse as an integral part of its eligibility requirements"

The 28 April press release stated that a market group, consisting of senior market participants, will be set up to oversee the tender process and select a constructor of the ABS data warehouse. As we go to print this market group has issued a request for information (RFI) to gather information regarding the commercial and technical strengths of potential constructors. The RFI will last for a further ten days. Following a review of the responses received to the RFI, a shortlist of the most suitable candidates to participate in the tender process will be used to determine the eventual constructor.

The Bank of England - going further sooner?

Like the ECB, the Bank of England was involved in a consultation process with market participants during the course of 2010, and like the ECB, as a major ABS investor in its own right, its focus was on the need for greater disclosure and transparency in ABS. In July 2010 it published a market notice outlining the measures it intended to implement. This was followed in November 2010 by a further market notice confirming certain changes that would be made to the eligibility criteria for ABS and covered bonds. It was clear from the consultation process and the initial market notice in July 2010 that the Bank of England was looking to introduce a set of requirements that went beyond the mere provision of loan-by-loan data (although this was still a key element) and was looking at producing something more comprehensive, including the provision of cash-flow models and the publication of transaction documentation. In introducing a more extensive set of requirements that went beyond the mere provision of loan-by-loan data, the Bank of England reforms had closer echoes to those that were being undertaken across the Atlantic by the SEC. Very crudely speaking, the Bank of England proposals in their scope sit half-way between those proposed by the SEC on the one hand and those by the ECB on the other.

"Very crudely speaking, the Bank of England proposals in their scope sit half-way between those proposed by the SEC on the one hand and those by the ECB on the other"

Furthermore, the November 2010 market notice indicated that the Bank of England measures would likely be implemented more quickly than those of the ECB described above: for RMBS and covered bonds, November 2011 was given as the implementation date. Following the implementation, there will be an additional twelve month transitional period during which the securities not meeting the new requirements may remain eligible, but will be subject to increasing haircuts.

In a similar way to the ECB, the Bank of England is requiring loan-by-loan information to be made available to market participants at regular intervals, at least quarterly and on the standardised templates developed by the Bank of England for each asset class. As to how investors are supposed to access the data, the market notice simply states that this is to be provided "on a secure website". As is discussed in more detail below, it is not clear exactly how, if at all, this is intended to interact with the ABS data warehouse proposed by the ECB.

While the ECB has remained focussed purely on the loan-by-loan disclosure, the November 2010 market notice confirmed that the Bank of England intended to impose a more comprehensive set of reforms and additional eligibility requirements - all under the general banner of improving disclosure and transparency. In addition to the loan-by-loan disclosure the Bank of England also requires the following: (i) a transaction summary setting out all the key features of the transaction to be made available to investors; (ii) standardised monthly investor reports containing a standard set of minimum information to be made freely available; and (iii) a waterfall cash flow model. The Bank intends for all the information listed at (i) to (iii) above also to be provided on a secure website. The requirement to provide a waterfall cash flow model echoes a similar requirement being imposed by the SEC in the U.S.

Additionally, the Bank of England has stated that, effective from July 2011, the prospectus and the transaction documents (with a limited amount of redaction of commercial terms) for all ABS transactions (irrespective of asset class), are to be made available to investors, potential investors and market professionals acting on their behalf (regardless of whether the transaction is public or private) – again this is to be on a secure website.

The Bank of England is currently in discussions with market participants regarding implementing similar requirements for other asset classes, notably CMBS, auto loans, credit cards and consumer loans.

Article 122a

The detailed requirements of Article 122a of the Capital Requirements Directive (Article 122a) are discussed in more detail in "Article 122a – early observations"[2] but Article 122a is another element of, generally, the push towards greater transparency and disclosure and, specifically, the provision of loan-by-loan data. It thus merits a brief discussion here. Among other things, Article 122a requires investors to satisfy their regulators that they have carried out a proper due diligence exercise in relation to each of their securitisation positions - including as to the underlying assets. Originators have a concurrent obligation to provide investors with readily available access to information on the underlying assets so that investors can conduct this exercise. For asset classes such as RMBS this effectively means a requirement to provide loan-by-loan data and this is what has been happening recently in the RMBS market. A more difficult question, and one that has yet to be resolved, is whether Article 122a will require loan-by-loan data to be provided for asset classes such as credit cards or auto loans which involve a large volume of granular exposures (this is an issue that will also need to be resolved in relation to the ECB and Bank of England initiatives). As set out in "Article 122a – early observations" above, our interpretation of the guidelines issued by the Committee of European Banking Supervisors is that loan-by-loan data will not be required for such assets.

As to how this information is provided, note that standardised industry templates (such as Bank of England or ECB templates) can be used provided the broad obligation outlined above is satisfied. Thus, certainly for RMBS, it appears that compliance with the ECB and Bank of England eligibility requirements will ensure compliance with the data-provision requirements of Article 122a.

What are the issues?

As noted above the two principal areas of concern regarding the ECB and the Bank of England initiatives are to do with how consistently they are being implemented, that is to say whether they are implemented consistently (i) with each other and (ii) with existing legislation and regulation. We will consider both of these in turn.

Are the ECB and the Bank of England singing from the same hymn sheet?

The aims of the ECB and the Bank of England are broadly similar regarding the provision of the loan-by-loan data: to provide investors, potential investors and other market professionals with granular loan-by-loan data on a frequent (at least quarterly) basis and on the standardised template developed for the asset class in question. As for the template, for RMBS, which is the "test case" for both central banks, the template developed by the Bank of England has been developed in line with the ECB equivalent, and broadly-

[2] See page 1.

> "There remains the risk that data stored in the ABS data warehouse in accordance with the ECB requirements may be ineligible for Bank of England purposes"

speaking each require the same information to be provided.

Despite these similarities, the inescapable fact remains that these are parallel initiatives, implemented by separate central banks and on different timelines. There are market concerns about this and it is fair to say that the Bank of England and the ECB are sensitive to them. Certainly, the Bank of England appeared to acknowledge this when it stated in the November 2010 press release that the RMBS template has been "designed to be, wherever possible, consistent with the loan-level requirements of other authorities, and reflects in particular those being developed by the ECB". Nevertheless, although the respective RMBS templates are similar, they are not identical. The concern remains that "similar" may not be good enough if, operationally, market participants who want the ability to access the ECB and the Bank of England need to gear their systems towards two separate templates. This would be logistically difficult. Furthermore, this would arguably create confusion, rather than confidence in the securitisation market and hinder, rather than help, the process of re-opening it.

Further uncertainty exists in relation to how the approaches of the ECB and the Bank of England surrounding the storage and publication of the data will sit alongside each other and, critically, whether data stored in compliance with ECB requirements on the ABS data warehouse will comply with the Bank of England requirements. All we know so far is that, in the November 2010 market notice, the Bank of England stated that loan-level data is required to be made available "via a subscription-only, secure online data site". Whether the ABS data warehouse satisfies this remains to be seen – the tender process for the ABS data warehouse has not even started yet. It would certainly make sense for the final ABS data warehouse to satisfy Bank of England eligibility criteria; as an incentive it could even perform the cash flow modelling disclosure that is another Bank of England requirement. At the moment, though, in absence of any clear policy statement on the point, there remains the risk that data stored in the ABS data warehouse in accordance with the ECB requirements may be ineligible for Bank of England purposes - a possible further area of inconsistency in the approaches of the central banks resulting in further uncertainty in the market and the opposite of the ECB's stated goal.

What will happen with the regulators?

As to how the new requirements for loan-by-loan data will interact with the Prospectus Directive, the Prospectus Directive requires that the prospectus contains all information regarding the issuer and the securities which is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses, and prospects of the issuer. The key question is whether the necessary "information" will extend to the loan-by-loan data. Our view is that it is the trends identified in the data, rather than the data itself that is the material element to the investment decision; if it were otherwise there would have been a market push towards loan-by-loan disclosure before now. Even under Article 122a, it is very much up to the investor to carry out its own tests on the raw data provided – thus it is what the investor makes of the data, rather than the data itself, which is key. It would also be practically unworkable, particularly in the case of, say, a large master trust programme, to consider such data as part of the prospectus owing to (a) its sheer volume, (b) the fact that it will likely be available only electronically and (c) the fact that the ECB and the Bank of England require the data to be updated at least every quarter. Also, in the UK the prospectus is viewed, as it is throughout the EU, as a legal document and the listing process (including the incorporation of information by reference) reflects this – the concept of non-documentary disclosure does not really exist. Nevertheless, the precise interaction of the new requirements with the Prospectus Directive requirements remains uncertain.

Another possible issue is whether the way in which loan-by-loan data is to be disclosed will also need to comply with the Transparency Directive, and in particular whether, if it is to be published through some sort of pan-European ABS data warehouse, this will need to be approved as a regulated information service by the competent authority in each relevant jurisdiction. As discussed above in relation to the Prospectus Directive, our view is that the loan-by-loan data ought not to be regarded as part of the prospectus. Accordingly, we do not think that the ongoing disclosure of loan-by-loan data will constitute disclosure of regulated information for the purposes of the Transparency Directive (in the same way that, for example, investor reports are not subject to the Transparency Directive). However, as with the Prospectus Directive, exactly how the loan-by-loan initiative will sit alongside the Transparency Directive is not yet settled.

There is also the issue of whether the publication of loan-by-loan data in the form proposed may infringe market abuse regulations in the relevant jurisdictions. Taking the UK as an example, the FSA (in its Code of Market Conduct) identifies the following as factors to be taken into account in determining whether or not information is "generally available" and thus not inside information, these factors being whether the information: (i) has been disclosed to a prescribed market through a regulatory information service; (ii) is open to inspection by the public; (iii) is otherwise generally available, including through the internet, or some other publication (including if it is only available on payment of a fee), or is derived from information which has been made public; (iv) can be obtained by observation by members of the public without infringing rights or obligations of privacy, property or confidentiality; and (v) can be obtained by analysing or developing other information which is generally available. The Bank of England does stipulate that the RMBS and covered bond asset-level disclosure will be made available to "investors, potential investors and certain other market professionals acting on their behalf" and the ECB has stated that the ABS data warehouse will allow loan-level information to be "readily available to market participants" and would ensure "investor access" to the information. Whether this is enough to satisfy market abuse regulations in each relevant jurisdiction is unclear at this stage: on the basis of the UK guidelines listed above, disclosure on a secure website which provides access to investors should fall within limb (iii) above, but the picture is not entirely clear-cut. Furthermore, these are mere guidelines and apply to the UK only; other jurisdictions may be stricter. What is clear is that great care will need to be taken in the publication of the loan-by-loan data in order to ensure that it does not infringe market abuse regulations in any relevant jurisdiction.

"The obligation to disclose a significant quantity of granular data and a large number of customer accounts (even on an anonymised basis) has caused much consternation for originator clients in practice"

The final issue concerns confidentiality and data protection. In its November 2010 market notice the Bank of England was careful to make clear that the "loan level data made available will be anonymised – it should not directly or indirectly disclose the identities of individual borrowers". The concern here is that there are elements of the data that could be used to identify individual borrowers (for example, the address or postcode of a particular property). Any pan-jurisdictional data warehouse would also need to fall in line with the data protection laws in each relevant jurisdiction. Whilst both the ECB and the Bank of England have considered data protection and confidentiality laws in formulating the requirements, the obligation to disclose a significant quantity of granular data and a large number of customer accounts (even on an anonymised basis) has caused much consternation for originator clients in practice, and every effort has been made to ensure that no personal information can be deduced from the loan-level data provided. Confidentiality issues have also surfaced regarding the Bank of England's requirement to make previously confidential transaction documents publicly available with effect from July 2011 and in particular as to whether the scope of redaction of the commercial terms will be broad enough.

Conclusion – more work ahead

The ECB has publicly stated that its goal was to restore investor confidence in the securitisation markets with a view to re-opening these markets. Increasing disclosure and transparency levels alone will not make that happen. However, for these requirements to be a help rather than a hindrance they (along with the requirements being implemented by the SEC in the United States) need to result in a set of disclosure and transparency rules and practice that is implemented consistently throughout the industry and clearly understood by all market participants. As we have seen we are some way from achieving that. Significant progress has been made in the last year on both sides of the Atlantic, but much work remains.

6. Transatlantic rating regulation and reform – what does this mean in practice?

Credit rating agencies ("CRAs") play a significant role in the financial markets by issuing creditworthiness opinions designed to help overcome the information asymmetry between entities which issue debt instruments and investors purchasing these instruments. CRAs have, however, been widely blamed for failing to identify and address the build up of risk ahead of the 2008 financial crisis and the reform of CRAs' activities is high on the agenda of the G20's recommendations for strengthening financial stability. As a result, we are now seeing a raft of European and US legislation intended to restore confidence in the quality, independence and objectivity of credit ratings.

European legislation

Background to the CRA Regulation

Regulation (EC) No 1060/2009 (the "CRA Regulation") was adopted in September 2009 and applies to CRAs issuing credit ratings intended for use for EU regulatory purposes by investors. The CRA Regulation imposes registration requirements and rigorous rules of conduct on CRAs in order to mitigate possible conflicts of interest and ensure sufficient transparency of credit ratings and the ratings process. Subject to certain exceptions set out in the CRA Regulation, investors may only use credit ratings issued by CRAs established in the EU and registered under the CRA Regulation. As of 7 June 2011, all provisions of the CRA Regulation will be in force.

The CRA Regulation aims to give "teeth" to previously adopted international standards in relation to CRAs. However, this will not be the end of the story as the CRA Regulation has already been subject to its first amendment and further legislative proposals are expected over the coming months.

The disclosure requirement

The CRA Regulation requires that where a prospectus published under the Prospectus Directive and Regulation (EC) No 809/2004 (the "PD Regulation") contains a reference to a credit rating, the issuer, offeror, or person asking for admission to trading on a regulated market must ensure that the prospectus includes clear and prominent information stating whether or not such credit rating is issued by a CRA established in the EU and registered under the CRA Regulation.

Practical issues for practitioners include:

1. **Prominent**: It remains unclear what "prominent" means. The PD Regulation uses the term "clear and prominent" to describe disclosure of other information, including risk factors and accounting standards so it would appear CRA disclosure need not be placed on the front page of the prospectus as long as the disclosure is highlighted in some way, for example with a heading. It would therefore be prudent to include the wording in the "Summary" section.
2. **Registration status**: To register, the CRA must submit details such as ownership structure, its rating analysts and the procedures and methodologies used to issue credit ratings. There have been delays in processing registration applications for CRAs (which are mostly still pending), and as at 12 May 2011, only four CRAs had been registered (it is worth noting that the CRAs which have been registered do not include any of Standard & Poor's, Moody's or Fitch). The issuer or sponsor should conduct its own due diligence in this respect, as they assume responsibility for the related disclosure. Practitioners should be mindful of the liability arising out of incorrect disclosure of a CRA's registration status.
3. **Which entity?**: In some cases it may not be clear at the outset of a transaction which CRA legal entity within a group will be issuing the rating, and care must be taken to ensure that the correct CRA entity is disclosed as its registration status may differ from that of other entities in the same group.
4. **Assets**: The CRA Regulation also requires the disclosure of information relating to credit ratings of assets held by an issuer. Where detailed disclosure on pools of rated assets is required, disclosure could be extensive, and in certain cases unmanageable.
5. **SF indicator**: Where a CRA issues credit ratings for structured finance instruments, it must clearly differentiate these instruments by using an additional symbol which distinguishes them from rating categories used for other financial instruments. CRAs each adopt their own relevant symbol, examples being (sf) or (SF) as a suffix to the given ratings.

"We are now seeing a raft of European and US legislation intended to restore confidence in the quality, independence and objectivity of credit ratings"

6. **Negotiation**: The language may be boilerplate in nature but it has been rigorously debated in recent transactions. Sufficient time should be left to finalising it.

Supplement a base prospectus or disclose in final terms?

There is some debate as to whether a supplement must be produced for base prospectuses approved prior to 7 December 2010 to comply with the CRA Regulation or whether, as an alternative, an issuer could include the necessary statements in final terms. The PD Regulation states final terms attached to a base prospectus may only contain the information items from the note schedules according to which the base prospectus is drawn up.

This could prevent the inclusion of the information about the CRAs' registration status in final terms and require the publication of a supplement, but in the UK the FSA is adopting the following approach:

1. programme updates and new prospectuses must include appropriate CRA disclosure (in both base prospectuses and in final terms); but
2. supplements to disclose CRA information are not expected for base prospectuses approved prior to 7 December 2010.

An unintended impact?

The disclosure requirements only apply to PD Regulation compliant trades. As a result, there may be increased use of private placements and issuances on unregulated markets to avoid increased disclosure requirements. Arguably this will cause less disclosure in the markets. In any event, it is clear the CRA disclosure requirements involve more than mere routine insertion of standard form language into a prospectus.

> "The CRA Regulation aims to give "teeth" to previously adopted international standards in relation to CRAs"

Endorsement and equivalence

Under the CRA Regulation, credit ratings issued by a CRA established in a third country may only be used in the EU if:

1. such credit ratings have been endorsed by a CRA established in the EU and registered in accordance with the CRA Regulation (the endorsement regime); or
2. the third country CRA, *inter alia*:
   a. is authorised or registered in and is subject to supervision in a third country which has been the subject of an equivalence decision adopted by the European Commission recognising the legal and supervisory framework of that third country as equivalent to the requirements of the CRA Regulation;
   b. does not issue credit ratings and carry out credit rating activities which are of systemic importance to the financial stability or integrity of the financial markets of one or more Member States; and
   c. has been certified by the European Securities and Markets Authority ("ESMA") (the certification regime).

The equivalence test under paragraph 2(a) above is particularly stringent given that it requires the European Commission to undertake a thorough assessment of the relevant third country regime in order to adopt an equivalence decision. In 2010 ESMA's predecessor, the Committee of European Securities Regulators ("CESR") published technical advice on the equivalence of the United States and Japan with the European regime. The equivalence of the EU and Japanese regimes was confirmed by a decision of the European Commission in September 2010. In relation to the US regime, regulators appear to have reached an impasse with the European Commission dragging its feet over making a determination of equivalence (it is thought due to uncertainties as to how the Dodd-Frank Act will be implemented) and the Securities and Exchange Commission ("SEC") awaiting the outcome of the equivalence assessment before agreeing cooperation arrangements. An assessment of the Australian regime is ongoing.

The standards for endorsement have also proved to be a bone of contention. The European Commission appears to favour an approach which would require the third country CRA to have arrived at its credit rating by a process that is both "as stringent as" the EU one and enshrined in domestic legislation.

Further progress for other jurisdictions where endorsement or certification applications are pending is now likely to be bogged down given that many countries either do not yet have a regime in place or are grappling with a new regime in its infant stage.

Amendments to the CRA Regulation

In December 2010, the European Parliament adopted a series of amendments to the CRA Regulation which were approved by the EU Council in April 2011. The final text of the amended CRA Regulation was published on 11 May 2011.

"ESMA will be responsible for approving applications for registration under the CRA Regulation and has also been granted significant powers of enforcement in respect of CRAs that do not comply with their obligations under the CRA Regulation"

ESMA's supervisory role

Supervision of CRAs will be transferred from national regulators to ESMA from July 2011 (national regulators will retain responsibility for the supervision and enforcement of those provisions of the CRA Regulation relating to the use of credit ratings for regulatory purposes). ESMA will be responsible for approving applications for registration under the CRA Regulation and has also been granted significant powers of enforcement in respect of CRAs that do not comply with their obligations under the CRA Regulation, including the ability to launch investigations, carry out dawn raids and impose fines or other penalties such as withdrawing a CRA's registration or suspending the use of credit ratings issued by a CRA. ESMA must also carry out checks by July 2014 on all CRAs' compliance with their "back testing" obligation.

Issuers of structured finance instruments

Issuers of structured finance instruments will now be required, subject to certain organisational and confidentiality conditions, to provide access to information to all interested CRAs, as well as the CRA which they appoint. The competing CRAs will then be able to access the information necessary to produce an unsolicited rating of the relevant instrument. This obligation, which already exists in the US (see below), is intended to reinforce competition between CRAs, avoid possible conflicts of interest under the issuer-pays model and enhance transparency and the quality of ratings. Whilst the intention in allowing the issuance of unsolicited ratings is to promote the use of more than one rating per financial instrument, the US precedent is not an encouraging indicator that this will be the end result.

What's next?

Commission's proposals on further amendments to the CRA Regulation

In November 2010 the European Commission published a consultation paper on issues relating to the activities of CRAs which have not yet been addressed by the CRA Regulation. In particular, the consultation paper looks at:

1. reducing reliance on credit ratings by financial market participants and encouraging firms to undertake their own credit risk assessments;
2. introducing a civil liability regime for CRAs that infringe provisions of the CRA Regulation;
3. increasing disclosure requirements for issuers of structured finance products in order to allow investors to carry out their own due diligence on a well informed basis; and
4. reducing conflicts of interest and preventing rating shopping.

A key proposal has been the creation of a new independent European CRA, backed by partial public funding, designed to stimulate competition in a market dominated by three big players: Standard & Poor's, Moody's and Fitch. The idea has, however, so far received a lukewarm response with the European Central Bank voicing concerns over the time it would take such a body to develop the methodology and practical experience necessary to become fully operative and whether the end result would in fact be the creation of artificial barriers to entry for new private entities.

The consultation has now closed and a legislative proposal is expected later this year. No timeline has yet been proposed for implementation of the new measures.

ESMA guidelines on the application of the endorsement regime

ESMA has been charged with updating the guidelines on the application of the endorsement regime adopted by CESR in June 2010. ESMA's feedback on a consultation paper issued in March 2011 has not been published at the time of writing. The intention is for the final guidelines to be adopted by 7 June 2011. The responses to the consultation paper make for interesting reading and demonstrate the strong criticism of the current approach to endorsement. Market participants are clearly concerned about the real potential to prohibit the use of credit ratings for regulatory purposes from major non-EU jurisdictions and the risk of significant increases in regulatory capital requirements.

ESMA technical advice on fees for CRA supervision

ESMA published a consultation paper in April 2011 on its technical advice to the European Commission on fees for the EU registration and supervision of CRAs and is due to deliver its advice to the Commission by 13 May 2011. Proposals set out in the consultation paper included a single periodic supervisory fee based on the turnover of the CRA relative to other CRAs registered in the EU and registration fee bands based on objective criteria for assessing the complexity of applications.

Level 2 measures

In a progress report on its reforms in the financial services sector published by the European Commission in February 2011, it was announced that the Commission intends to adopt "level 2" implementing measures for the CRA Regulation by July 2011 and ESMA is currently drafting regulatory technical standards for this purpose.

US legislation

The Dodd-Frank Act

As in Europe, credit rating agencies have received increased scrutiny in the United States following the recent financial crisis. Congress pointedly remarked in the Dodd-Frank Act that "inaccuracy [in the ratings on structured financial products] contributed significantly to the mismanagement of risks by financial institutions and investors…" and further concluded that "such inaccuracy necessitates increased accountability on the part of credit rating agencies." The Dodd-Frank Act therefore includes a variety of provisions (sections 931-939) aimed at increasing the transparency, accountability and accuracy of credit ratings, and the SEC has passed a number of new requirements intended to address perceived problems in the ratings process.

Conflict of interest rules

Even prior to the passage of the Dodd-Frank Act, in order to promote competition in the ratings industry and alleviate potential conflicts of interest, the SEC adopted Rule 17g-5. This rule requires each credit rating agency registered with the SEC (known as a "Nationally Recognised Statistical Rating Organisation" or an "NRSRO") to maintain a website listing all structured transactions, public and private, sold in the US (or with a US issuer) which they are hired to rate. These websites are accessible only to the other NRSROs and are required to contain links to a second set of websites, maintained by each transaction sponsor, for each transaction the NRSRO was hired to rate. Transaction sponsors, in turn, are required to post to this website all information provided to the hired NRSRO. The idea behind this requirement is that NRSROs that are not "conflicted" as the result of receiving a fee from the transaction sponsor would provide a check on the integrity of the ratings provided by the hired NRSRO by reviewing the information on the sponsor websites and providing "unbiased" ratings. However, the rule was so broadly worded that it requires any substantive communications (even phone calls) with the NRSRO to be uploaded onto the sponsor's website, which initially presented significant logistical issues to transaction participants. Even after those issues were largely resolved, industry consensus is that few, if any, NRSROs have availed themselves of this information to issue unsolicited ratings of structured products.

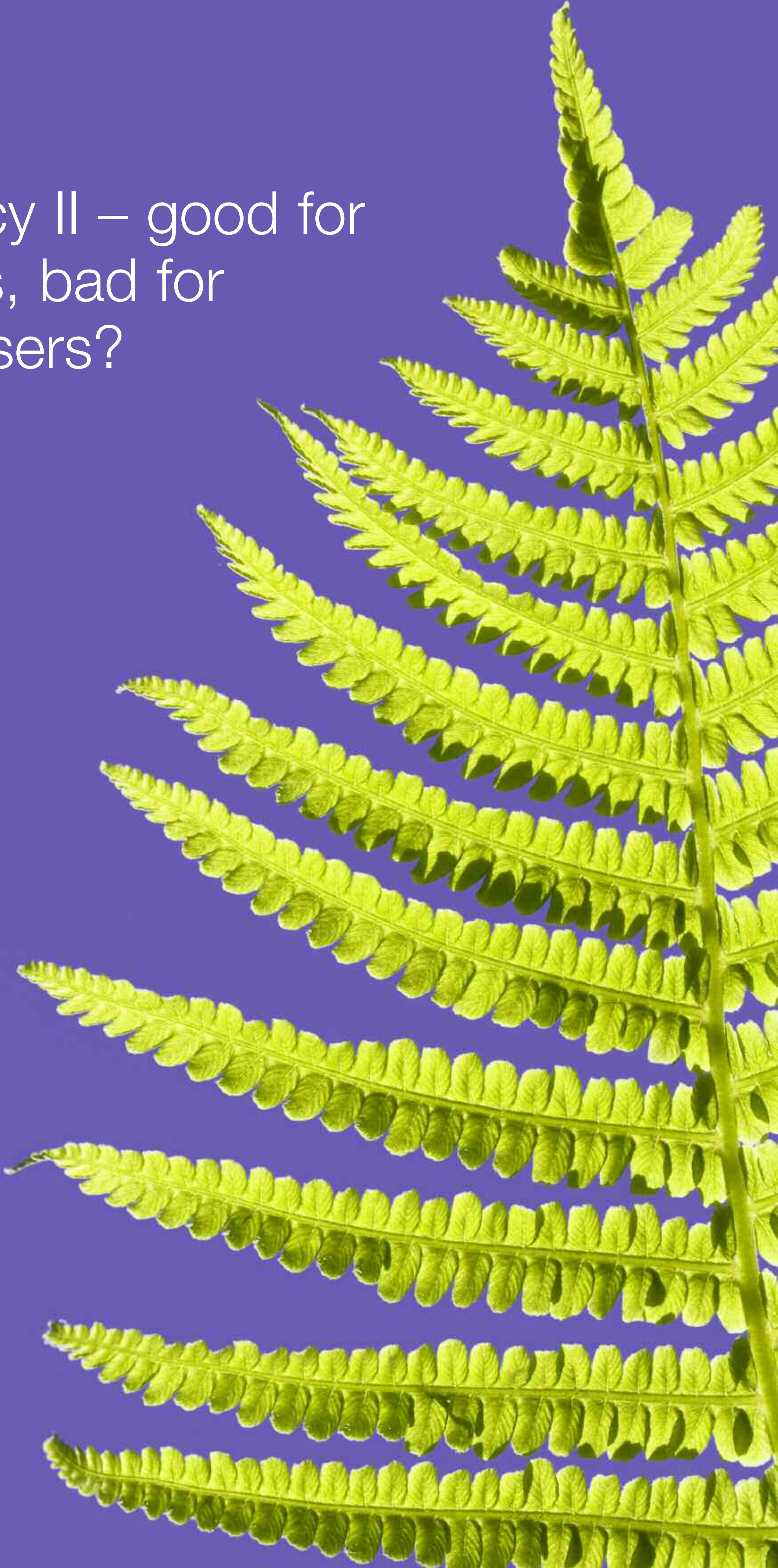
"Whilst the intention in allowing the issuance of unsolicited ratings is to promote the use of more than one rating per financial instrument, the US precedent is not an encouraging indicator that this will be the end result"

Given that it remains unclear how effective Rule 17g-5 and other measures taken by the SEC have been in removing perceived conflicts of interest from the ratings process for structured products, it is possible that Congress might still adopt the more burdensome "Franken Amendment", which would resolve the conflict of interest issue by taking the responsibility of choosing a credit rating agency out of the hands of the market and placing it with the SEC. Under the Franken Amendment, a ratings oversight board comprised of a majority of investor representatives would select the rating agency to conduct the initial evaluation of each new set of structured finance products. This draconian method, which would address the conflict of interest problem by removing the issuer's discretion altogether, has been met with considerable opposition from market participants.

Disclosure obligations

Regulatory changes on asset-backed securities ("ABS") in the U.S. have likewise increased the disclosure obligations of NRSROs. Notably, the SEC recently passed a number of rules aimed at enhancing market information on filled and unfilled repurchase requests. As part of the repurchase request disclosure requirements, the SEC also adopted Rule 17g-7, which requires NRSROs to include in a credit report relating to ABS a description of representations, warranties, and enforcement mechanisms available to investors in a rated ABS, and a description of how these representations and warranties differ from issuances of similar securities. The meaning of "similar securities" has been the subject of some uncertainty. The new rule, which becomes effective on 28 September 2011 would apply to non-US issuers in private markets and applies to any credit report issued by an NRSRO thereafter.

7. Solvency II – good for insurers, bad for securitisers?



Much has been made over the last two years by industry participants of amendments to the Capital Requirements Directive ("**CRD**") and in particular, Article 122a of the CRD which introduced restrictions on European bank investors in securitisation positions. Relatively less focus has been directed by the securitisation industry at new European regulation of the capital position of insurance undertakings known as the Solvency II Framework Directive ("**Solvency II**"). This may be due to the fact that the provisions of Solvency II remain in draft (unlike Article 122a which became effective from 1 January 2011); however, although Solvency II is not in force, certain provisions under Solvency II are effectively in place at present as the restrictions relating to repackaged loans are only grandfathered prior to 1 January 2011. What has become abundantly clear is that the current provisions for assessing capital requirements under Solvency II treat securitised positions in a disproportionately adverse way, especially when compared to the capital treatment ascribed to certain other asset classes such as corporate bonds and covered bonds or even the actual loan collateral backing a securitisation.

Background to Solvency II

The current regulatory regime for insurance firms provides quantitative investment criteria for admissibility which restricts the investment discretion of insurers. In place of this, Solvency II will provide a risk-based, economic-based and principle-based framework for the supervision of insurance undertakings. Solvency II will introduce a principles-based "prudent investor" approach which means that investments must be made to ensure the security, quality, liquidity and profitability of the asset portfolio as a whole.

Solvency II provides a framework for a new approach to capital resources requiring insurers to hold capital resources to cover technical provisions plus a risk margin (allowing them to meet their commitments to policyholders arising from their expected obligations under insurance contracts) and in addition to cover unexpected losses over a one year time period arising from risks affecting their business, including underwriting risks, market risks, counterparty risks and operational risks. Insurance firms will be required to hold sufficient financial resources of the right quality to cover those risks and capital and excess assets will meet these financial resources requirements if they satisfy certain criteria depending on availability, loss absorbency and subordination.

Two target levels of capital resources are specified under the regime, namely the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR).

The capital requirements to support risk arising from different types of investment by an insurer will be calculated principally in accordance with the market risk module forming part of the standard SCR formula set out in Level 2 Regulations or using an approved internal model. One consistent criticism of Solvency II is that the new provisions for calculating the SCR are overly complex and technical; it is difficult to fully understand the ramifications of the draft provisions for certain products as provisions can be read in a number of ways which produce conflicting results and certain key provisions have changed over successive drafts of the rules without explanation, causing further confusion. However, in the following sections, we provide some explanation of the various market risk sub-modules within the calculation (based on the latest published draft rules) and explain the anticipated implications for asset-backed securities.

Impact of SCR market risk module

Regulations to be made under Solvency II will require the SCR to be calculated by reference to a number of modules and sub-modules each focused on a particular category of risk. It should be noted that the capital requirements set out in Solvency II reflect the standardised approach; individual insurance undertakings are entitled to develop their own risk models which will be approved by the relevant local regulator. We understand that almost 200 insurance undertakings have submitted their own advanced models to the FSA alone for preliminary approval. The following sections only deal with the standardised approach.

As part of the SCR calculation insurance undertakings are required to calculate the capital requirement for market risk in respect of relevant assets and liabilities which reflects interest rate risk, equity risk, property risk, spread risk, risk concentrations, currency risk and illiquidity premium risk. The results of these separate calculations are then combined to provide an overall capital requirement for market risk using a correlation matrix.

Treatment of asset-backed securities

Methodology currently proposed for ABS within Solvency II disproportionately prejudices ABS

The standard formulae for calibration of the capital charges attributable to ABS appear principally in the spread risk component within the market risk module although other sub-modules could also apply including concentration risk and currency risk. Much industry concern has been voiced over the clear imbalance in the capital treatment of asset-backed securities when compared with corporate bonds and covered bonds. This is due to the fact that the capital treatment for corporate bonds and covered bonds is linked to a single calculation (with preferential treatment given to certain eligible AAA rated covered bonds due to a lower attributed spread shock factor) based on the rating and duration of the bonds themselves. However, the capital charge for ABS is calculated using one of two formulae. The applicable formula is the one which produces the higher of two capital requirements. These two formulae are (1) the requirement based on the corporate formula above but with higher spread shock factors and (2) a "look-through" requirement based on the rating and tenor of the underlying assets in the structure. Interested parties such as the Association of Financial Markets in Europe ("AFME") have pointed out to the European Insurance and Occupational Pensions Authority ("EIOPA")[1] that the "look-through" approach gives rise to incongruous results; most obviously, due to the fact that most ABS underlying collateral is unrated, the look-through approach will generally provide a significantly higher capital charge than the spread risk approach which applies to corporate bonds and covered bonds of similar rating. This does not make much sense when comparing an investment in RMBS to an investment in a covered bond referencing identical residential mortgage pools originated by the same originator for example. It seems that the differences stem from a fundamental suspicion of ABS structures which conflates some of the difficulties experienced with certain CLO structures to all asset classes irrespective of the quality of unrated granular asset pools such as prime residential mortgages.

Look-through requirement creates incongruous results

A second unexpected result of application of the spread risk sub-module of SCR is that the application of attachment and detachment points can result in lower capital charges for lower quality collateral. Typically high quality collateral will require less credit enhancement and therefore produce a lower attachment point; however, the blunt application of attachment points as a proxy for quality would result in a higher capital charge for many typical prime RMBS structures than for a typical sub-prime RMBS as demonstrated in Tables 1 and 2 taken from analysis generated by Bank of America Merrill Lynch.

In addition the capital requirements in relation to a portfolio of individual loans secured on property appear to be lower

Table 1: Typical attachment points for securitisations of RMBS

	RMBS (Prime)		RMBS (Sub-prime)	
Rating	**Attach**	**Detach**	**Attach**	**Detach**
AAA	13.5%	100.0%	17.0%	100.0%
AA	9.0%	13.5%	10.0%	17.0%
A	6.0%	9.0%	6.0%	10.0%
BBB	2.5%	6.0%	2.5%	6.0%
BB	N/A	N/A	1.0%	2.5%

Source: BofA Merrill Lynch Global Research

Table 2: Solvency II estimated capital charges for securitisations of RMBS assuming 5 years duration

Rating	RMBS (Prime)	RMBS (Sub-prime)
AAA	11.6%	7.8%
AA	100.0%	100.0%
A	100.0%	100.0%
BBB	100.0%	100.0%
BB	100.0%	100.0%
Weighted Avg	23.5%	23.5%

Source: BofA Merrill Lynch Global Research

[1] Letter from AFME to EIOPA dated 31 March 2011 in response to QIS5 consultation.

"What has become abundantly clear is that the current provisions for assessing capital requirements under Solvency II treat securitised positions in a disproportionately adverse way, especially when compared to the capital treatment ascribed to certain other asset classes such as corporate bonds and covered bonds or even the actual loan collateral backing a securitisation"

(assuming a reasonable LTV ratio) than would be the case should the same portfolio be wrapped into an ABS instrument, since less credit appears to be given to the collateral in the latter case.

Restrictions on investing in repackaged loans

In addition to the adverse capital treatment of ABS, insurers may not be able to invest in such instruments at all if they do not satisfy certain criteria. Only one category of assets is excepted from the new principles-based prudent investor approach to investment under Solvency II: repackaged loans. These are defined as the repackaging of loans into tradeable securities and other financial instruments that effectively transfer credit risk from originators to investors. Prompted by the concerns which led to the promulgation of Article 122a of the CRD, the Solvency II Framework Directive bans insurers from investing in such repackaged loans unless the originator retains an economic interest of at least 5% and certain other qualitative criteria are met.

The CEIOPS final advice expands on these criteria and proposes onerous requirements. It lays down seven principles, including:

- The 5% retention by the originator must be on an ongoing basis throughout the life of the securities.
- The investing insurer will need to undertake significant due diligence on the sponsor and originator to ensure that they have sound criteria and processes for granting credit, effective systems and controls for ongoing administration and monitoring and for identifying problem loans, adequate diversification and adequate credit risk policies.
- There are onerous requirements for the investing insurer to monitor the investment on an ongoing basis and report risks, apply stress-testing and demonstrate a thorough understanding of the product and the risks.
- Significant due diligence and ongoing monitoring is required to ensure compliance with the criteria and if the rules are breached the securities must be disposed of. If it is not possible to dispose of the securities at a reasonable price and within a reasonable timeframe (i.e. it is not in the best interests of the policyholders to do so), alternative measures would be considered such as a capital charge.
- Existing investments as at 1 January 2011 can be grandfathered but the requirements will apply to these investments from 31 December 2014 where the underlying exposures are changed after that date.

The above proposals go beyond the scope of the implementation guidelines elaborated by the European Banking Authority in respect of Article 122a; in particular, the EBA has clarified that investors are not required to sell their bonds or suffer a higher capital charge if the originator fails to retain a 5% interest notwithstanding disclosure of its intention to do so. It is to be hoped (and we think it is likely) that the final rules and guidance under Solvency II will be conformed as much as possible to the Article 122a regime in order to avoid any unnecessary differences between the rules applying to banks and insurance companies. Indeed the original reason for the introduction of these provisions at a late stage in the development of the Framework Directive was to ensure a level playing field between banks and insurance company investors in ABS.

Does Solvency II incentivise insurers to become lenders?

Both insurance undertakings and banks have noted with interest the relatively favourable capital treatment which appears to be accorded to investments in loans directly and in particular commercial and residential mortgages which are secured over real estate. Although the interpretation of the relevant provisions varies, it seems that under the standardised approach, holdings in a commercial mortgage with a loan to value

"One consistent criticism of Solvency II is that the new provisions for calculating the SCR are overly complex and technical"

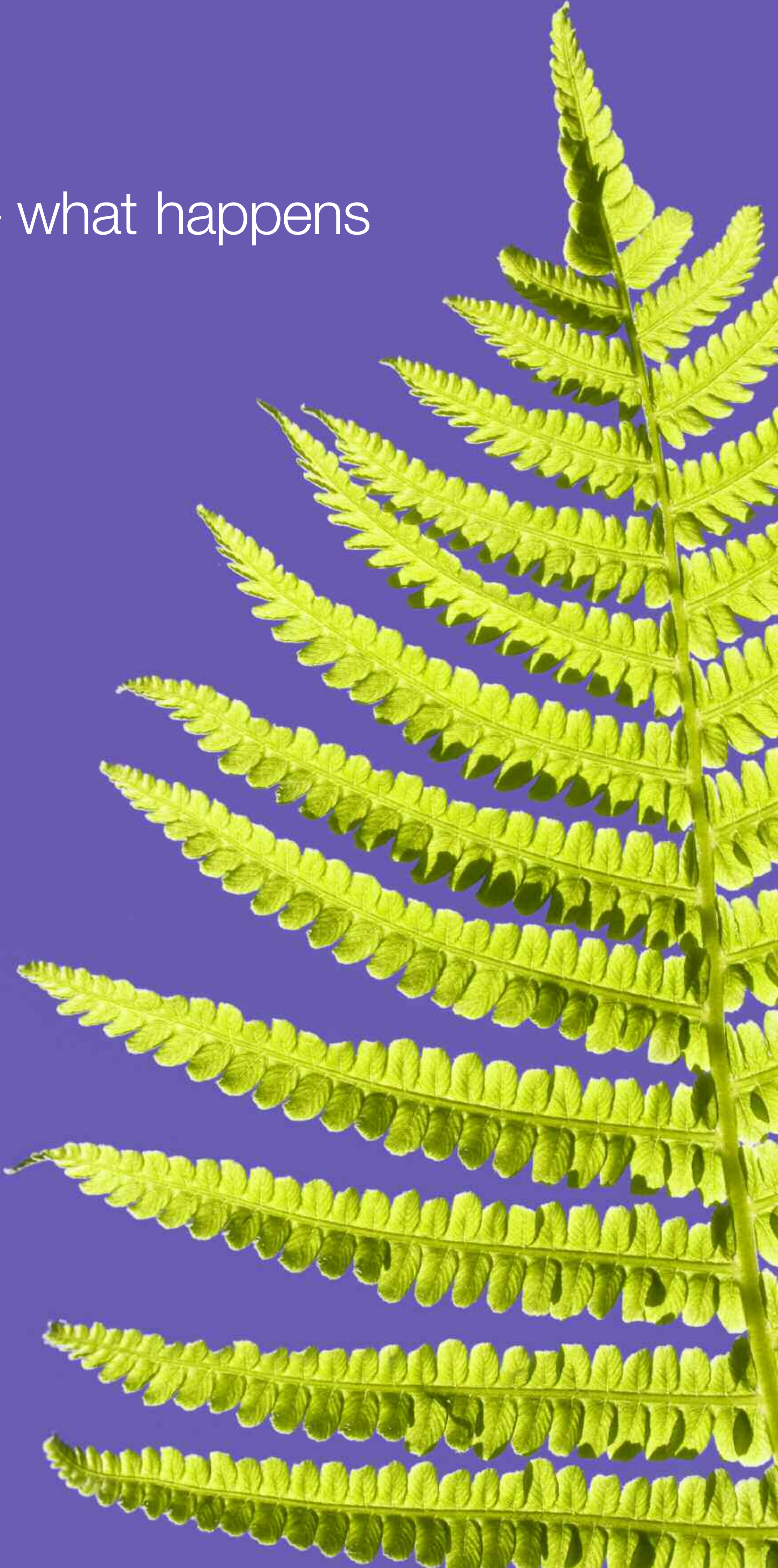
"It seems counter-intuitive that the capital treatment for holding a whole loan is better than that afforded to the senior tranche of an AAA rated RMBS or CMBS which benefits from subordination and credit enhancement and is therefore less likely to suffer a loss"

ratio falling within certain criteria would attract a capital charge of no more than 15% and possibly significantly less. Whilst this is a positive incentive for insurance undertakings to acquire commercial mortgage loans in the secondary loan market and even to acquire portfolios of residential mortgages, it seems counter-intuitive that the capital treatment for holding a whole loan is better than that afforded to the senior tranche of an AAA rated RMBS or CMBS which benefits from subordination and credit enhancement and is therefore less likely to suffer a loss. One of the key differences between investing in asset-backed securities as opposed to holding the assets directly is the perceived greater control afforded to a direct lender; whilst this is true of a bilateral position, the issue is less clear-cut for a widely syndicated loan position. However, it is not clear that any perceived lack of control should generate a vastly different capital position and does not take into account the positive benefits of investing in listed, tradeable securities such as greater liquidity.

Final rules awaited

In terms of timing of the final provisions of Solvency II, it is currently anticipated that draft Level 2 Regulations will be published in June 2011 and will be finalised before the end of 2011. Solvency II is scheduled to be implemented on 1 January 2013 though it is likely to be subject to transitional provisions in some areas. It is to be hoped that responses provided to Quantitative Impact Study 5 (QIS5) which elaborate on the inconsistent treatment described above and the complexity of the requirements will result in a less draconian treatment of ABS which is more commensurate with the economic risks of investing in ABS.

8. CRD3 – what happens next?



The deadline for changes to the CRD taking effect has been pushed back to the end of the year. Regulators still do not have a plan for implementing many of the changes, and clients are left asking "what happens next?"

Key points

The FSA has yet to publish final rules for implementing the main key requirements of Directive 2010/76/EU ("CRD3") relating to trading books, re-securitisations and disclosure of securitisation risks. The European Banking Association (the "EBA") is mandated under CRD3 to provide guidance to national regulators as to its implementation, and in these areas its proposals either remain in the consultation phase or are yet to be published in their finality.

CRD3 is unclear with respect to a number of key details, such as what is caught within the definition of "re-securitisation", and what transitional provisions will apply. The current lack of information with respect to timing and implementation for most provisions of CRD3 will continue until very close to the end of year deadline and affected parties will not have much time to prepare.

More consultation than guidance

CRD3 follows Directive 2009/111/EC ("CRD2") in forming part of a sequence of major amendments to the Capital Requirements Directive (the "CRD"). In addition to amending regulation of remuneration policies, CRD3 amends the following areas of the CRD in respect of capital requirements: assessment of trading books, re-securitisations, disclosure of securitisation risks and collateral eligibility for covered bonds.

The original deadline for implementing CRD3 was 1 January 2011. However, only rules in respect of remuneration have been implemented in the UK (primarily in SYSC 19A (Remuneration Code) (the "Remuneration Code") and BIPRU 11.5 (Technical criteria on disclosure: General requirements)). These rules apply from 1 January 2011 in respect of firms already within the scope of the Remuneration Code and by 1 July 2011 at the latest in respect of firms that are newly within its scope.

In June 2010 the Commission pushed the deadline for implementing the remaining CRD3 requirements to 31 December 2011. The FSA has responsibility for implementing CRD3 requirements in the UK. It published CRD3-related proposals in July 2010, but did not include any final rules in respect of trading books, re-securitisations and securitisation risk disclosure.

The FSA circulated the consultation document *Strengthening Capital Standards 3 – further consultation on CRD3 (CP11/9)* in May 2011 with a 2 month consultation period to follow.

It is important to note, however, that the FSA intends to "copy-out" some provisions of CRD3 (such as in respect of covered bonds) directly into its rules without further consultation.

Re-securitisations

CRD3 increases the capital requirements for banks investing in re-securitisation positions (which will receive a higher risk weighting than securitisation positions). How wide the net is in catching re-securitisations remains to be seen. "Re-securitisation" is defined as securitisation where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation position.

The broad definition and lack of materiality threshold make one question whether any tranched position exposure to an asset pool would be considered a re-securitisation exposure, even if only a single underlying asset in the pool is a securitisation exposure. What is clear, however, is that instruments will be treated as re-securitisation exposures where performance is linked to one or more re-securitisations (for example, CDOs of asset-backed securities would be caught).

The FSA position in respect of commercial paper issued under an ABCP programme as set out in the consultation paper *Strengthening Capital Standards 3 (CP09/29)* (December 2009) is that they will not generally be considered to be a re-securitisation position provided the conduit funds itself entirely with a single class of paper and either of the following are met:

1. the sponsor provides full support for the paper to the extent that the paper is effectively exposed to the default of the sponsor, instead of the underlying assets; or
2. programme-wide credit enhancement ("PWCE") is not a re-securitisation, and not tranched (i.e. the PWCE covers all losses above the sponsor-provided protection across the various pools of underlying assets).

The CEBS Guidelines on Article 122a published at the end of December 2010, adopt a different conceptual position to the FSA. In the view of CEBS (prior to its absorption into the EBA on 1 January 2011) ABCP conduits are almost invariably separate securitisation schemes and therefore subject to Article 122a on a stand-alone basis regardless of the transactions that they are undertaking. However, CEBS recognised, in informal

"How wide the net is in catching re-securitisations remains to be seen" communication, at least, that this would mean that a securitisation being placed or funded through an ABCP conduit could well result in exposures to the ABCP conduit (for example by commercial paper investors) being re-securitisation positions under the CRD3 proposals. Our belief is that CEBS wanted to include ABCP conduits within Article 122a and considered that the EBA, as its successor, would look separately at how best to deal with ABCP conduits and re-securitisation under the CRD3 proposals thereby making use of the opportunity given by the delay in implementation of CRD3.

In our view the FSA position is more logical and practical and would avoid many concerns for ABCP conduits under Article 122a and CRD3. However, CEBS, in our view, took a clear policy decision on behalf of European banking regulators to include ABCP conduits in Article 122a and hence our expectation is that this policy decision will need to be worked through CRD3 on re-securitisations before it is implemented. Our feeling in this regard, on the basis of previous helpful adjustments to CRD3 and CEBS' tacit acknowledgement that traditional ABCP conduits are not the intended target of re-securitisation rules, is that the CRD3 proposals will be changed to address some of the concerns in respect of ABCP conduits. In the meantime, as mentioned above the FSA has issued *Strengthening Capital Standards 3 – further consultation on CRD3 (CP 11/9)*, which sets out proposals for implementing the current text of CRD3 on re-securitisations. These proposals will, of course, need to change if CRD3 is amended.

Trading book

Changes to the CRD reflect increases to capital requirements with the intention of addressing traditionally low levels of trading book capital, and differences between banking books and trading books in credit risk and illiquidity. CRD3 seeks to equalise capital charges for securitised products in a trading book with existing charges in the relevant banking book.

CRD3 introduces a new incremental risk charge (the "IRC") for all firms that use internal models to calculate their exposure to market risk, also known as method value-at-risk ("VaR") modelling.

Firms using VaR modelling will also be required to calculate on a weekly basis charges for a stressed calibration of the VaR capital charge, based on a historical period of stressed market conditions ("stressed VaR").

The IRC will apply to firms that have approval from national regulators to model based on the risk of a price change in an investment due to issuer-based factors "specific risk" in its trading book. The IRC is intended to replace an incremental default risk charge (the "IDRC") on capital relating to the potential for direct and indirect loss arising from a default in a trading book. The effect of the IRC will be to address not only default risk, but also "migration risk" for unsecuritised credit products (i.e. the risk of a loss due to an internal or external ratings change or a credit migration event).

"In addition to preparing for CRD3 as soon as final rules are issued, clients should be aware of the status of any current waivers from FSA rules that may be affected"

"Affected parties will not have much time to prepare"

CRD3 permits firms to use an approach for capturing incremental default and migration risk that does not comply with the parameters set out in CRD3, provided that the resulting capital requirement is at least as high. To implement this, the FSA proposes the use of a waiver which would allow firms switching to a modelled advanced approach to calculate their previous capital requirements on the basis of the CRD Standardised Approach, rather than Basel I. The FSA's initial proposals for implementing measures were circulated for comment in December 2009, but final rules have not yet been published.

CRD3 gives the EBA a mandate to monitor practices in this area and to develop guidelines to ensure consistent implementation across member states. Such guidance, however, is still pending.

Disclosure of securitisation risks

CRD3 extends the obligation to disclose information relating to securitisation risks to include trading books as well as banking books. Information about trading books and banking books must be disclosed separately, and they must disclose any re-securitisation positions in each.

In addition all securitisation activities of a sponsor must be disclosed, and broken down between on-balance sheet and off-balance sheet exposures.

Covered bonds

CRD3 introduces changes to the eligibility criteria for the assets that may be used to collateralise covered bonds. The amendments change certain asset eligibility criteria and the transactional provisions relating to these. However, the types of assets affected by the changed eligibility criteria are very specific (e.g. units issued by French Fonds Communs de Créances) and from a UK perspective UK-regulated covered bond issuers do not currently include such types of assets in their covered bond collateral pools.

The FSA adopted a "copy-out" approach to the changes related to covered bonds and due to a lack of comments from stakeholders, intends to implement its proposed changes in relation to covered bonds without further comment or consultation.

Existing waivers may be in jeopardy

In addition to preparing for CRD3 as soon as final rules are issued, clients should be aware of the status of any current waivers from FSA rules that may be affected. The FSA are prohibited from waiving directive requirements unless expressly set out in the relevant directive.

There may be scope for waivers from rules introduced or retained that go beyond CRD requirements; however, clients that currently rely upon waivers from FSA rules should assess the importance of such waivers in respect of their business and consider alternatives in the event that such waivers are no longer available.

9. The Financial Services Compensation Scheme and The Banking Act 2009 – set-off risk revisited

Since we last wrote on this subject in our New Horizons publication in June 2010, the European Commission has moved to strengthen protection for depositors[1]. Some of these changes have already been incorporated into UK law[2], others are likely to be made between now and the end of 2012. We are of the opinion that these changes operate to further reduce the risk of depositors setting off amounts owed to them against amounts they owe to a bank. This should mean that transactions will need less credit enhancement for current account set-off risk. This article considers recent and proposed changes to the Financial Services Compensation Scheme (the "FSCS") and the Banking Act 2009 (the "Banking Act") and the extent to which these reduce the set-off risk for securitisation transactions.

A brief summary of English law set-off considerations

We set out below a brief summary of the relevant types of set-off under English law.

In certain circumstances, depositors can set off deposits they hold in an originating bank against amounts they owe under the securitised receivables. Generally, the originating bank will not have notified the depositor at the time of assignment that their loans have been assigned to the issuing entity. In such a situation, a depositor may be able to exercise the following rights of set-off, which arise prior to receiving notice of the assignment:

1) Legal set-off: this is only available as a defence to a court action where both claims are liquidated and ascertainable with certainty and due and payable at the commencement of the action. The claims do not have to arise out of the same transaction or connected transactions. This is not a 'self-help' remedy and can only be exercised after court action; and

2) Equitable set-off: this is only available where the cross-claim arises out of the same or closely connected transactions. The depositor may deduct the amount of their cross-claim from the debt they owe to the originating bank under the loan, and tender the balance of the debt (if any) to the originating bank. The amounts must be due and payable.

Once notice of the assignment of the loan to the issuing entity has been given to the depositor, no further set-off rights in respect of unrelated cross-claims will accrue between the depositor and the originating bank, although a depositor may still be able to exercise the following rights of set-off:

1) Legal set-off: where the cross-claim was accrued due to the depositor before the depositor received notice of the assignment and both claims are liquidated and ascertainable with certainty;

2) Equitable set-off: where the cross-claim arises out of the same loan or is sufficiently connected with that loan so as to allow the depositor to deduct amounts due from them to the originating bank; and

3) Insolvency set-off: on insolvency of the originating bank or bankruptcy of the depositor, mandatory set-off would arise where there is sufficient mutuality between the sums owed.

Concerns about set-off

Some rating agencies have expressed concerns about the possibility of a depositor setting off amounts owed to it by the originating bank against amounts it owes to the issuing entity. This could result in cash-flow problems for the issuing entity and is one factor in the credit enhancement calculations of the rating agencies. In particular, there is some debate about the time from which the deposit may be set off, whether it has to be due and payable or whether it is sufficient that the claim is in existence. Our view remains that only cross-claims relating to deposits for which the time for payment has fallen due and for which demand has been received by the originator prior to the giving of notice are capable of being set off by the borrower against the issuing entity in respect of the securitised receivables.

This article will focus on the concerns raised and how these are mitigated by the legislation surrounding deposit protection schemes and how this has evolved in the last year.

Impact of the FSCS up to 31 December 2010

The FSCS was established on 1 December 2001 as a compensation fund of last resort for customers of authorised financial services firms. If a bank or other deposit-taking financial institution was unable to pay or likely to be unable to pay claims made by borrowers with respect to deposits they had with that institution, then a maximum compensation of £50,000 was available to the depositor under the FSCS.

[1] EU proposal to strengthen deposit-guarantee schemes (July 2010).
[2] SI 2010/2583.

This maximum amount of £50,000 was to be paid to the depositor net, after having set off any amounts owed by the depositor to the bank. The FSCS was and still is only required to compensate a depositor in respect of a protected deposit where the depositor, insofar as it is able and required to do so, assigns the whole of its rights to the FSCS. After such an assignment, the depositor would no longer have any right of set-off.

As the compensated amount was not ring fenced and could be set off against amounts owing from the depositor, depositors may have been discouraged from choosing the FSCS route, especially where the uncompensated deposits were equal to or larger than the debt. Instead the depositor could choose to set off the whole amount owed against all of its deposits.

Recent changes to the FSCS

From 31 December 2010 a number of changes have been made to the FSCS, due mainly to changes in the underlying EU provisions. The two most important changes are the increase in compensation up to £85,000 and that the compensation must now be paid gross.

Maximum compensation limit

The amount of compensation was set by the European Commission at €100,000. This is a maximum harmonisation measure and so members states do not have any discretion to set a higher or a lower limit. In the UK this limit has been set at £85,000, which is to be reviewed every five years in light of currency fluctuations. Maximum harmonisation was chosen in order to ensure a level playing field, to promote financial stability, and to protect the free movement of capital. For example, during the credit crises, British depositors transferred their deposits to Ireland, which had introduced unlimited deposit guarantees. This was very disruptive for British banks.

> "Across the EU, 95% of eligible accounts will now be covered by a deposit protection scheme"

> "This is a maximum harmonisation measure and so members states do not have any discretion to set a higher or a lower limit"

Member states retain the flexibility to protect larger deposits arising from real estate transactions and certain life events (such as divorce) above the €100,000 limit, provided that such protection is limited to 12 months[3]. This has not yet been incorporated into English law but if the European Commission's proposal of July 2010 is accepted by the European Parliament and the European Council then this may become part of English law in due course.

This increase means that across the EU, 95% of eligible accounts will now be covered by a deposit protection scheme. While it is arguable that the FSCS might not effectively reduce the risk of set-off in relation to deposits which are greater than £85,000, our view is that this increase further reduces the risk to banks and issuing entities of depositors applying set-off as the number of depositors who are not eligible for FSCS or other deposit protection scheme compensation has been reduced. Furthermore, even for deposits above £85,000 a depositor may prefer to choose the FSCS route as they may prefer the short-term security of £85,000 available immediately in their bank account over the long-term benefit of a reduction in their debt to the bank. Indeed, such a depositor may only choose to exercise set-off in respect of the excess over £85,000 or not at all if the time and expense involved in going to court is too much.

Gross payments

From 31 December 2010 payments made by the FSCS to depositors are to be made gross, with no set-off. Set-off can only be applied where the total of the sums held by the bank for the depositor exceeds the limit of £85,000 and only in relation to any amount above that limit[4]. As set out above, a depositor is likely to prefer the security of having easy access to a sum of money, rather than having to go to court to set off a sum against a longer term debt. Also, as depositors who want to use the FSCS will have to assign their rights to the FSCS, there will no longer be any mutuality so even for those few depositors with amounts over £85,000 their ability to set off will be lost if they choose this route.

Implications of changes to the FSCS on set-off risk

As set out in our 2010 article, our view is that the FSCS is an effective mitigant of the set-off risk relating to deposits. This view has been reinforced by the recent changes, as (a) the change to gross payments will further encourage depositors to choose the FSCS route

[3] EU proposal to strengthen deposit-guarantee schemes (July 2010).
[4] SI 2010/2583.

“Too much weight is given to the risk of current account set-off in structuring and rating securitisation transactions”

and therefore assign their rights to the FSCS and (b) the increase in the amount compensated has reduced the overall number of depositors who would have a large enough deposit to consider pursuing a claim outside the FSCS. This lower risk should be reflected in the structuring of securitisation transactions and significantly less enhancement for current account set-off risk. This will lower the cost of securitisation transactions, thus benefiting the real economy by reducing financing costs for originating banks and the cost of credit for consumers.

Banking Act

Furthermore, key provisions of the Banking Act have a complementary mitigating effect on set-off risk, particularly for deposits above the £85,000 limit.

Section 4 of the Banking Act sets out certain special resolution objectives, which include the following:

- protecting and enhancing the stability of the financial system of the United Kingdom (including, in particular, the continuity of banking services);
- protecting and enhancing public confidence in the stability of the banking system of the United Kingdom; and
- protecting depositors.

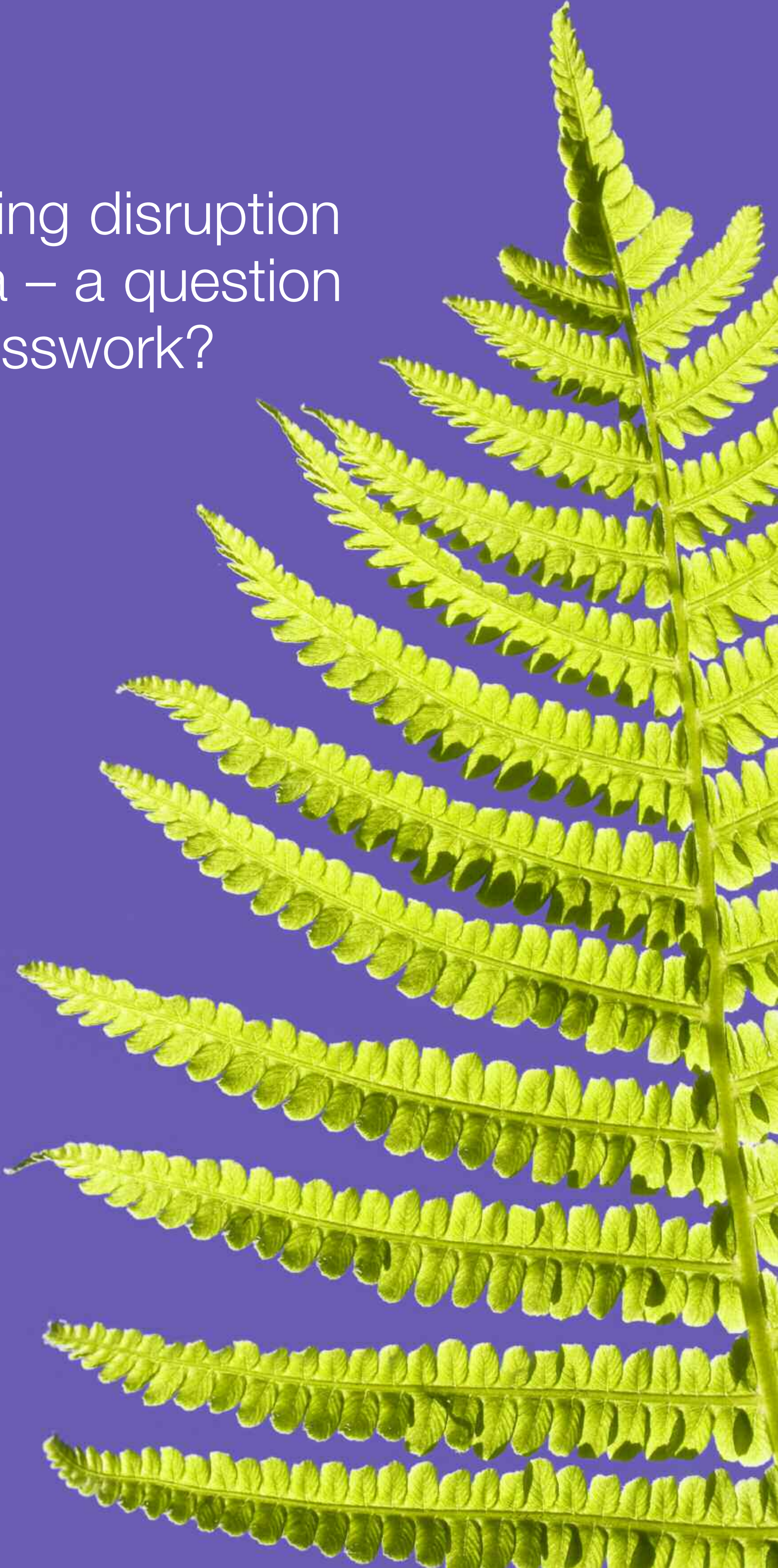
Ensuring the protection of deposits and avoiding a run on the banks is likely to be a major consideration for the authorities when considering these objectives. With this in mind, it is unlikely that cancelling the accounts of depositors on the grounds that their rights under such accounts could be set off against debts owed to originating banks would meet any of the objectives set out above. In addition, such action would be perceived as unfair and contrary to public policy as it would effectively prevent the depositor from having instant access to their funds in return for a reduction in their long-term debt obligations. Such action would also differentiate between depositors with loans outstanding with the same bank, and those whose loans were with banks they did not have a deposit with, which is also likely to be contrary to public policy.

In terms of funding of the FSCS, although the scheme is funded by contributions from the banks and financial institutions which are its members, in practice the scheme is ultimately backed by the UK government. The FSCS is a private company limited by guarantee and without share capital. The FSCS may borrow from the “National Loans Fund”, which is an HM Treasury account held at the Bank of England and created to stabilise the UK’s monetary system. Borrowings from this account must be for the purpose of funding expenses incurred or expected to be incurred under the scheme. These borrowings are expressly permitted under the Banking Act.

Conclusion

In our view, too much weight is given to the risk of current account set-off in structuring and rating securitisation transactions. The FSCS and the Banking Act were already acting to reduce this risk and have been strengthened since 31 December 2010. This area of law is heavily influenced by European Union law and we believe that the UK government and the European Union will continue to protect depositors and thereby reduce the risk of current account set-off for originating banks.

10. Servicing disruption criteria – a question of guesswork?



Moody's have recently introduced new criteria to mitigate their concerns on the ability to quickly replace a servicer on the insolvency of the originator and servicer in European ABS transactions. This is an additional layer of protection to the existing mechanisms currently employed, such as back-up servicers, servicer replacement downgrade triggers and back-up servicer facilitators.

Much of Moody's concern appears to arise from the perceived passivity of many of the counterparties to European securitisations and in particular the lack of contractual provisions requiring a trustee to find a replacement servicer or ultimately act as servicer to the extent no replacement can be found. This has led to greater focus on the availability of replacement servicers and cash managers and the timing implications for a smooth handover. The focus of this article is the new estimation provisions which have been introduced to recent deals to mitigate the risk of unavailability of data during periods where the servicing is disrupted.

In March 2011, Moody's published their "*Global Structured Finance Operational Risk Guidelines: Moody's Approach to Analyzing Performance Disruption Risk*" which provided that:

"Moody's will also seek to understand if liquidity can be drawn independently from the receipt of servicer reports during a servicing disruption and if the amounts due under the notes (and swaps or other senior payments) can be computed independently from the receipt of the servicer reports so that senior payments are not disrupted (for example by the use of "*estimation language*.")"

Moody's express the meaning of "estimation language" as follows:

"Estimation language refers to a structural feature in which payments of senior fees and expenses, swap and senior note interest payments continue to be made without a servicer report through the use of an estimated payable amount. In the cases where estimation language is used, we will review the structure taking into consideration the presence of the following features, among others:

(i) the terms of the notes acknowledges that payments to note holders can be made through use of estimated amounts;

(ii) swap counterparties have signed up to the use of estimation language;

(iii) estimation of notional outstanding is set to equal the outstanding amount at previous interest payment default;

(iv) excess spread is trapped during the estimation period;

(v) principal is trapped during the estimation period;

(vi) deferrable interest and step-up coupons are trapped during the estimation period;

(vii) a reconciliation mechanism is included in the waterfall and the swap agreement;

(viii) use of estimation language is expected to only cover the period before a replacement servicer becomes fully operational."

The absence of data from which payments can be calculated could result in a payment date arising with no means by which to calculate the payments due. The approach most commonly seen in recent transactions is where data is unavailable (for instance where the servicer becomes insolvent and is unable to comply with the information provision requirements of the documents) amounts payable are calculated on the basis of the trend shown in a recent series of payment dates. When the relevant data becomes available and the payments that should have been made are known, reconciliation payments are made. To date, the absence of a principal trapping mechanism and the continued ability to pay excess spread during any period where amounts are being estimated has not resulted in a lower than expected rating although this is expected to change.

Swap counterparties are also very involved in negotiating the estimation language as they rightly see strongly worded estimation language (which could, for instance, require principal and excess spread trapping) as providing an extra protection for themselves.

Given that most transactions already have back-up servicers in place, or, as we have seen on some recent transactions, a back-up servicer facilitator (to facilitate the appointment of a back-up servicer should the servicer be downgraded), the chance that, at any particular time, data would not be available in order to make calculations is fairly slim.

Another point to note is that Moody's are not the only firm who identify and try to mitigate the risk of absent data. Swap counterparties too are more aware of it and in some instances are pro-actively requiring and heavily negotiating the inclusion of estimation language in order to protect themselves, should data on a particular transaction become unavailable (for example, to ensure there is enough cash in the structure to ensure a reconciliation payment can be made if a number of payments are made on the basis of an estimated swap notional amount that turns out to be wrong).

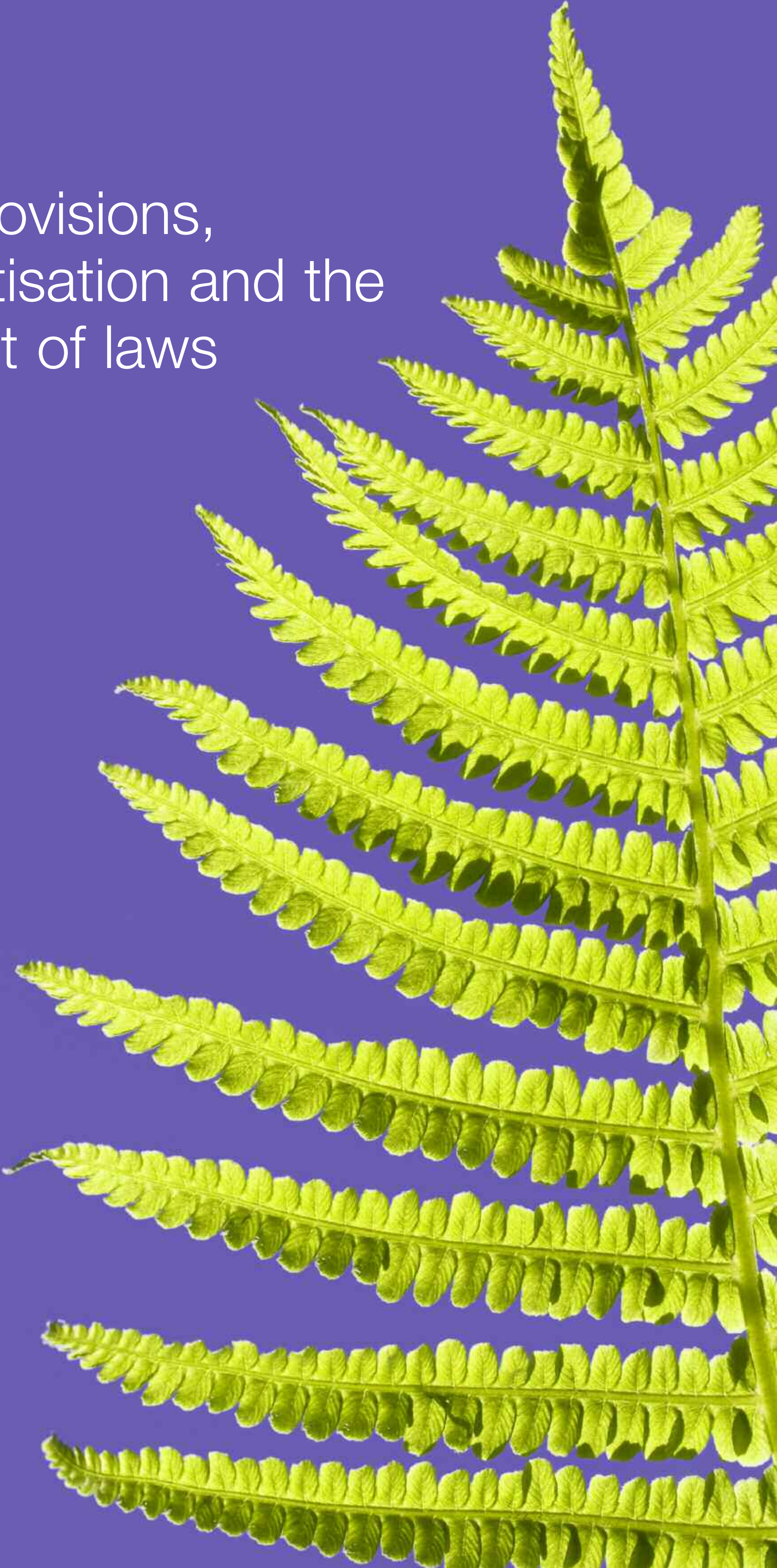
As more transactions which fall under these new criteria are closed we expect to see a pattern emerge where a balance is drawn between the likelihood of data being unavailable and the impact of estimation periods on the cash flow – where the likelihood is low (for instance when there is an ample choice of replacement servicers and the data is readily accessible to a replacement), we would expect the cash flows to continue as normal, albeit based on estimates. Where the likelihood is high (for instance, where there are not that many replacement servicers in the market or the data is stored in a manner which is not easily shared), we would expect to see more significant changes – for instance principal trapping during such periods. In recent practice the approach adopted has not been entirely intuitive as the new criteria have been applied in transactions with small originators with small portfolios but not in transactions with large originators with large portfolios whereas it is likely there are a large number of institutions capable of servicing small portfolios (originated by smaller originators) while the number of institutions capable of servicing large portfolios (originated by larger or more highly rated originators) is significantly less.

"As more transactions which fall under these new criteria are closed we expect to see a pattern emerge where a balance is drawn between the likelihood of data being unavailable and the impact of estimation periods on the cash flow"

We would anticipate the likely consequences of incorrect estimates to also form part of this balance – for instance, on an RMBS, an estimate of a single month's figures based on a historical trend are unlikely to be far from reality, and any reconciliation needed would likely be comfortably serviced by receipts in the next collection period – however, if there is a revolving pool, where the principal balance could change quite significantly from one payment date to the next, it may be more sensible to trap cash, until the actual shape of the underlying portfolio is known.

If these criteria remain a permanent fixture for ABS transactions, as the market begins to open up further and more transactions close we hope to see a more consistent pattern of application emerge as to how they are applied to transactions.

11. Flip provisions, securitisation and the conflict of laws



It is now more than 18 months since the Court of Appeal handed down its decision in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*[1] on application of the anti-deprivation principle to flip provisions in securitisation waterfalls. Nevertheless, this decision continues to cast a shadow over securitisation markets, largely as a result of ongoing concerns from some of the rating agencies, in particular Fitch, as to the enforceability of such provisions against an insolvent swap counterparty. In many transactions, this has led to a requirement for a legal opinion on the enforceability of the flip provision under the law of the swap counterparty's incorporation. Giving this opinion does, however, open the door to a number of complex conflict of laws questions. This article discusses these issues in the context of an English law governed securitisation.

There are two questions which are relevant in considering whether a flip provision will be enforceable. First, whether the provision is enforceable as a matter of the governing law of the payment waterfall. Secondly, where the swap counterparty is incorporated in a jurisdiction other than that of the governing law, whether the flip provision will remain enforceable in the case of that swap counterparty's insolvency. This second question requires consideration of the conflict of laws rules which would apply if the swap counterparty became insolvent.

This article considers these two questions in the context of a securitisation transaction governed by English law, focusing on the position where the swap counterparty is incorporated outside England. Separate consideration is given to the position where the swap counterparty is incorporated in another EU jurisdiction and where the swap counterparty is incorporated outside the EU. The article begins with a brief analysis of the anti-deprivation principle and its application to flip provisions.

A. Flip provisions and the anti-deprivation principle

The payment waterfall for most securitisation transactions provides that amounts payable to swap counterparties are payable either in priority to or *pari passu* with amounts payable to noteholders, unless an event of default occurs in respect of the swap counterparty, in which case the swap counterparty will be subordinated to the noteholders. This arrangement has come to be known as the "flip provision".

In *Perpetual*, Lehman Brothers Special Financing Inc. ("LBSF") argued that this arrangement contravened a principle of insolvency law which has come to be known as the anti-deprivation principle ("ADP"). Put simply, the ADP makes any arrangement which deprives an entity of any of its assets as a consequence of its insolvency unenforceable, unless the deprivation falls within a limited number of exceptions. The argument advanced by LBSF in *Perpetual* was that subordination of the swap counterparty on its insolvency amounted to such a deprivation and was therefore unenforceable.

There was some confusion in *Perpetual* as to exactly what was the right which was alleged to have been deprived.[2] However, the better view would seem to be that the right to be paid in priority to the noteholders was itself an asset of LBSF. Happily for securitisation markets, the Court of Appeal rejected LBSF's argument that the flip provision amounted to a deprivation of this asset. It did so primarily on the basis that the flip provision was an integral part of the payment priorities, such that LBSF had never had more than a contingent right to priority for so long as it was not in default,[3] as well as because the collateral over which the security had been granted had been purchased with proceeds of the issuance supplied by the noteholders.[4] However, the final act in this drama is yet to be played out, as an appeal from the Court of Appeal's decision was heard in the Supreme Court in March 2011, with judgment pending at the time of writing.

The effect of the decision in *Perpetual* is that, at least for the time being, a flip provision of the kind usually employed in a securitisation transaction should be

[1] [2010] Ch 347; [2009] EWCA (Civ) 1160 ('Perpetual').

[2] Compare the analysis of Lord Neuberger MR in Perpetual (n 1) [62]–[65], in which he appears to shift from focusing on the security interest granted by the issuer to focusing on the priority right granted by the noteholders.

[3] Ibid [63]–[65] (Lord Neuberger MR) and [135] (Patten LJ).

[4] Ibid [61] (Lord Neuberger MR). For a more detailed analysis of the Court's reasoning, see Claude Brown and Timothy Cleary, 'Impact of the Global Financial Crisis on OTC Derivatives in Structured Debt Transactions' (2010) 5 Capital Markets Law Journal 218, 223–5.

enforceable as a matter of English law, particularly where, as is usually the case, the collateral has been purchased using the noteholders' subscription money.[5]

However, in parallel with the proceedings in the English Courts in *Perpetual*, LBSF brought proceedings in the US Bankruptcy Court in which it argued that the flip provision contravened the so-called "*ipso facto*" provisions in sections 365(e)(1) and 541(c) of the US Bankruptcy Code.[6] These provisions essentially prohibit any termination or modification of any contractual rights or obligations as the result of the onset of insolvency in respect of a party, or any obligation being conditional on a party not being insolvent. In these parallel proceedings, Peck J held that, notwithstanding the position under English law as the governing law of the payment waterfall, the *ipso facto* provisions of the US Bankruptcy Code prevailed, and prohibited the trustee from giving effect to the flip provision.[7] These US proceedings subsequently settled without any resolution of the conflict between the two decisions.

"The effect of the decision in Perpetual is that, at least for the time being, a flip provision of the kind usually employed in a securitisation transaction should be enforceable as a matter of English law"

"The ADP makes any arrangement which deprives an entity of any of its assets as a consequence of its insolvency unenforceable, unless the deprivation falls within a limited number of exceptions"

One important consequence of these parallel proceedings was that the rating agencies became interested in the question of what should happen where a flip provision is enforceable under its governing law, but unenforceable under the law applying to the insolvency of the swap counterparty. We will return to this question later in this article. First, however, it is necessary to consider the application of the ADP, as a principle of English law, to non-English swap counterparties.

B. Application to non-English swap counterparties

Historically, the anti-deprivation principle has been understood as existing to support the statutory insolvency regime laid down in the Insolvency Act 1986 and its predecessors.[8] In fact, in *Perpetual* the court went further, using the fact that the ADP was based on the proposition that it is not permitted to contract out of the provisions of the insolvency legislation to conclude that the courts should be wary of extending its scope too far.[9] This suggests that the principle forms part of English insolvency law, and is only relevant where the insolvent entity is subject to insolvency proceedings in England, whether directly or, for example by virtue of section 426 of the Insolvency Act 1986. However, in *Perpetual*, the insolvent entity was not an English company, and was not subject to insolvency proceedings in England. Rather, LBSF was a US entity which had filed for Chapter 11 protection under the US Bankruptcy Code. Nevertheless, it appears that it was common ground between the parties that the ADP applied in these circumstances,[10] on the basis that the Chapter 11 filing "is for the purpose of maximising the return on the insolvency and cessation of business".[11] More recently, the application of the ADP was considered again in relation to LBSF (although not in the context of a securitisation), by Briggs J in *Lehman Brothers Special Financing Inc. v Carlton Communications Limited*,[12] although this

[5] The position is slightly less clear in the case of covered bonds, where it is not possible to show that the collateral backing the guarantee from the covered bond company was actually purchased with the funds provided by the noteholders.

[6] *In re Lehman Brothers Holdings Inc, et al; Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Limited* 422 BR 402 (2010) ('*Perpetual (US)*').

[7] For a discussion of this decision see Brown and Cleary (n 4) at 226–7.

[8] See *British Eagle* at 781 (Lord Cross); *Perpetual* (n 1) [50] (Lord Neuberger MR).

[9] *Perpetual* (n 1) [57] (Lord Neuberger MR).

[10] *Perpetual* (n 1) [43] (Lord Neuberger MR). The application of the ADP to non-English insolvency proceedings was considered in more detail by the Chancellor of the High Court at first instance, in which he stated that the application of the ADP outside of English insolvency proceedings is justified both under the common law and the Cross-Border Insolvency Regulations 2006 as part of the court's obligation to co-operate with the insolvency regimes of foreign states: *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch) [48] ('*Perpetual (Ch)*'). However, this justification was at least in part based on the fact that the foreign representatives of LBSF could, under the Cross Border Insolvency Regulations 2006 ("CBIR"), commence proceedings under the Insolvency Act 1986 anyway: at [48]. This is, however, not the case where the insolvent swap counterparty is incorporated in another EU member state, as discussed in Part C of this article.

[11] *Perpetual* (n 1) [43] (Lord Neuberger MR).

time without any discussion of whether the principle should in fact apply to a non-English insolvent entity.

Whether this broader scope for the principle is correct is perhaps still an open point. Just prior to *Carlton Communications*, in *Lomas v JFB Firth Rixson*,[13] there was argument as to whether the principle should in fact apply to administration under the Insolvency Act 1986 (as opposed to winding up or liquidation),[14] and although in that case Briggs J held that the principle should apply to administration,[15] it is likely that this argument will be advanced again in the pending appeal from that decision to be heard later this year.[16] However, unless or until a court rules to the contrary, in light of *Perpetual*, it is necessary to proceed on the basis that the ADP (as a principle of the governing law of the payment waterfall) can be raised in the English courts in relation to an arrangement which deprives a party of an asset where that party is subject to insolvency proceedings, whether or not under the Insolvency Act 1986, where those proceedings are analogous to liquidation or administration. Further support for this broader scope can also be found in the earlier case law, in which the principle was considered to be founded in public policy arguments rather than necessarily in the specific statutory scheme of the Insolvency Act 1986.[17]

"It is necessary to consider the impact of the ADP in relation to any English law governed securitisation transaction which contains a flip provision, regardless of whether or not the swap counterparty is incorporated in England"

The conclusion to be drawn from this is that it is necessary to consider the impact of the ADP in relation to any English law governed securitisation transaction which contains a flip provision, regardless of whether or not the swap counterparty is incorporated in England. Fortunately, on the basis of the present authorities, this is unlikely to pose a problem in most cases. However, the fact that the ADP does apply to such arrangements — even if it applies in the negative — has important implications when it comes to considering the cross-border implications. It is to these considerations which we now turn.

"Following the decision in *Perpetual*, and the contradictory outcome in the parallel proceedings in the US, rating agencies began asking for legal opinions on the enforceability of flip provisions under the law which would govern the insolvency of the swap counterparty"

C. Cross-border considerations: EU swap counterparties

It is not standard practice for legal opinions to be required in relation to the obligations of parties to a securitisation transaction other than the issuer. Rather, the rating agencies require transaction parties, including swap counterparties, to comply with various criteria to minimise the risk that the issuer, and therefore the noteholders, will be exposed to any credit or insolvency risk in relation to those transaction parties. However, following the decision in *Perpetual*, and the contradictory outcome in the parallel proceedings in the US, rating agencies began asking for legal opinions on the enforceability of flip provisions under the law which would govern the insolvency of the swap counterparty.

In the case of a swap counterparty which is a credit institution incorporated in an EU jurisdiction, the starting point for such analysis is Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions (the "WUD"), as implemented in each member state.[18] In contrast with the position under the EUIR which allows separate primary and secondary proceedings with respect to a single

[12] [2011] EWHC 718 (Ch) ('*Carlton Communications*').
[13] *Lomas v JFB Firth Rixson Inc.* [2010] EWHC 3372 (Ch) ('*Firth Rixson*').
[14] Ibid [98].
[15] Ibid.
[16] A notice of appeal from the decision in *Firth Rixson* was filed with the Court of Appeal on 10 January 2011.
[17] See *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758, 780 (Lord Cross) and *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd* [2001] 1 WLR 1159 [88] ('*Money Markets*').
[18] See, eg, in the case of the UK, the Credit Institutions (Reorganisation and Winding up) Regulations 2004.

“Merely because US bankruptcy law contains clear provisions which apply to arrangements such as flip provisions does not mean that all jurisdictions will contain corresponding provisions”

debtor, the underlying principle of the WUD is that there should be only one set of insolvency proceedings in respect of an insolvent entity, and those proceedings should be opened in the credit institution’s home member state,[19] which corresponds to the jurisdiction in which it is regulated. As a corollary of this, the WUD provides that the applicable law governing such insolvency proceedings should be the law of the home member state, except to the extent otherwise provided in the WUD itself.[20] Article 10(2) of the WUD goes further, and expressly sets out a number of matters which are to be determined by the law of the home member state in the context of a winding up, including “the rules relating to voidness, voidability or unenforceability of legal acts detrimental to all the creditors”.[21] This would appear to cover contractual arrangements such as a flip provision, regardless of the governing law of those arrangements. It is, therefore, necessary to consider whether the insolvency law of the home member state of the swap counterparty would render such arrangements unenforceable.

It is not the intention of this article to offer a detailed analysis of the enforceability of flip provisions under the insolvency laws of each member state. However, a few observations are warranted. First, in many jurisdictions the analysis is a difficult one and, with the exception of *Perpetual* in England, the marked rarity of swap counterparty insolvencies since the flip provision became a standard feature of securitisation transactions means that the analysis must be undertaken in the absence of any useful case law.

Secondly, as mentioned above, the rating agencies’ interest in the enforceability of flip provisions arose primarily because of the contradictory judgments of the English and US courts in *Perpetual*. These differences arose because of the very clear *ipso facto* provisions in the US Bankruptcy Code and the “long-arm” jurisdictional reach of the US Bankruptcy Courts. However, merely because US bankruptcy law contains clear provisions which apply to arrangements such as flip provisions does not mean that all jurisdictions will contain corresponding provisions. Indeed, to begin with, English law does not. As has been recognised in all the English cases on the ADP, the principle is notoriously difficulty to pin down, particularly when applied to assets comprising contractual rights. Were it not for the decision in *Perpetual* it would be very difficult to give a clear answer to the question whether there is anything under English law that would affect the enforceability of a flip provision in the case of an insolvent swap counterparty.

The position is also unclear in some of the other key European jurisdictions. For example, in France, there is jurisprudence to the effect that an arrangement which increases the obligations owed by an insolvent party is unenforceable. However, there is not, as yet, any equivalent jurisprudence to suggest that reducing the insolvent party’s rights, as is the case with a flip provision, is similarly unenforceable. In the case of German law, the position is also vague. There is a general provision under Section 133 of the German Insolvency Code which could allow a flip provision to be challenged if it could be shown that in entering into the arrangements the parties had been influenced by a desire, directly or indirectly, to prejudice any creditor of the swap provider. While there are good grounds to argue that this is not the primary intention of the flip provision — its primary purpose being to avoid a swap counterparty default causing the whole securitisation to unravel — whether this is sufficient to conclude that the parties were not even indirectly influenced by a desire to prejudice other creditors is difficult to ascertain in the absence of any direct case law. Italian law also contains general principles which crystallise the

“It would, therefore, be open to the noteholders ... to provide evidence of this to prevent the application of the home member state law in any proceedings in relation to the flip provision”

[19] WUD article 3(1) (in relation to reorganisation measures) and 10(1) (in relation to winding up). In most cases the home member state will be the entity’s jurisdiction of incorporation.

[20] WUD article 3(2) (reorganisation) and 10(2) (winding up).

[21] WUD article 10(2)(l).

"The impact of article 30 of the WUD must also be considered where an English incorporated swap counterparty is a party to a payment waterfall which is governed by the law of another EU member state"

assets of an insolvent party at the point of the declaration of insolvency, and which render any modification of those assets by contractual provisions that are triggered by or become applicable after a declaration of insolvency unenforceable. In addition, there are various types of special insolvency proceedings which may apply to Italian credit institutions in relation to which the general principles just described would not apply.

There are, however, a number of carve-outs from the general scheme laid down in articles 3(2) and 10 of the WUD which may significantly reduce the difficulty of getting comfortable on the enforceability of flip provisions in the case of securitisation transactions governed by English law. Of these, the most relevant is article 30 of the WUD, which effectively disapplies articles 3(2) and 10(2)(l) in the case of legal acts which are detrimental to the creditors as a whole where the beneficiary of those acts provides proof that the act is subject to the law of a member state other than the home member state and that that other law does not allow any means of challenging the act in the case in point.[22]

A flip provision in an English law securitisation would seem to be covered by this carve-out. That is, a flip provision is a contractual arrangement — that is, a legal act — which is detrimental to the creditors of the swap counterparty, in the sense that it reduces the likelihood that the swap counterparty will be paid in full by the issuer, thereby reducing the assets available for distribution to the swap counterparty's creditors. The flip provision itself is subject to English law, which is different from the law of the home member state. Finally, and crucially, in the case of a flip provision along the lines of that which was upheld in *Perpetual*, English law does not allow any means of challenging the flip provision, or at least no means of successfully challenging the flip provision, which is the only practical way of interpreting the provision. It would, therefore, be open to the noteholders, as the beneficiary of the flip provision, to provide evidence of this to prevent the application of the home member state law in any proceedings in relation to the flip provision.

Unlike some of the other carve-outs in the WUD, which expressly state which law is to govern a particular issue, article 30 merely disapplies articles 3(2) and 10 as regards the enforceability of certain legal acts. This is unfortunate, as it means that, strictly-speaking, the WUD is silent as to what law should apply to such arrangements. There are two possible interpretations of this silence. On the one hand, given that article 30 does not disapply the basic provisions in article 3(1) and 10(1) that provide that insolvency proceedings may only be opened in the home member state, the fact that the WUD is silent as to which law should govern the enforceability of any legal acts means that recourse must be had to the applicable conflict of laws rules of the home member state to determine whether or not to apply the governing law of the arrangements — that is, English law — or the insolvency law of the home member state, as was the case in the US proceedings in *Perpetual*. Support for this conclusion may also be derived by comparing the approach in article 30 with the approach in various other carve-outs which expressly provide for which law is

"How should the English courts respond to the judgment of a foreign court that an English law flip provision is unenforceable against an insolvent non-English swap counterparty, notwithstanding that ..., the provision is enforceable under English law?"

[22] Article 30 of the WUD does not disapply all of article 10. Article 10(2)(d) provides that the law of the home member state shall apply to determine "the effects of winding-up proceedings on current contracts to which the credit institution is party". A broad interpretation of this provision would include the enforceability of such contracts. However, it is suggested that article 30 should nevertheless disapply article 10(2)(d) to the extent that it relates to enforceability. There are two reasons for this. First, although article 30(1) tracks the wording of article 10(2)(l), it does not expressly refer to that article. Rather, it disapplies article 10 "as regards the rules relating to voidness, voidability or unenforceability". Thus, to the extent that article 10(2)(d) does relate to enforceability, it is subject to the carve-out in article 30(1). Secondly, if article 30 does not apply in this way, then its scope would be severely limited, as many proceedings relating to unenforceability would remain subject to article 10(2)(d).

to apply to the subject-matter of those carve-outs.[23]

On the other hand, however, there are stronger arguments to suggest that, despite the peculiar drafting form employed, the intention behind article 30 is that the governing law of the legal act should apply to determine the enforceability of the arrangement. In particular, recital 28 to the WUD, clearly anticipating article 30, states that "[c]reditors who have entered into contracts with a credit institution before a reorganisation measure is adopted or winding-up proceedings are opened should be protected against provisions relating to voidness, voidability or unenforceability laid down in the law of the home member state where … there is no available means of contesting the act concerned in the case in point". There would be little "protection" afforded to creditors if article 30 does in fact leave the determination of the applicable law, and therefore the enforceability of the arrangements, up to the conflict of laws rules of the home member state.

This argument is amplified by the fact that Regulation (EC) No 593/2008 ("Rome I"), which provides general rules for determining the law applicable to the enforcement of contractual obligations, does not apply to "questions governed by the law of companies ... such as ... winding up".[24] Consequently, if neither article 3(1) of Rome I, nor article 30 of the WUD applies to determine the governing law of the flip provision, it would be necessary to engage in a jurisdiction-by-jurisdiction analysis of the conflicts of laws rules in order to determine which law would apply to determine the enforceability of a flip provision. This is inconsistent with the entire corpus of EU legislation governing choice of law. Therefore, even without considering the intention evident in recital 28 to the WUD, there are strong grounds for arguing that the effect of article 30 is that the enforceability of an arrangement such as a flip provision is to be determined by the governing law of the relevant contract.[25]

"The purpose of the relevant provisions was to ensure that the assets of an insolvent, or near-insolvent, company are protected for application in accordance with the collective proceedings under Chapter 11"

Finally, although the focus of this article is on securitisations governed by English law, the impact of article 30 of the WUD must also be considered where an English incorporated swap counterparty is a party to a payment waterfall which is governed by the law of another EU member state. However, this does not simply mean that the ADP is not relevant in these circumstances, because article 30 will only disapply English insolvency law where the relevant governing law does not allow any means of challenging the flip provision. This could lead to some confusing, and perhaps unintended outcomes.

"There are both striking similarities and significant differences between the types of adversary proceedings in *Rubin* and proceedings involving the ADP or equivalent rules in other jurisdictions"

First, the position under English law is somewhat unusual in that, as discussed above, it would seem that the ADP can apply to entities which are subject to some form of insolvency proceedings, even though those may not be English insolvency proceedings. However this may not be the case in other jurisdictions, where any rules that may render a flip provision unenforceable may only apply to insolvent entities which are subject to insolvency proceedings in that jurisdiction. Given that the effect of the WUD is that a credit institution may only be subject to insolvency proceedings in its home member state, this means there may be many situations where no general "anti-deprivation" or clawback provisions would be applicable. The effect of this is that, it becomes possible to contract out

[23] See, eg, WUD articles 25 and 26, which provide that netting agreements and repurchase agreements shall be governed solely by the governing law of such agreements; article 23, which provides that the opening of winding-up proceedings shall not affect set-off rights which are permitted by the law applicable to the credit institution's claim; and article 27, which provides that transactions carried out in the context of a regulated market shall be governed solely by the law of the contract which governs such transactions.

[24] Rome I article 2(f).

[25] This is also the approach suggested by Bob Wessels in his commentary on the WUD, albeit without engaging in the detailed analysis set out in this article: see Bob Wessels, 'Commentary on Directive 2001/24/EC on the Reorganisation and Winding-up of Credit Institutions' in Gabriel Moss and Bob Wessels (eds), *EU Banking and Insurance Insolvency* (OUP 2006) [2.156].

"There is considerable confusion as to whether a flip provision does in fact amount to a dealing with the property of the insolvent swap counterparty, or whether it is merely an integral feature of the priority right"

of the insolvency law of the jurisdiction of incorporation (which is also the jurisdiction of the insolvency proceedings) by choosing to have the payment waterfall governed by a law under which there are simply no rules governing arrangements such as a flip provision, at least in relation to swap counterparties not incorporated in that member state.

Secondly, article 30 will not disapply the home state law where the governing law of the arrangement *does* permit the arrangement to be challenged. This could result in contradictory outcomes, particularly if the arrangement is unenforceable in both the home member state and the state of the governing law. Perhaps the consequences would not matter much if the effect under both jurisdictions was to render the flip provision entirely unenforceable. However, conflict could arise if the law of one jurisdiction would only render the flip provision unenforceable in certain circumstances, while the other would render it entirely unenforceable. In these circumstances, the courts of the home member state would give effect to the home state law. However, if an action is brought in the courts of the state of the governing law for enforcement of the principle — as was the case in *Perpetual* — it is uncertain how the courts would approach the question. Such an action would not necessarily be insolvency proceedings as such, and therefore would not be excluded by articles 3(1) or 10(1) of the WUD. In the absence of provisions in the WUD itself precluding the courts of the governing law state from exercising jurisdiction, such conflicts would need to be resolved by the law of that state.[26] In most cases, however, it is likely that the courts of the home state would have the final say.

D. Cross-border considerations: beyond the EU

The uniform rules laid down in the WUD only apply to EEA credit institutions. For swap counterparties incorporated in any other jurisdiction, there are two key questions to be considered. First, can the insolvent swap counterparty (or its insolvency officeholder) raise an argument in the English courts (either by commencing or being joined as a party to proceedings) arguing that a flip provision is unenforceable and, if so, what law should apply to govern such an argument? Secondly, how should the English courts respond to the judgment of a foreign court that an English law flip provision is unenforceable against an insolvent non-English swap counterparty, notwithstanding that, following the ruling in *Perpetual*, the provision is enforceable under English law?

There are no easy answers to either of these questions. While *Perpetual* would initially appear to suggest that the answer to the first question is "yes", and that the English law will apply to determine whether the flip provision is enforceable, the more recent Court of Appeal decision in *Rubin v Eurofinance SA*[27] means that the answer may not actually be quite as straightforward as it appeared to be in *Perpetual*. *Rubin* is even more relevant to the second question. It is therefore useful to consider the second question first, and then return to the first question in light of that analysis.

In *Rubin*, the court was asked to consider

"It is possible that if a non-EEA swap counterparty became subject to insolvency proceedings in its home jurisdiction, and the insolvency law of that home jurisdiction contains a rule similar to the ADP under English law, the English courts may be prepared to extend the reasoning in *Rubin*"

[26] Note that in the UK, the UNCITRAL Model Law on Cross-Border Insolvency would not be applicable in England in this case, as article 2(h) of the CBIR excludes its application to EEA credit institutions. A similar exclusion applies to third country credit institutions, being non-EEA institutions which are authorised under the Financial Services and Markets Act 2000 to accept deposits or issue electronic money: see CBIR article 2(i). References in this article to "articles" of the CBIR are references to the articles in Schedule 1 to the CBIR, which implements the 1997 UNCITRAL Model Law on Cross-Border Insolvency in the UK.

[27] [2010] EWCA Civ 895 ('*Rubin*').

whether proceedings under sections 547 and 548 of the US Bankruptcy Code (referred to as the "adversary proceedings"), which are similar to the provisions in sections 238 and 239 of the Insolvency Act 1986 in relation to transactions at an undervalue and preferences, should be recognised as foreign insolvency proceedings by the English courts and, if so, whether the judgment of the US Bankruptcy Court in those adversary proceedings should be enforceable against the defendants who had not been located in the United States nor submitted to the jurisdiction of the US Bankruptcy Court. The insolvent entity was subject to Chapter 11 proceedings under the US Bankruptcy Code, and it was accepted that these Chapter 11 proceedings constituted foreign insolvency proceedings of the kind that can be recognised by the English courts either pursuant to the CBIR[28] or the common law.[29] To answer these questions, it was necessary for the court to decide whether the adversary proceedings did in fact form part of the insolvency proceedings.

Traditionally, a distinction has been drawn between proceedings which relate to determining the assets of an insolvent entity, which includes the enforceability of contractual rights held by that entity, and proceedings which relate to the distribution of those assets in accordance with a collective regime. The former are *in personam* claims, which do not form part of the insolvency proceedings, and are therefore subject to the normal conflicts of laws rules which, under English law, would only receive recognition in limited circumstances, such as where the defendant had submitted to the jurisdiction of the foreign court. The latter are insolvency proceedings which the English courts have jurisdiction to recognise under the common law.[30]

The adversary proceedings in *Rubin* resulted in judgments against the defendants ordering them to pay certain sums to the insolvent entity, and in this regard they looked like *in personam* judgments. However, as Ward LJ explained, the adversary proceedings were different from normal civil claims for payment of a debt. They were proceedings which could only be brought by the properly appointed insolvency official under the US Bankruptcy Code, just as proceedings under sections 238 and 239 of the Insolvency Act 1986 may only be brought by a liquidator or administrator.[31] In addition, the purpose of the relevant provisions was to ensure that the assets of an insolvent, or near-insolvent, company are protected for application in accordance with the collective proceedings under Chapter 11, and are not dissipated outside of that scheme.[32] They are thus central to the collective nature of insolvency proceedings.[33] For these reasons, Ward LJ concluded that the adversary proceedings did in fact form part of the Chapter 11 insolvency proceedings and, consequently, could be recognised as foreign main proceedings under the CBIR.[34] Having recognised them as such, Ward LJ held that the judgments in the adversary proceedings could be enforced against the defendants under the common law in order to give effect to unitary bankruptcy proceedings in relation to the insolvent entity.[35]

The decision in *Rubin* cannot be conclusively applied one way or the other in the context of the enforceability of flip provisions. There are both striking similarities and significant differences between the types of adversary proceedings which were recognised and enforced in *Rubin* and proceedings involving the ADP or equivalent rules in other jurisdictions. To begin with the differences, the adversary proceedings were embedded in statute, and were of a type which could only be brought by the duly appointed insolvency practitioner under the US Bankruptcy Code. Further, English insolvency law contains very similar provisions, thereby ensuring that, had the judgments in the adversary proceedings not been enforceable in the English courts, the insolvency practitioners could have commenced proceedings under section 238 or 239 of the Insolvency Act 1986 (as permitted by article 23 of the CBIR) which would have likely achieved a very similar outcome. In contrast, while the US equivalent of the ADP is to be found in the *ipso facto* provisions of the US Bankruptcy Code, the ADP itself is not codified in the

28 Ibid [41].
29 See extract from Lord Hoffmann's speech in *Cambridge Gas* discussing the principle of universality in the context of the English private international rules applicable to insolvency: ibid [43].
30 Ibid [41].
31 Ibid [49].
32 Ibid [52].
33 Ibid [61].
34 Ibid.
35 Ibid [62].

Insolvency Act 1986. Further, the ability to raise an ADP argument is not limited to the insolvency practitioners. While *Perpetual* does appear to have established that it is necessary for some form of collective insolvency proceedings to have been commenced in relation to the insolvent entity, there is nothing to prevent an aggrieved creditor of the insolvent party which happens to be a party to relevant proceedings from challenging the enforcement of a particular arrangement such as a flip provision on the basis that it contravenes the ADP.

Further, unlike a proceeding in relation to a preference or a transaction at an undervalue, which clearly relates to a *dealing with* the property of the insolvent company, there is considerable confusion as to whether a flip provision does in fact amount to a dealing with the property of the insolvent swap counterparty, or whether it is merely an integral feature of the priority right. This is one area where the approach taken under the *ipso facto* provisions in the US Bankruptcy Code differs markedly from the ADP under English law. Whereas the *ipso facto* provisions are couched in terms of actions which affect the company's property — that is, its contractual rights — in *Perpetual* the Court of Appeal clearly considered the priority right held by LBSF to be a limited or contingent right which was not altered by the onset of insolvency.[36]

Nevertheless, there are strong similarities between the ADP and the adversary proceedings which were held to be enforceable in *Rubin*. Despite the different legal form, the underlying purpose of the ADP is the same as that which underpins sections 238 and 239 of the Insolvency Act 1986 — that is, the principle forms part of the body of rules which exist to preserve insolvent estate and ensure the property of the insolvent company is available for distribution amongst the company's creditors in accordance with the collective insolvency regime.[37] The centrality of the principle to the scheme of English insolvency law is reflected in Lord Neuberger MR's statement in *Perpetual* that the principle is "based on the proposition that one cannot contract out of the provisions of the insolvency legislation",[38] which echoed the earlier comments of Lord Cross in *British Eagle* to the effect that the rule was based on the assertion that it was not possible to contract out of the *pari passu* principle.[39] This would suggest that there is at least an argument that proceedings relating to the ADP should be classified as forming part of the collective scheme of insolvency proceedings.

It is, therefore, possible that if a non-EEA swap counterparty became subject to insolvency proceedings in its home jurisdiction, and the insolvency law of that home jurisdiction contains a rule similar to the ADP under English law, the English courts may be prepared to extend the reasoning in *Rubin* so as to allow those proceedings to be recognised and enforced in England. However, one should not get too carried away with this possibility, particularly in the case of a flip provision, where the position under English law at present seems relatively clear that it does not contravene the ADP. If the foreign insolvency proceedings were to produce a different outcome, it is likely that that would mean that the relevant rules were sufficiently different from the ADP that much of the persuasive power of the reasoning in *Rubin* would no longer apply. In a case such as *Perpetual*, where all the transaction documents are governed by English law, all the assets are located in England and there are third party creditors who would be adversely affected by giving effect to the foreign proceedings rendering the flip provision unenforceable, it is difficult to see why the English courts should not adopt the same approach as they did in *Perpetual* and ignore the foreign insolvency law for the purpose of determining the enforceability of the flip provision.

To return to the first question — namely whether a non-English insolvent entity can raise an ADP argument in the English courts — the answer will essentially depend on whether the reasoning in *Rubin* is extended to such that the English court co-operates with the foreign insolvency officeholder, either under Chapter IV of the CBIR or under the common law, and gives recognition to the non-English anti-deprivation type proceedings. If they are recognised as

[36] Whether this remains the correct way to approach this issue may now be open to some doubt in light of the more recent decisions in *Firth Rixson* (n 13), *Carlton Communications* (n 12) and *Folgate London Market Ltd v Chaucer Insurance plc* [2011] EWCA Civ 328.

[37] John Armour, 'The Uncertain Flight of British Eagle' (2003) 62 CLJ 39, 40; Look Chan Ho, 'The Principle Against Divestiture and the Pari Passu Fallacy' (2010) 1 JIBFL 3.

[38] *Perpetual* (n 1) [50].

[39] *British Eagle* (n 17) 780,

[40] See CBIR article 6.

foreign main proceedings, then an automatic stay will apply under article 20(1)(a) of the CBIR to prevent any individual actions in the English courts in relation to the swap counterparty's rights, which would include the enforceability of a flip provision, unless the court decides that to do so is either contrary to public policy[40] or decides to lift or modify the stay under article 20(6) of the CBIR. On the other hand, if the proceedings are not recognised as foreign insolvency proceedings, then it would be necessary for the insolvent swap counterparty (or its representative) to bring proceedings in the English courts to apply the ADP to a flip provision.

Conclusion

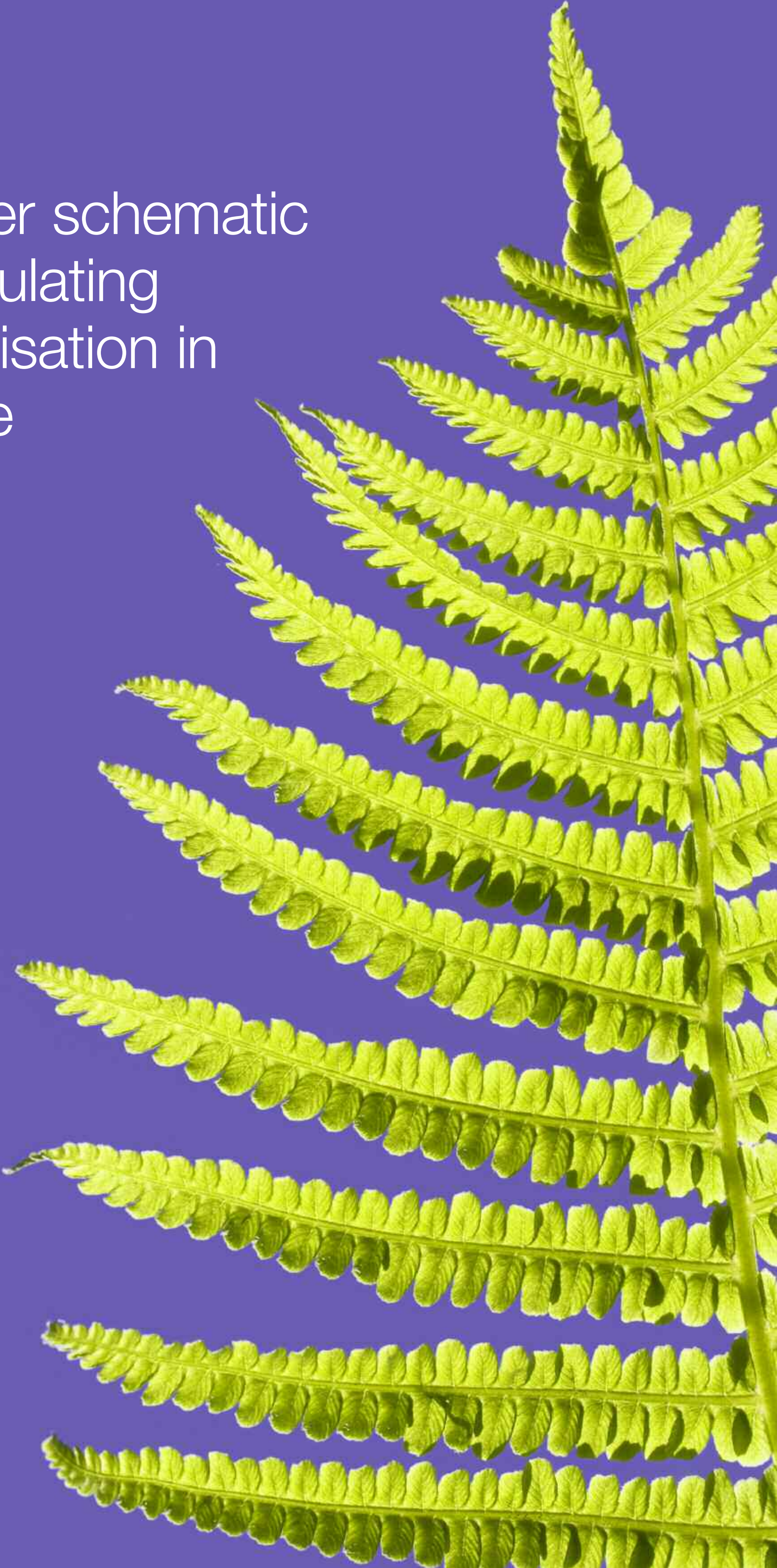
The enforceability of flip provisions in an English law securitisation waterfall will, in most cases, be enforceable under English law and will not contravene the ADP. This is the case regardless of whether the swap counterparty is incorporated in England, in another EU state or in any other jurisdiction.

There is, however, considerable uncertainty as to whether, despite its enforceability under its governing law, a flip provision would be enforceable in various other jurisdictions if insolvency proceedings were commenced against the swap counterparty in that jurisdiction. Nevertheless, in the case of a swap counterparty incorporated in another EU member state, article 30 of the WUD provides a degree of protection for a flip provision contained in an English law governed payment waterfall, on the basis that the flip provision cannot be successfully challenged under English law.

In the case of a swap counterparty incorporated outside the EU and subject to insolvency proceedings in that jurisdiction, the position will be more complex, and will depend on the degree to which any rules in that jurisdiction which are similar to the ADP can be said to form an integral part of a collective insolvency scheme such that they should be directly enforceable in England under the principles laid down by the Court of Appeal in *Rubin*.

[40] See CBIR article 6.

12. A better schematic for regulating securitisation in Europe



In many political, regulatory, investor and even social circles, the word "securitisation" is associated with "US Sub-prime", "CDO squared" or "big problem": a large dustbin into which to throw the woes and excesses of the global financial crisis of 2007. However, there are many other financings or products labelled "securitisation" that have previously provided, and will need in the future to provide, funding for the real economy or to underpin financial stability. Current regulation has effectively treated them, good or bad, all the same while excluding other transactions that involve in substance essentially the same or very similar financial products on the basis of a technical, form-based definition.

The purpose of this article is first to highlight the conceptual difficulties covered by the current "one size fits all" regulatory definition of securitisation put forward by the Basel II Accord, secondly to highlight the key factors that should differentiate products for regulatory oversight and then thirdly to propose an alternative way of categorising transactions in Europe in the context of the Basel II/CRD definitions and their use in other regulations (for example relating to credit rating agencies). This new schematic is intended initially to supplement the Basel II/CRD definitions and should assist European regulators and governments in tailoring regulatory oversight and applying existing and new regulation to these transactions in a better focussed, more logical, manner. Eventually it is to be hoped that the development of regulation along these lines will supplant the need to use the current Basel II/CRD definitions entirely.

The root of this proposal is the assertion that securitisation is a set of skills rather than a single definable product. The widespread use of these skills has caused the range of financial products commonly "badged" as securitisation to stretch from forms of secured corporate debt to exotic derivative trades. However, even though there are common elements from the securitisation skills "tool box" in many of these product types there are many more areas of divergence in the nature of the products. Consequently it can be argued that it is preferable to have a closer alignment of regulatory engagement with the product types rather than a "one size fits all" approach emphasising some abstract perceived "unifying" concept. In other words different products that may be considered as securitisation should have different analyses.

The schematic put forward in this article would undoubtedly create some "hard cases" and require some fine judgments. In our view this is both inevitable in an area that will continue to innovate over time but more importantly such cases would be considered in a more logical and appropriate manner than the many "hard cases" that are currently under consideration.

Conceptual difficulty within the definition of securitisation

The Basel II Accord included a regime for securitisation for the first time in a BIS Accord and attempted to encompass a broad range of transactions as securitisation by focussing on stratification of risk through credit tranching as the defining feature of securitisation. The Basel II definition, essentially adopted by the EC in the Capital Requirements Directive ("CRD"), has proved to be problematic: in part by being over and under inclusive in the types of transaction that are potentially included. For example layered corporate debt of an operating company in a leveraged financing can be caught whereas a single class of debt serviced by a ring-fenced portfolio of assets may not. Politicians and regulators have then exacerbated the impact of the Basel II/CRD definition by using it to underpin other regulatory initiatives ranging from rating agency supervision to risk retention where its shortcomings have caused unintended adverse consequences and often left those tasked with applying the relevant regulations, both regulators and supervised entities, confused and struggling to implement them sensibly.

Another problem with the potential breadth of the definition of securitisation lies in the overlap of political and regulatory concerns at the macro level. Put simply, it is a perceived fact that "bad" securitisations were a significant cause of the global credit crisis and should be restricted whereas it is also recognised that "good" securitisations are to be encouraged as an essential part of the solution for funding the recovery of the real economy in many jurisdictions. Until a richer appreciation is developed of how labelling something a securitisation actually relates to the nature of an individual type of financial product, this schizophrenia will persist.

Key factors in differentiating product types

How a securitisation is defined for regulatory purposes is very important to many market participants, for both legal and institutional reasons. In proposing the new schematic a number of key factors were considered to distinguish between product types. The following sets out the relevance and approach taken to these factors.

(i) *Regulatory capital relief vs securitisation positions for investors*

It is important to note that defining a transaction as a "securitisation" has an impact from two broad directions: first from the perspective of the originator of the transaction particularly where regulatory economic risk transfer is sought and secondly from the perspective of an investor in the securitisation (i.e. for these purposes a person holding a securitisation position). This distinction is recognised in Basel III/CRD, in particular the imposition of minimum requirements for significant credit risk transfer for originators to obtain capital relief and the prohibition on the originator providing implicit support to the securitisation neither of which affect the characterisation of the transaction as a securitisation for an investor. Consequently, at present, it is recognised and not uncommon for securitisation transactions to not obtain regulatory capital relief for the originator but be treated as securitisation exposures by investors and other transaction parties. The proposal set out below adapts this dual perspective and considers it a useful practical guide to regulatory treatment of certain product types.

(ii) *Ownership rights in securitised assets*

Another key consideration for securitisation, that has increasingly been marginalised in regulation, is the ownership rights to the underlying assets that are the subject of the transaction. At its inception the securitisation market was simply a technique to allow investors to own together, in the form of securities, pools of real economy assets. In other words the transaction structure, including the special purpose entity, was a convenient way for investors to hold the relevant assets: implicitly until such time as the assets performed or were disposed of. The evolution of the securitisation market has had two material developments that has diminished the extent of asset ownership – multi-layered structures and risk-transfer products. In multi-layered structures, such as typical master trusts, investors may have rights against an issuing vehicle that is a number of levels "removed" from the actual real economy assets and moreover their rights may only relate to a fraction, a proportion, of each individual asset (e.g. the "investor interest" concept common in most master trusts). In such structures actually obtaining or controlling the assets is in practice not possible. The development of structures where there is risk transfer but not ownership of the assets, for example synthetic securitisation structures, have sought to recast securitisation as a technique to transfer the risk in assets rather than their ownership and that therefore this risk can be transferred through financial products as well as by a legal sale of reference assets.

While the issue of legal ownership should not determine regulatory treatment for risk-based capital purposes, it has broader implications both for regulators in terms of issues such as managing securitisation programmes under bank resolution regimes and for investors in respect of their rights to deal with the relevant assets in default situations. Consequently there is a sound case to differentiate between structures where there are effective direct ownership rights in the assets transferred to investors and those where ownership rights are effectively retained by the originator or the securitisation scheme itself[1].

(iii) *Continual involvement of originator in generating assets*

Where a structure used in a securitisation either requires or is designed to add new assets on a continual basis over time then it is clear there will be an on-going involvement of the originator in generating assets[2]. In such circumstances it is almost invariably the case that the originator will feel compelled – either through contractual obligation or by reputational imperative – to keep generating and adding assets. The need to keep "feeding the beast" is a phrase often heard about such structures. This is true even if the rating agency analysis of the assets securitised within the structure is predominantly of a "static pool" amortising down from a fixed point of time (typically the end of the revolving/substitution period caused

[1] This would include a master trust structure where although the originator may be replaced as servicer, there will be a replacement servicer who will control the assets on behalf of the securitisation scheme, typically at a higher "tier" of the structure, rather than allowing investors to direct dealings with the assets.

[2] These are typically called "revolving" structures. The credit card and mortgage master trusts, in particular, are good examples of this type of structure. The ability to add some assets to a fundamentally amortising structure to replace fully performed or defaulted assets (i.e. broadly "substitution") does not make that structure a "revolving" structure.

by the occurrence of a trigger event). Regulators and market commentators have expressed concerns in the past about the extent to which revolving structures are effective at transferring risk on assets away from originators and onto investors. Can there be said to be a "clean break" for the originator or indeed "significant risk transfer" if it retains responsibility for continuing to add assets? It is the contention of this article that the continued involvement of the originator in generating assets for the securitised asset pool is inconsistent with ownership rights to the assets being transferred to investors and should preclude regulatory and accounting "sale" treatment. However, investors are exposed to the assets with no direct undertaking from the originator to support losses or to make payments on the relevant securities. Consequently for investors in securitisations from such structures, their exposure is likely to be a securitisation exposure to the securitised assets. This "continuing involvement" definition has also been a key aspect in connection with accounting considerations about the nature of asset sales.

(iv) *Regulating transactions vs supervising originators*

There is a tendency for regulators considering a securitisation undertaken by a bank originator to focus mainly on the transaction itself. For transactions which essentially aim to transfer ownership and control of the assets to investors, this may well be appropriate as the regulators should be concerned with the nature and extent of the continued involvement of the originator in the assets and the proceeds from the assets. However, this is likely to not be the best area of oversight when the securitisation is part of a securitisation scheme where the assets are essentially collateral for an on-going funding platform. In respect of such transactions it is the operation of the funding platform, in particular its range of maturities and ability to refinance maturing liabilities, that is the key function that should be considered by regulators. In other words when the securitisation scheme is essentially part of the on-going funding operations of the bank originator there is a strong argument it should be regulated as part of the treasury function of that bank. This difference of emphasis between when to focus on regulating transactions and when to focus on supervising originators is also a key factor used to differentiate product types in this proposed schematic.

(v) *Alignment of interests: application of retention requirements*

A particular, and topical, area where the inadequacies of the definition of securitisation has caused difficulties is the area of alignment of interest between originators/arrangers of securitisations and investors: in other words the need for "skin in the game". Article 122a of the CRD introduced for European credit institutions a restriction on acquiring exposure to the credit risk of a securitisation exposure unless the originator, sponsor or original lender explicitly disclosed that it would retain on an on-going basis a material net economic interest of not less than 5%. Recital 24 of the CRD states that the rationale for this is as follows:

"It is important that the mis-alignment between the interest of firms that "repackage" loans into tradable securities and other financial instruments (originators or sponsors) and firms that invest in these securities or instruments (investors) be removed. It is also important that the interests of the originator or sponsor and the interest of investors be aligned."

These are understandable concerns given the difficulties caused by the originate-to-distribute model in the United States sub-prime market. However, it is far less clear to see how those concerns apply to many products currently defined as securitisations. As a consequent the application of Article 122a, in effect from 1 January 2011, to many transactions has been muddled and often counter-intuitive. For example, in those secured corporate debt transactions which previously would have been known as "whole business securitisations", does the existence of tranched debt cause Article 122a to apply and if so how and why if the originator is simply a borrower under a loan for which it grants security over its assets? Alignment of interest between originator and investors here is complete and straightforward without seeking some approved mechanical form of material net economic interest.

A better approach, as put forward in this article, would be to consider how effectively alignment of interest works with regard to different types of product. So, for example, as indicated above, alignment of interest with secured corporate debt is always present and if secured treasury funding platforms are to be on-balance sheet treasury functions for bank originators with no capital reduction then again there is obvious alignment of interest between the bank originator and investors. Indeed, as an aside, a more radical but simpler regulatory approach to many of the issues around "skin-in-the-game" rules would be to say that the rules do not apply where the assets previously were held on-balance sheet of the bank originator in the banking book and the bank originator gets no reduction in regulatory capital as a result of the transaction[3].

The proposed schematic

This article proposes that types of financial products currently labelled generically as securitisations under the Basel II/CRD definitions be further grouped in accordance with the following new schematic:

- asset portfolio ownership in securities form
- lending to corporates secured on assets in securities form
- secured treasury funding platforms
- diverse portfolio investment products
- synthetic risk acquisition products

The nature and detail of regulation can then be tailored to the type of financial product.

In other words, initially at least, there would be a determination whether the financial product/transaction in question fell within the Basel II/CRD definition of a securitisation followed by a second determination of what type of financial product it was to determine the appropriate regulatory treatment (which may be that the financial product should not be treated as a securitisation at all). Over time it could be envisaged that the regulation of the types of financial product on a holistic basis, rather than on a differentiated basis due to application of a technical definition that is not based on the financial product itself, could lead to the initial determination being made redundant.

Turning to each type of financial product in turn, this article will consider the nature and typical features of the financial product as well as the direction such features indicate regulation should take.

(i) Asset portfolio ownership in securities form ("Asset Ownership")

These are the types of financial product closest to the original structures and intent of securitisation. In essence they involve identified stand-alone portfolios of assets being transferred to a special purpose entity ("SPE") which holds the assets for investors who have funded the SPE to acquire them and who are paid interest and repaid principal from the cashflow generated by that identified portfolio as it amortises over time. For a transaction to fall within this category, the asset portfolio should be static with minimal rights of substitution. From the originator's perspective the securitisation is conceptually "issue and forget"[4] as it will have transferred ownership and control of the asset portfolio to investors and will have no obligation to continue "topping up" the asset portfolio.

From the investor's perspective they will have jointly acquired ownership of the asset portfolio and their rights to deal with the asset portfolio should be commensurate with ownership – including, in certain circumstances, having the ability to require the sale of the asset portfolio. It also follows that their exposure is to the assets of the transaction and their own regulatory treatment should reflect that.

Assuming the originator does not become an investor itself to a material extent, the lack of originator ownership and control (and also neither a legal or implicit commitment to continue providing assets to the securitisation) should mean regulatory and accounting "sale" treatment is permissible for the originator.

Overall, Asset Ownership should be considered as a securitisation for regulatory purposes. In addition, given the fact that Asset Ownership is conceptually about passing ownership and the risk of ownership to investors, explicit "skin-in-the-game" requirements are justified.

(ii) Lending to corporates secured on assets in securities form ("Secured Lending")

These are types of financial product where their essence is lending to corporates secured against specified cash generative assets. Examples of such products would include structured financings of operating businesses, covered bonds and fully supported asset-backed commercial paper ("ABCP") programmes. The typical features of such financial products involve significant retention of ownership rights and continued control by the originator/conduit

[3] Other parts of Article 122a can apply even if there are no mechanical retention requirements. For example investor diligence requirements (currently set out in paragraphs 4 and 5 of Article 122a) could apply to investors in a transaction even if there is no mechanical retention in that transaction.
[4] Of course it is likely the originator will continue to service the assets under a separate contractual arrangement with the SPE.

sponsor. This can include extensive rights to change the asset portfolio through additions and removals subject to complying with covenants (which covenants themselves may be capable of amendment and re-statement). The interests of the originator/conduit sponsor are always aligned with the investor for regulatory purposes as, essentially, they always "remain on the hook" for ultimately repaying investors.

From the perspective of investors, they are secured financiers of the originator and not owners of the assets and conceptually the key consideration is the originator/conduit sponsor's covenant to pay and the security provided for that covenant. From this perspective the use of SPEs is to simplify and improve the analysis of the quality and value of the collateral.

The above considerations lead to a number of conclusions. First, the on-going originator ownership and control should preclude regulatory and accounting sale treatment for the originator. Secondly, from an investor perspective this is corporate risk of the originator/conduit sponsor secured on assets and should be marked as such. This leads to a third, and important, conclusion: Secured Lending should not be treated as a securitisation for regulatory purposes. For the avoidance of doubt this also means that retention requirements of the type promulgated in Article 122a of the CRD should not apply to Secured Lending transactions.

(iii) Secured treasury funding platforms ("Treasury Platforms")

These are structures where asset portfolios are used as collateral to raise on-going finance for the treasury operations of the originator of the relevant asset portfolio. Examples of financing through such Treasury Platforms would include revolving master trust programmes, structured repo asset swap facilities and bank lending secured and repayable by reference to the asset portfolio. For the originator such structures are "mini-treasuries" tying finance to the on-going performance of the asset portfolio and the management of on-going funding needs along a liability maturity curve. From the perspective of investors in respect of such Treasury Platforms the asset portfolio is essentially pledged to investors who are exposed to the performance of that portfolio while also relying on the on-going support of the originator. The fact that such Treasury Platforms can be used to raise different types of finance against the same portfolio of assets makes them broader than traditional single portfolio "asset ownership transfer" structures of the type referenced in (i) above.

The nature of Treasury Platforms as an on-going funding platform for an originator typically means the originator retains significant on-going control over both assets, i.e. the need to continually replenish the portfolio, and also liabilities, i.e. periodic new issuance. Much of this control is constituted by enforceable obligations both against and for the originator (e.g. the obligation on the originator to add assets and the obligation of the structure to issue when directed by the originator). However, in addition there is a significant undocumented imperative on the originator to support the platform should difficulties arise and it is apparent that this imperative underpins the analysis and investment decision of many investors even if it is not directly enforceable[5]. These on-going direct obligations and the significant undocumented imperative to provide support (i.e. a form of moral hazard for regulators to consider) as well as significant on-going control should preclude regulatory and accounting "sale" treatment for the originator for financings using the Treasury Platform. In fact there is a strong argument that regulation should focus on regulating the "treasury function" explicit in the operation of the Treasury Platform as if it were part of the wider treasury operations of the originator. It is important to note that this also means that there is on-going alignment of interest between the originator of the Treasury Platform transactions and investors as the originator will not only have explicit obligations and undocumented imperatives to support but will also retain capital against the asset portfolio held by the Treasury Platform.

On the other hand investors are directly exposed to the performance of the asset portfolio and repayment of their securities is explicitly tied to monies generated by the asset portfolio. Moreover while they may consider the "moral imperative" of the originator to

[5] For example, it is widely acknowledged that originators of large "Treasury Platform" programmes took steps to support their programmes during the financial crisis in 2007-2010.

support the programme as part of their investment decision, this is unlikely to be enforceable at law and hence should be disregarded by regulators when considering the prudent regulatory treatment for investors. This leads to the conclusion that for investors, securities issued by a Treasury Platform structure should be considered as a securitisation position.

As a result of the above, issuance through Treasury Platforms should be considered as securitisations for regulatory purposes: albeit securitisations that are always "on-balance sheet" for the originator. However, the inherent alignment of interest between the originator of the Treasury Platform and investors should mean mechanical retention requirements of the type set out in Article 122a should not apply to transactions undertaken through the Treasury Platform.

(iv) Diverse portfolio investment products ("Portfolio Investments")

Another form of financial product that has become characterised as a securitisation are structures that package together various forms of debt obligations to generate yield for investors based on a diversified portfolio of risk. These products include collateralised debt obligations ("CDOs") and their many manifestations as well as structured investment vehicles ("SIVs") and funding arbitrage vehicles such as arbitrage CP conduits. In broad terms such financial products are essentially a form of investment vehicle for investors to acquire exposure to a diversified portfolio of financial assets rather than ownership of a portfolio of substantially similar assets generated by real economy financing activity. While this is, of course, a generalisation it does highlight the need to keep this category separate: a diversified investment product versus the types of corporate exposure products or asset ownership products mentioned previously.

Investors in such Portfolio Investments in essence jointly own the assets making up the underlying portfolio(s). As the individual assets are typically acquired in the market and/or would be subject to a relatively liquid market, the logical ultimate remedy for investors in case of default should be to dispose of the portfolio assets in the market. In other words, investors' rights should be commensurate with ownership of their investment. As with all investment products, investors need to understand the investment and the assets backing their investments. To the extent the risk on the portfolio investments is tranched then under current regulation they should be, and currently are, securitisation exposures for investors. Going forward, they may also be "re-securitisation" exposures should an asset in the asset portfolio be a securitisation exposure itself.

Notwithstanding the foregoing, from an investor perspective Portfolio Investments should be regulated as a form of investment product rather than trying to squeeze them into securitisation regulation that focuses on, among other things, asset origination and servicing. Another reason to treat Portfolio Investments as a form of investor product is that it is often difficult to identify a real originator[6] as existing financial assets may be bought in the market by a portfolio manager who then packages them together. To the extent that the assets are sold by an actual "originator" (e.g. a bank selling leveraged loans into a CDO) then the likelihood of a lack of subsequent originator ownership and control should permit regulatory and accounting "sale" treatment. The corollary of this, however, is that explicit "skin-in-the-game" requirements are justified[7].

Taking the above into account, this leads to the conclusion that under current regulation, Portfolio Investments should be considered as a securitisation for regulatory purposes but going forward they would be better regulated through tailored regulation as a distinct form of investment product.

(v) Synthetic risk acquisition products ("Synthetic Risk Acquisition")

As part of the urge to create a unifying concept of securitisation (see above) regulators have been prepared to expand the scope of securitisation regulation from the traditional "ownership of assets" underpinning of securitisation into tranched risk, typically of identified assets, where no ownership rights to the assets are transferred. Hence Synthetic Risk Acquisition products are regulated currently as securitisations where there is tranching of risk, e.g. types of

[6] A problem highlighted in the CEBS Guidelines of 31/12/2010 on Article 122a of the CRD.
[7] This assertion does not mean that the objective tests for material net economic interest retention should not be better focussed for Portfolio Investment transactions.

credit default swaps, credit linked notes and other forms of credit derivatives, but not otherwise. Part of the proposal put forward by this article is to re-establish the ownership rights associated with traditional securitisation as an important de-limiter of the scope of regulation of securitisation. Consequently Synthetic Risk Acquisition products, where there is no asset ownership by investors and contractual rights only, should be regulated separately from other regulation of securitisation: in essence they are regulatory "risk mitigation" products and that is where their regulation should be based.

Of course there are some common features with "ownership" securitisation and investors need to understand underlying risk exposure. However, that is as true of "single name" exposure as much as "tranched exposure" to an asset portfolio and distinguishing between the two on the basis of a securitisation label is unnecessary and somewhat misleading. Another advantage of placing Synthetic Risk Acquisition products within risk mitigation is that it allows better, sharper regulation of "ownership" securitisation without overlaying complex and often contradictory requirements based around synthetic "risk" products[8]. This should allow the development of better, more focused regulation of securitisation going forward while allowing further development of risk mitigation for regulatory purposes.

Under current regulation Synthetic Risk Acquisition products should permit regulatory "risk mitigation" with similar capital effects for the originator to the regulatory "sale" of the relevant assets but should not allow "accounting sale" where such accounting treatment is based on the originator ceding control of the relevant assets. For investors there is risk exposure to the assets and where this risk is tranched then under current regulation this is a form of securitisation exposure. Going forward it would be preferable to develop the risk mitigation rules to reflect the risk acquired by the "protection buyer" and to take Synthetic Risk Acquisition products out of securitisation regulation entirely. These rules should also consider the extent to which explicit "skin-in-the-game" requirements apply to "protection sellers" and the precise form those requirements should take.

Next steps and conclusion

The impact of the proposed schematic set out in this article is summarised in Table 1: Summary of proposed treatment of different financial products. As can be seen it would remove some types of corporate financial product from the purview of securitisation regulation (consistent with the treatment of covered bonds) and would prohibit regulatory capital relief for certain types of product with significant on-going control and implicit support from the originator.

The schematic outlined in this article is not intended to be the last word on how to regulate securitisation. On the contrary it is intended that by setting out a better, more coherent and logical route map for regulating financial products previously lumped together as securitisation, it will allow regulators to develop more appropriate regulatory approaches to, what are after all, diverse financial products. As politicians and regulators alike grapple with differentiating between "good" and "bad" securitisations perhaps a more rewarding exercise would be to consider how to regulate the key features of different products better.

[8] For example, if securitisation is solely about tranched risk acquisition on assets why require in Basel II "true sale" for traditional securitisations at all?

Table 1: Summary of proposed treatment of different financial products

Type of Financial Product	Securitisation for Regulatory Purposes	Direct Ownership Rights	Regulatory "Sale" Possible	Accounting "Sale" Possible	Explicit Retention Requirement justified
Asset portfolio ownership in securities form ("**Asset Ownership**")	Yes	Yes	Yes	Yes	Yes
Corporate lending secured on assets in securities form ("**Secured Lending**")	No	No	No	No	No
Secured treasury funding platforms ("**Treasury Platforms**")	Yes	No	No	No	No
Diverse portfolio ownership in securities form ("**Portfolio Investments**")	Yes	Yes	Yes	Yes	Yes
Synthetic risk acquisition products ("**Synthetic Risk Acquisition**")	No[9]	No	Yes[10]	No	Possibly[11]

[9] Should be treated as part of credit risk mitigation regulation.
[10] In form of reduction in risk weightings of exposures for regulatory capital purposes.
[11] Would be part of consideration of requirements for "protection sellers" in respect of credit risk mitigation.

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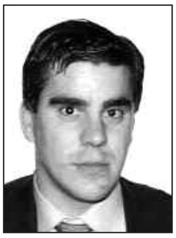

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