Securitisation: a guide to UK financial services and regulatory issues

by *Rachpal K. Thind* and *Tom Hunter*, Sidley Austin LLP

Practice notes | **Maintained** | United Kingdom

An outline of the key UK financial services and regulatory issues affecting securitisations.

This note replaces the note formerly known as *Securitisation: regulatory framework and reforms*.

Scope of this note

This note is a guide to the key UK financial services and regulatory issues that may need to be considered by those structuring, participating in, or investing in, *securitisations*. It highlights and summarises the relevant requirements; and it provides links to further guidance and commentary. For an overview of the EU regulatory regime for securitisations, see *Practice note, The Securitisation Regulation: a new EU framework*.

This note has been written primarily by reference to "traditional", "true sale" or "cash flow" securitisations, which involve a transfer of assets, as opposed to synthetic securitisations, in which the securitisation *special purpose vehicle* (SPV) gains risk exposure to the assets pursuant to a *credit default swap* or other derivative contract, but does not acquire the assets themselves. However, some of the principles discussed in this note are relevant also in synthetic securitisations (and the note briefly highlights certain issues that are specific to synthetic securitisations). In addition, this note focuses on securitisations that are funded through the issuance of securities (commercial paper, notes or bonds), rather than by way of loans (see *Marketing and funding the deal*) but most of the issues covered below would be applicable equally regardless of how the deal is funded. For further information on typical transaction structures, see *Practice Note, Types of securitisation*.

Background and context

Securitisations are complex, high-value transactions involving numerous parties, extensive documentation and, potentially, multiple jurisdictions. The range of asset-types that may be securitised is broad; and there are many different securitisation methods and structures in use.

For general background on securitisation, including information about the commercial objectives of such transactions, typical deal structures, the parties and documentation involved in securitisations and explanations of certain terminology used in this note, see *Country Q&A, Structured finance and securitisation in the UK (England and*

Wales): overview; *Practice note, Securitisation: overview* and *Practice note, Types of securitisation*.

As a result of this complexity and diversity, those involved in securitisation need to navigate a matrix of various legal and regulatory issues. This note focuses on certain UK financial services and regulatory matters that are of particular significance in the context of securitisations. However, it is not comprehensive, and there are other, broader UK financial services and regulatory issues of general application that may be relevant, including with regard to:

- **Authorisation and supervision of parties**: For example, does the entity arranging the transaction, or a manager or underwriter selling the securities funding the securitisation, have all the relevant permissions that it may require under the *Financial Services and Markets Act 2000* (FSMA) in order to perform that function; and is it in compliance with any applicable conduct of business rules in that regard? For more information, see *Checklist, When does a person or firm need FCA or PRA authorisation: flowchart*.
- **Financial crime**: For example, have all relevant parties conducted customer due diligence on other relevant parties in accordance with *The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (SI 2017/692)*, and carried out any required checks with regard to financial sanctions? For more information, see *Practice notes, Money Laundering Regulations 2017: implications for financial institutions* and *Financial sanctions: implications for financial institutions*.
- **Market abuse**: For example, if a party has acquired inside information in the course of arranging the securitisation, has it disclosed the information, or delayed its disclosure, in accordance with the *UK Market Abuse Regulation* (UK MAR); or, if one of the managers or underwriters of the securitisation engages in stabilisation of the securities, does it do so in accordance with the "safe harbour" under *article 5* of the UK MAR? For more information, see *Practice notes, UK Market Abuse Regulation (UK MAR)* and *Stabilisation* (albeit the note focuses on stabilisation in the context of shares, as opposed to debt securities).

In addition, aside from financial services and regulatory matters, there are many other legal issues that may be relevant in structuring a securitisation. These are not considered here, but see box, *Other legal issues* for examples of such issues and links to further information.

In many cases, securitisations will involve parties from more than one jurisdiction. For example, a UK originator may have made loans to obligors in the UK and the EU, which it is securitising through an Irish issuer, and potential investors may be located throughout the world. In such cases, the laws of various jurisdictions may be relevant to the transaction; and different laws may govern different aspects of the deal. This note covers only English law and does not address the laws of any other jurisdiction or any conflicts of laws issues.

Overview

This note begins with a section introducing the *UK Securitisation Regulation*, which is a key piece of legislation in relation to securitisations. It then describes the relevant issues by reference to the following broad topics and themes:

- Preliminary, structuring and general issues.
- *Receivables*: origination and selection.
- Receivables: transfer.
- Receivables: acquisition, holding and servicing.
- Marketing and funding the deal.
- Investing in the deal.
- Disclosure and reporting.

Each of these sections highlights and summarises key issues that the transaction parties and their advisers may need to consider, and provides links to further guidance and commentary.

Other legal issues

Other legal issues that may be relevant in structuring a securitisation include those relating to the following:

- Transfers of receivables (including the effect of transfer restrictions, perfection requirements, "true sale" considerations and re-characterisation risk) (see *Practice notes: Securitisation: overview: Key legal issues* and *Collateralised loan obligations (CLOs): overview: Key themes and legal issues*).
- Insolvency issues (including "bankruptcy-remoteness" of the issuer) (see *Practice notes: Securitisation: overview: Key legal issues* and *Collateralised loan obligations (CLOs): overview: Key themes and legal issues*).
- Data privacy (including as regards transfer of data by the originator and use of such data by the issuer or other parties) (see *Practice note, Data protection in corporate transactions (GDPR and DPA 2018) (UK)*).
- Tax treatment (including the issuer's liability to corporation tax and the potential application of withholding tax, value added tax and stamp duty (see *Practice note, Securitisation: tax*).
- Potential liability in respect of information included in (or omitted from) a *prospectus* or other offering document (or other materials) relating to

the securitisation, for example on the basis of misrepresentation or the making of misleading statements (see *Standard document, Memorandum on liabilities of directors in respect of a prospectus*).

The relevant legal issues, and their implications, may vary according to the nature and characteristics of the proposed securitisation. For example, in the case of a *collateralised loan obligation* (CLO) transaction, there will be a number of issues to be considered and addressed that may not arise (or that may be treated differently) in other types of securitisation.

For further information, see: *Country Q&A, Structured finance and securitisation in the UK (England and Wales): overview*.

UK Securitisation Regulation

A key piece of legislation in relation to securitisations is the *UK Securitisation Regulation*. This comprises *Regulation 2017/2402/EU* (EU Securitisation Regulation), as it forms part of UK law by virtue of the *European Union (Withdrawal) Act 2018* as amended by the *European Union (Withdrawal Agreement) Act 2020* (together, EUWA), and as amended by the *Securitisation (Amendment) (EU Exit) Regulations 2019*.

The EU Securitisation Regulation has been in effect since 1 January 2019, when it largely superseded a broadly similar regulatory regime that had been implemented under various other EU regulations and directives (Pre-2019 Rules). However, under *article 43* of the UK Securitisation Regulation, securitisations established before 2019 generally continue to be subject to the relevant Pre-2019 Rules (as onshored in the UK pursuant to EUWA or as their effect is otherwise preserved), unless new securities have been issued under the transaction on or after 1 January 2019.

This note does not consider the Pre-2019 Rules, but see *Practice Note, The Securitisation Regulation: a new EU framework: box: Grandfathering and transitional provisions* for further information regarding the applicable transitional arrangements.

The UK Securitisation Regulation applies to:

- Originators, original lenders and sponsors of securitisations.

  The UK Securitisation Regulation is generally understood to apply directly only to originators, original lenders and sponsors that are established or regulated in the UK. The legislation does not expressly provide for any such limitation in its scope, but there are a number of factors to support the market view that it is intended to be restricted in that way. However, by reason of certain requirements imposed on investors in securitisations (and as described below), in practice, the UK Securitisation Regulation can have extraterritorial effect. The result is that, for example, in the case of a US securitisation with UK investors, a US originator may need to take action in accordance with the UK Securitisation Regulation, even though not directly subject to it. See, for example, *Risk-retention requirements*, *Requirements as to credit-granting criteria* and *Investing in the deal*.

- Issuers or borrowers in securitisations.

  These are referred to in the UK Securitisation Regulation as "securitisation special purpose entities" or "SSPEs", but this note generally uses the more conventional term "issuer" or "SPV". As in the case of originators, original lenders and sponsors, the UK Securitisation Regulation is understood to apply directly only to UK issuers, but can have extraterritorial effect, such that, in practice, non-UK issuers may need to take action in accordance with the UK Securitisation Regulation.

- Certain types of investors in securitisations which are regulated under the UK financial services regime (referred to as "institutional investors").

  See box, *Institutional Investors* for full details of the categories of institutional investor.

The UK Securitisation Regulation distinguishes, in certain respects, between asset-backed commercial paper programmes (ABCP), under which securitisations are funded through the issuance of short-term securities (one year or less), and securitisations funded through the issuance of longer-term securities (notes or bonds) or through loan facilities. The regulatory principles are generally the same, in each case, but some aspects of the rules differ to reflect the specific characteristics of ABCP. For the sake of simplicity, this note focuses on the rules applicable to non-ABCP securitisations.

Note that the terms of the UK Securitisation Regulation are not identical to those of the EU Securitisation Regulation. In most cases, the differences relate directly to the onshoring of the EU Securitisation Regulation under EUWA (for example, there are references to the UK in place of references to the EU and powers are allocated to UK authorities rather than EU bodies). However, certain other amendments were made to the text of the UK Securitisation Regulation pursuant to EUWA which may mean that the requirements under the UK Securitisation Regulation do not correspond directly, in all respects, to those under the EU Securitisation Regulation. This could be significant where, for example, a securitisation is being targeted at relevant investors both in the EU and in the UK. In such a case, it may be that the requirements imposed on the former are not identical to those imposed on the latter; and this could result in additional complexity when structuring a deal to ensure compliance by both sets of investors.

Note on temporary transitional directions

Under the temporary transitional directions made by the *Prudential Regulation Authority* (PRA) and the *Financial Conduct Authority* (FCA), regulated financial firms may be required or permitted to comply with legislation and rules as in effect immediately before the end of the Brexit transition period, rather than with the current version of such legislation and rules. Those directions apply until 31 March 2022. This note describes only current law; and does not consider the application or implications for firms of the directions. For more information, see *Practice note, Brexit and financial services: temporary transitional directions*.

Institutional Investors

- An insurance undertaking or a reinsurance undertaking, as defined in *section 417(1)* of *FSMA*.
- An occupational pension scheme, as defined in *section 1(1)* of the *Pension Schemes Act 1993* that has its main administration in the UK, or a fund manager of such a scheme appointed under *section 34(2)* of the *Pensions Act 1995* that, in respect of activity undertaken pursuant to that appointment, is authorised for the purposes of *section 31* of FSMA.
- An AIFM, as defined in *regulation 4(1)* of the *Alternative Investment Fund Managers Regulations 2013*, which markets or manages AIFs (as defined in *regulation 3* of those Regulations) in the UK.
- A UCITS, as defined by *section 236A* of FSMA, which is an authorised open-ended investment company as defined in *section 237(3)* of FSMA.
- A management company, as defined in *section 237(2)* of FSMA, that is appointed to manage a UCITS.

A CRR firm, as defined by *article 4(1)(2A)* of the *UK Capital Requirements Regulation* (UK CRR) (that is, a credit institution or an investment firm).

Preliminary, structuring and general issues

This section notes a number of issues that do not relate specifically or exclusively to any of the themes considered in the sections below, but may also need to be analysed at the outset, to assess their impact on the proposed transaction. In certain cases, a rule may prohibit deals of the relevant type, or the involvement of particular parties. Alternatively, it may be necessary to include specific structural features or contractual terms to address the relevant requirements.

Restrictions on re-securitisation

If the proposed transaction would comprise a re-securitisation (that is, a securitisation in which the underlying exposures themselves are, or include, securitisation positions), it will be prohibited by *article 8* of the *UK Securitisation Regulation*, unless one of a narrow range of exemptions applies. Accordingly, the parties to a proposed re-securitisation may need to analyse the scope and terms of the exemptions to ascertain whether the deal can proceed.

For further information on the re-securitisation prohibition and the exemptions, see *Practice Note, The Securitisation Regulation: a new EU framework: Re-securitisation (Article 8)*.

Restrictions on parties

The *UK Securitisation Regulation* imposes restrictions and requirements with regard to the entities that can qualify as an issuer (in the terms of the UK Securitisation Regulation, a "securitisation special purpose entity", or SSPE), an originator or a sponsor of a securitisation.

Jurisdiction of issuer

Article 4 of the UK Securitisation Regulation prohibits an issuer being established in a jurisdiction that is considered high-risk by the Financial Action Task Force or in a jurisdiction that has not signed an agreement with the UK to ensure its compliance with certain standards promulgated by the Organisation for Economic Co-operation and Development in relation to taxation matters.

Jurisdiction of originator and sponsor in STS

Article 18 of the UK Securitisation Regulation imposes restrictions on the types of entity that can qualify as an originator or sponsor with regard to a simple, transparent and standardised securitisation (STS). For further details on STS, see *Simple, transparent and standardised securitisations*. In particular (subject to certain temporary transitional provisions with regard to securitisations notified as STS pursuant to the *EU Securitisation Regulation*):

- In the case of a securitisation other than ABCP, it cannot be designated as STS unless the originator and the sponsor are established in the UK.
- In the case of an ABCP programme or an ABCP transaction, it cannot be designated as STS unless the sponsor is established in the UK.

Purpose/substance of originator

Under *article 6* of the UK Securitisation Regulation, an entity cannot qualify as an originator for purposes of the risk-retention requirements (see *Risk-retention requirements*) if it has been established or operates for the sole purpose of securitising exposures. This is commonly referred to as the "sole purpose" test or the "substance" requirement. Binding technical standards to be made by the PRA and the FCA pursuant to article 6 (Article 6 Technical Standards) will specify in further detail the conditions of this requirement. Pending the implementation of those standards, the onshored version of the relevant EU technical standards is applicable on a transitional basis.

In many transactions, particularly where the originator is an established trading company using securitisation as one of a number of means of financing its business, this restriction is not likely to be a concern. However, in certain cases, the analysis will be less clearcut, and the parties will need to consider carefully whether the applicable conditions are satisfied, or whether it is necessary (if possible) to identify a different party to hold the required retained interest. For further information on the substance requirement, see *Practice Note, The Securitisation Regulation: a new EU framework: Risk retention: Originator*.

Risk-retention requirements

Risk-retention rules were first introduced as a result of the 2008 financial crisis, in response to regulators' concerns that defaults and losses associated with securitisations at that time had been exacerbated by the use of the so-called "originate to distribute" model. This involved arrangements in which loans were advanced with the express intention that they would be securitised in deals in which the lenders had no on-going role. The perception was that unscrupulous lenders had made risky loans (for example, without proper assessment of borrowers' creditworthiness) in the knowledge that any default would occur only after they had been securitised, and so would not cause loss to the lenders. The regulatory solution was to ensure that originators, original lenders and sponsors retain an on-going economic interest in their securitisations (sometimes known as having "skin in the game"), so that they continue to be subject to the risk of loss on the securitised receivables.

The *UK Securitisation Regulation* provides for two complementary sets of obligations in this regard:

- *Article 6* imposes on the originator, the original lender or the sponsor a requirement to retain, on an on-going basis, a material net economic interest in the relevant securitisation of not less than 5% in accordance with one of the prescribed retention methods. Those methods are set out in *article 6(3)*, as supplemented by the Article 6 Technical Standards (or, pending their implementation, the onshored version of the relevant EU technical standards), and they include, for example, the retention of an interest in a portion of the securitised receivables, or the retention of part of each class of securities funding the securitisation. See box, *Retention methods* for a summary of each prescribed method of retention. *Article 6* also prohibits the relevant entity entering into any hedge or other credit mitigation arrangement in respect of the retained interest (subject to certain limited exceptions).
- *Article 5* provides that an institutional investor is permitted to invest in a securitisation only if, amongst other things, it has verified that the originator, the original lender or the sponsor retains an interest in accordance with *article 6* or, where the originator, the original lender or the sponsor is established outside the UK, that it retains an economic interest of at least 5% in accordance with *article 6* (which, in effect, is the same as the requirement that would apply if the originator, original lender or sponsor were established in the UK).

One consequence of the restriction imposed on investors under *article 5* is that, in effect, an institutional investor must verify that an originator, original lender or sponsor retains an interest in accordance with *article 6* even where such originator, original lender or sponsor would not be directly subject to *article 6* (for example, where the originator is a US entity). By this means, in practice, *article 6* has extraterritorial application.

Retention methods

The methods of retention prescribed by article 6(3) are as follows:

- Retention of not less than 5% of the nominal value of each tranche sold to investors.
- In a revolving securitisation or a securitisation of revolving exposures, retention of not less than 5% of the nominal value of each securitised exposure.
- Retention of randomly-selected exposures that would otherwise have been securitised, if the retained exposures equate to not less than 5% of the nominal value of the securitised exposures.
- Retention of the first loss tranche in an amount of not less than 5% of the nominal value of the securitised exposures.
- Retention of a first loss exposure of not less than 5% of every securitised exposure.

Note that, in certain respects, the Article 6 Technical Standards (or, pending their implementation, the onshored version of the relevant EU technical standards) provide for alternative methods of satisfying the prescribed methods of retention.

The transaction parties will need to consider the risk-retention rules at the outset, including:

- Identifying which party (or parties) qualify as originator, original lender or sponsor for purposes of the UK Securitisation Regulation definitions; and, if there are more than one such entity, whether all or (where permitted) only one will retain the required interest.
- Determining which retention method to use, and what form the retained interest will take.

For further information on the risk-retention rules, see *Practice Note, The Securitisation Regulation: a new EU framework* and *Country Q&A, Structured finance and securitisation in the UK (England and Wales): overview*.

Simple, transparent and standardised securitisations

The *UK Securitisation Regulation* establishes a framework for the issuance of STS. A securitisation that satisfies prescribed criteria as to its simplicity, transparency and standardisation can be designated as STS. For certain types of investor, the regulatory capital treatment of an investment in STS is significantly more favourable than in the case of a non-STS securitisation (see *Capital adequacy*). The STS regime is voluntary. It is for the transaction parties to decide whether to seek STS status.

If, in principle, the transaction parties do wish to ensure that the transaction qualifies as STS, it will be necessary to assess whether it is possible to satisfy all applicable STS criteria; and, if so, to build in appropriate structural features and to include suitable terms in the transaction documentation. However, the parties will also take into account the extent to which any benefits of achieving STS status (for example, in terms of enhanced marketability, or better pricing) justify the additional burden of complying with the STS requirements.

The transaction parties may elect to engage a third party verifier to assess and confirm compliance with the STS criteria. Third party verifiers must be authorised by the FCA to perform this function. Authorised third party verifiers include Prime Collateralised Securities (PCS) UK Limited (*PCS*).

A securitisation is designated as STS upon the originator and sponsor filing with the FCA a notification of compliance with the prescribed criteria. The originator and sponsor will be liable to sanctions under the UK Securitisation Regulation if, in fact, any STS criteria are not satisfied (even if they have engaged a third party verifier to assess compliance).

For further information on STS, see *Practice Note, The Securitisation Regulation: a new EU framework*.

Derivatives: regulatory issues

In many securitisations, the issuer will enter into one or more *derivatives* contracts, typically to hedge against interest rate risk, currency risk and/or timing mismatch risk. For further information on hedging in this context, see *Practice note, Structured finance: overview: The use of derivatives in structured finance*. In such cases, the parties will need to consider the implications of *UK EMIR*, and, in particular, the classification of the issuer for purposes of UK EMIR and the applicability to the issuer of any clearing or reporting requirements with regard to the relevant derivative contracts. For further information on UK EMIR, see *Practice Note, UK EMIR*.

UK Benchmarks Regulation

The *UK Benchmarks Regulation* (UK BMR), amongst other things, imposes restrictions on the use of certain benchmarks (for example, an interest rate index) by UK-regulated firms. The UK BMR applies to activities including the issuance of securities that reference a relevant benchmark and entering into a financial contract that references such a benchmark. In general terms (but subject to certain exemptions), a benchmark can be used only if it is included on the FCA's register of benchmarks, it is provided by a UK administrator that is on that register or, if it is provided by a non-UK administrator, certain additional conditions are satisfied. Accordingly, in any securitisation that references a relevant benchmark, the transaction parties will need to check the FCA's register and ensure compliance with the provisions of the UK BMR.

In addition, if the securitisation references a relevant benchmark, and a prospectus is required to be published for purposes of offering the relevant securities, in accordance with *FSMA*, the *UK Prospectus Regulation* and the FCA's *Prospectus Regulation Rules* (see *Marketing and funding the deal*), the prospectus must include clear and prominent information stating whether the benchmark is provided by an administrator included in the FCA's register.

For further information on the UK BMR, see *Practice Note, UK Benchmarks Regulation (UK BMR)*.

Ratings requirements

The transaction parties may decide to engage *credit rating agencies* (CRAs) to issue *ratings* in respect of the securities that will finance the securitisation (for example, if such ratings would be expected to enhance the marketability or price of the securities). If so, the parties will need to consider the requirements of the *UK CRA Regulation*, and select and engage the CRAs accordingly. The following are the key issues in this context:

Restriction on use of ratings

Subject to certain temporary transitional arrangements with regard to ratings issued prior to the end of the Brexit transition period by EU CRAs, a UK-regulated firm cannot use credit ratings for regulatory purposes unless:

- The rating is issued by a CRA established in the UK and registered with the FCA in accordance with the CRA Regulation.
- The rating is issued by a CRA established in a third country certified by the FCA as equivalent for this purpose (and certain other conditions are satisfied).
- The rating is issued by a third-country CRA, but endorsed by a UK CRA.

Dual ratings

An entity seeking a credit rating on a structured finance instrument (including a securitisation) must obtain ratings from at least two CRAs on that instrument.

Use of smaller CRAs

Where an entity intends to appoint at least two CRAs, it must consider the appointment of at least one of those CRAs from among agencies that have no more than a 10% share of the structured finance credit ratings market (but is not obliged to make any such appointment).

Mandatory rotation of CRAs

Subject to certain exceptions, CRAs are prohibited from issuing ratings on re-securitisations with underlying assets from the same originator, for more than four consecutive years. Note, however, the general prohibition on re-securitisations under the UK Securitisation Regulation (see *Restrictions on re-securitisation*).

For general information on ratings in securitisation, see *Practice Note, Securitisation: overview: Rating agencies* and *The credit rating process in a securitisation* and *Country Q&A, Structured finance and securitisation in the UK (England and Wales): overview: The role of the rating agencies*.

For further information on the UK CRA Regulation, see *Practice Note, UK CRA Regulation*.

Potential characterisation as CIS or AIF

In certain respects, a securitisation may be considered to have characteristics similar to those of a fund. In particular, in general terms, both types of arrangement will commonly include the following elements:

- There are multiple parties investing in an entity.
- That entity pools the cash received from the investors and uses it to buy financial assets.
- The return to the investors may depend, at least to some extent, on the performance of the underlying assets.

For a number of reasons, the parties to a securitisation will generally wish to ensure that the arrangement is not characterised as a fund. In particular, the objective will be that the issuer should not constitute a *collective investment scheme* (CIS) as defined in *section 235* of *FSMA* or an alternative investment fund (AIF) as defined in *regulation 3* of the *Alternative Investment Fund Managers Regulations 2013* (AIFM Regulations).

In a typical securitisation, the analysis of these issues should be relatively straightforward and there would likely be a clear basis on which to argue, on general principles, that the issuer does not fall within the definition of a CIS or an AIF.

Secondly, in any event, there are specific exemptions, as follows:

- *The Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001* (CIS Order) includes an exemption, such that arrangements do not amount to a CIS if two conditions are satisfied (see *article 3* and *Schedule, paragraph 5*):
    - the rights or interests of the participants in the arrangement are represented only by instruments creating or acknowledging indebtedness within the meaning of *article 77* of the *Financial Services and Markets Act 2000*

    (Regulated Activities) Order 2001 (SI 2001/544) (RAO). *Article 77* includes bonds and other debt securities; and

    - such instruments are issued by a single body corporate other than an open-ended investment company. Although the scope of the definition of an open-ended investment company may be uncertain to some extent, it is not likely to include the issuer in a typical securitisation.

- The AIFM Regulations provide expressly that a securitisation special purpose entity is not an AIF. The meaning of the term "securitisation special purpose entity" is not the same as in the UK Securitisation Regulation, but it is defined broadly and should generally include the issuer in a typical securitisation. In addition, the FCA's guidance in *PERG 16.2G* (see Question 2.44) states that, where an SPV issues debt securities and applies the issue proceeds to acquire financial assets, the return on which is channelled back to the holders of the securities, the FCA will assume that the SPV is not an AIF so long as the arrangements fall within the exclusion for debt securities under the CIS Order (as described above).

This analysis will be more complex if a securitisation has specific features that arguably bring the issuer more clearly within the definition of a CIS or an AIF or that may cause it to fall outside the exemptions noted above. If, in such a case, the conclusion is that the transaction does (or may) constitute a CIS or an AIF (and proceeds on that basis) there would be a number of additional (and potentially onerous) regulatory requirements to be satisfied. Such requirements are beyond the scope of this note but, for further information on CIS and AIFs, see *Practice notes, Regulated activities: establishing, operating or winding up a collective investment scheme* and *UK regime for alternative investment funds (AIFs)*.

Eligible collateral conditions

The *Bank of England* (BoE) and the *European Central Bank* (ECB) each offer a number of schemes, as part of their monetary policy operations, under which banks can fund their liquidity requirements. In each case, funding is provided only on a secured basis. Each scheme's rules prescribe the assets (known as "eligible collateral") that will be accepted as security for this purpose. The requirements vary from scheme to scheme, but, in many cases, securities funding securitisations may be used as eligible collateral. The BoE and the ECB also operate certain asset purchase schemes, involving the outright purchase of assets, rather than the provision of secured finance; and, again, securities funding securitisations will commonly be one of the types of asset covered by such schemes.

In each case, the BoE and the ECB prescribe detailed criteria that must be satisfied in order for any asset (including any securities funding a securitisation) to be accepted as eligible collateral or to be acquired under an asset purchase programme. In the case of securitisations, such criteria may relate to the jurisdiction of the issuer, the characteristics of the securitised assets, the credit rating assigned to the securities funding the securitisation, the disclosure and reporting to be made available to investors and various other factors.

Therefore, if the parties to a securitisation intend that the securities should qualify as eligible collateral, or should be covered by any asset purchase programme, they will need to review all applicable criteria and then structure the transaction accordingly and include appropriate terms in the transaction documentation.

For further information on eligible collateral, see *Practice Note, Securitisation: eligible collateral for central bank operations*.

PCS Labels

PCS, as noted above, is authorised by the FCA as a third party verifier for purposes of the STS regime. As a separate (non-regulated) function (which it began to perform several years before the EU Securitisation Regulation came into force) PCS also offers a service awarding "Labels" to qualifying securitisations that apply for them.

This is a commercial (though not-for-profit) service; not a regulatory regime. Applications can be made by transaction parties and, if PCS's criteria are satisfied, it will award a True Sale PCS Label or a Risk Transfer PCS Label, as applicable. The criteria relate primarily to asset quality, transparency and simplicity. If the transaction parties intend to apply for a PCS Label, they will need to review the applicable criteria at the outset to determine whether it will be possible to comply.

For further information, see PCS's *website*.

Receivables: origination and selection

This section is the first of three that focus on the receivables (the assets that are the subject of the securitisation transaction, and which are the source of payments to the investors in the securitisation). This section highlights conditions that may need to be satisfied in originating and selecting the relevant assets in order for them to be suitable for securitisation.

The following two sections then consider certain requirements relating to the transfer of assets into the transaction, and requirements applicable to the parties that acquire, hold and service the assets.

Requirements as to credit-granting criteria

The *UK Securitisation Regulation* aims to ensure that certain minimum standards are satisfied in the origination of securitised assets, as regards credit assessments and underwriting policies, procedures and systems. As in the case of the risk-retention requirements (see *Risk-retention requirements*), there are two complementary sets of obligations:

- Under *article 9(1)*, obligations are imposed directly on originators, sponsors and original lenders, including requirements to apply the same credit-granting criteria and approval processes in all cases, whether the relevant assets are securitised or not, and to have systems in place to apply those criteria and processes in order to ensure that credit-granting is based on a thorough assessment of each obligor's creditworthiness. In addition, under *article 9(3)*, where an originator purchases assets from a third party prior to securitisation, it must verify that the third party has satisfied those conditions.

- *Article 5* provides that an institutional investor is permitted to invest in a securitisation only if, amongst other things (and subject to certain exceptions), it has verified that:
  - the originator or the original lender has granted the credits comprising the receivables on the basis of sound and well-defined criteria and clearly-defined processes; and
  - the originator or the original lender has systems in place to apply those criteria and processes in accordance with *article 9(1)* or, where the originator or the original lender is established outside the UK, it has systems in place to apply those criteria and processes to ensure that credit-granting is based on a thorough assessment of each obligor's creditworthiness (which, in effect, is the same as the requirement that would apply if the originator or original lender were established in the UK).

One consequence of this restriction under *article 5* is that, in effect, an institutional investor must verify that an originator or original lender has applied certain elements of the standards prescribed by *article 9(1)* even where such originator or original lender would not be directly subject to *article 9* (for example, where the originator is a US entity). The resulting practical implication being that the relevant aspects of the credit-granting requirements of the UK Securitisation Regulation have extraterritorial application.

Accordingly, the parties to a transaction will need to determine whether the relevant credit-granting criteria and processes comply with the requirements of the UK Securitisation Regulation. If they do not, it may not be possible to proceed with a securitisation of the relevant assets. Assuming that the assets are compliant, it may be necessary to provide to potential investors (most likely, in the prospectus or other offering document) information describing the relevant criteria and processes, so they can satisfy the requirements imposed on them under *article 5*.

Prohibition on "cherry-picking"

An originator will be subject to sanction under the *UK Securitisation Regulation* if it selects assets to be securitised with the aim that losses on the securitised assets will be higher than losses on comparable assets that it does not securitise (an approach known as "cherry-picking"). However, it is permitted to securitise assets having a higher-than-average credit risk profile, as compared to the retained assets, as long as this is clearly communicated to potential investors. See *recital 11* and *articles 6(2)* and *29* of the UK Securitisation Regulation.

These restrictions will be relevant in connection with the selection of assets for securitisation and in relation to the disclosure to be included in the prospectus or other offering document.

Prohibition on self-certified residential loans

Article 9(2) of the *UK Securitisation Regulation* prohibits the securitisation of residential loans originated on or after 20 March 2014 (which was the date on which the *EU Mortgage Credit Directive (2014/17)* came into force), if the loans were made on the basis of information about the financial status of the borrower that may not have been verified by the lender. This would include so-called self-certified mortgages where borrowers declared their income, but the lenders did not obtain any evidence to support those declarations. For further information, see *Practice Note, The Securitisation Regulation: a new EU framework: Self-certified Loans (Article 9(2))*.

STS: characteristics of receivables

If the parties intend a securitisation to be designated as STS (see *Simple, transparent and standardised securitisations*), they must ensure that the assets comply with criteria prescribed under the UK Securitisation Regulation. For example:

- The assets must all be of a single type (such as, all residential mortgages, or all auto loans, but not a combination).
- The assets must meet prescribed criteria as to their homogeneity.
- The assets must not comprise:
    - securitisation positions (so a resecuritisation, even if otherwise permitted (see *Restrictions on re-securitisation*) could never qualify as STS);
    - self-certified residential loans, whenever originated (see *Prohibition on self-certified residential loans*);
    - commercial mortgages where the deal is structured so that payments to noteholders will depend primarily on sale of the underlying property (meaning that *commercial mortgage-backed securities* (CMBS) cannot qualify as STS); or
    - any assets which are in default, or in respect of which the underlying obligor is bankrupt or otherwise credit-impaired.

See *article 20* of the UK Securitisation Regulation.

Residential mortgages and consumer finance

Common asset classes in securitisations include residential mortgages and consumer finance. Agreements of this type are generally subject to specific regulatory regimes.

Under those regimes, any failure to originate the agreement in accordance with the applicable rules, or to comply with prescribed on-going requirements, could result in the agreement being unenforceable, enforceable only with a court order or otherwise subject to challenge. Therefore, where assets of this type are proposed to be securitised, there is likely to be additional due diligence with regard to the agreements in order to assess compliance with the applicable rules.

In outline, the relevant regulatory regimes are as follows:

- The residential mortgage regime, which governs regulated mortgage contracts and certain other home finance agreements.
- The consumer credit regime, which covers regulated credit agreements and regulated consumer hire agreements (all being unsecured facilities).
- The consumer buy-to-let (CBTL) regime, which governs secured and unsecured finance arrangements with consumers relating to property that will in part, or whole, be occupied as a dwelling on the basis of a rental agreement.

Arrangements within the residential mortgage regime and the consumer credit regime are regulated by the FCA under *FSMA* and its secondary legislation, in particular the *RAO*. Consumer credit/hire agreements are also subject to the *Consumer Credit Act 1974* (CCA) and certain other consumer-protection legislation. CBTL agreements are regulated by the FCA under the *Mortgage Credit Directive Order 2015 (SI 2015/910)* (MCD Order).

Key issues to be assessed in the course of due diligence on any agreement subject to these regimes would include:

- Was the originator duly authorised under FSMA or the MCD Order, as applicable, to enter into the agreement?
- In the case of the residential mortgage regime, has the originator complied with the relevant requirements of the *FCA's Handbook* in respect of the agreement, for example, as regards the provision of pre- and post-contractual information to the borrower (under the *Mortgages and Home Finance: Conduct of Business sourcebook (MCOB)*)?
- In the case of consumer credit:
  - does the agreement comply with the requirements of the CCA with regard to content, format and execution?
  - was all required pre- and post-contractual information provided to the borrower in accordance with the CCA and the related statutory instruments, the *Financial Services (Distance Marketing) Regulations 2004 (2004/2095)* (Distance Marketing Regulations), if applicable, and, in each case, the *FCA's Consumer Credit sourcebook (CONC)*?
  - does the borrower have a right to cancel the agreement under the CCA or the Distance Marketing Regulations, or a right to withdraw from the agreement

under the CCA; and, in any such case, have the relevant time periods for cancellation or withdrawal expired?

  - is there a risk of challenge by the borrower on the basis of the unfair relationships provisions of the CCA?

- As regards CBTL, have the conditions of the MCD Order (which, again, includes requirements as to the provision of pre- and post-contractual information) been satisfied?

Note that the parties' due diligence is likely also to assess the extent to which any relevant agreement includes terms that may be unenforceable against the borrower by reason of being unfair under the *Consumer Rights Act 2015* or as a result of a breach of the prohibition on unfair practices under the *Consumer Protection from Unfair Trading Regulations 2008 (SI 2008/1277)*. However, these are matters of general consumer protection, as opposed to consumer credit regulation, and are not considered in this note.

For further information, see *Checklist, Key requirements under consumer credit regime for lenders entering into regulated credit agreements*, and Practice notes:

- *Regulated activities: mortgage-related activities*.
- *Regulated activities: home reversion and home purchase plans*.
- *Regulated activities: sale and rent back activities*.
- *Mortgage conduct of business regulation: MCOB overview*.
- *Introduction to UK consumer credit regime*.
- *Regulated activities: entering into a regulated credit agreement as lender*.
- *Regulated activities: entering into a regulated consumer hire agreement as owner*.
- *Unfair relationships under the Consumer Credit Act 1974*.
- *FCA consumer buy-to-let mortgage regime*.

Receivables: transfer

This section considers certain requirements relating to the transfer of assets into the transaction.

STS: methods of transfer

If the parties intend a securitisation to be designated as STS (see *Simple, transparent and standardised securitisations*), they must ensure that the issuer acquires the assets by way of a true sale (or by means of an assignment or transfer having the same legal effect as a true sale) that is enforceable against the seller and any third party (see *Practice notes, Securitisation: overview: True sale* and *Collateralised loan obligations (CLOs): overview: Bankruptcy remoteness*). The *UK Securitisation Regulation* prescribes certain additional conditions that must be satisfied with regard to the transfer of assets, including as to the potential impact of insolvency *clawback* provisions and the required terms for perfection of equitable assignments.

The UK Securitisation Regulation makes no specific provision for an STS framework for synthetic securitisations (in which the issuer gains risk exposure to the receivables pursuant to a credit default swap, or other derivative contract, but does not acquire the assets themselves) and such securitisations generally do not qualify for the beneficial regulatory capital treatment that is available for non-synthetic STS (see *Capital adequacy*). However, the *EU Securitisation Regulation* and the *EU Capital Requirements Regulation* are to be amended to establish an STS framework specifically for on-balance sheet synthetic securitisations (and to provide for the senior tranche of STS synthetic securitisations that satisfy certain prescribed criteria to benefit from lower capital requirements). The compromise texts of EU Regulations to effect these amendments were adopted by the Council of the EU on 16 December 2020 (see *Legal update, COVID-19: Council of EU invites COREPER to approve final compromise text of proposals to amend MiFID II Directive as part of capital markets recovery package*). Currently, it is not known whether the UK will make similar amendments to the UK Securitisation Regulation (and, if so, whether it will do so independently or only in line with the changes to be made within the EU).

For further information on true sale and synthetic securitisations, see *Practice Note, Securitisation: overview* and *Practice Note, Types of securitisation*.

Capital adequacy: significant risk transfer

If the originator in a proposed securitisation is a CRR firm within the meaning of the *UK Capital Requirements Regulation* (UK CRR) (that is, a UK credit institution or investment firm) it will be subject to the capital adequacy requirements of the UK CRR (and related rules of the PRA or FCA). Amongst other things, it will be required to hold a prescribed amount of regulatory capital to protect against the risk of default on its assets (such assets including, for example, loans it has made). Compliance with such regulatory capital requirements can have significant financial (and other) implications for CRR firms, which they will commonly seek to mitigate.

Therefore, where an originator is a CRR firm, it may be that one of its objectives in establishing the securitisation will be to enhance its regulatory capital position. Specifically, the firm may be aiming to reduce the total amount of regulatory capital it needs to hold (and the costs associated with holding such capital), or it may wish to be able to write new business without further increasing its regulatory capital requirements. For example, a bank which is currently required to hold a prescribed amount of regulatory capital in respect of a pool of personal loans made to its customers may plan to securitise those loans so that it can then make new loans but without increasing its net regulatory capital.

Firms are able to attain such regulatory capital relief by way of securitisation only where there is a significant risk transfer (SRT); that is, significant credit risk associated with the securitised assets is considered to have been transferred to third parties. Under the UK CRR and related guidance, and the rules of the PRA and the FCA, there are detailed requirements as to the terms and legal effect of the transfer of the receivables which must be satisfied in order for there to be a significant risk transfer for regulatory capital purposes. These include rules limiting the extent to which the originator can retain control over the securitised assets or can provide support to the transaction (for example, by buying back assets or covering payment shortfalls).

Where relevant, the SRT requirements will need to be assessed and addressed in the course of structuring the securitisation and drafting the transaction documents.

For a general overview of the UK CRR and links to related resources, see *Practice note, UK Capital Requirements Regulation (UK CRR)*. For further information on regulatory capital in the context of securitisation and SRT, see *Practice note, Structured finance: overview: Capital adequacy considerations*.

Receivables: acquisition, holding and servicing

This section looks at regulatory requirements applicable to the parties that acquire, hold and service the securitised assets.

Requirements for authorisation under financial services legislation

In deals where the assets to be securitised are subject to specific regulatory regimes, it will be important to ascertain whether the party that will acquire and hold the assets (typically, the issuer, although there may also be other entities involved) will itself require authorisation under the relevant regime in order to do so.

Similar issues arise also in the context of the arrangements for servicing the securitised assets. Typically, the issuer will have no personnel, facilities or systems of its own and so will not be in a position to administer the receivables itself (for example, to collect payments, to determine interest rates, to agree contract variations or to enforce borrowers' obligations). Therefore, the issuer will appoint a servicer for this purpose, which will commonly be the originator itself but could be a third party. For further information on the role of servicers, see *Practice Note, Securitisation: overview: Servicer*. The question is whether it is necessary for the issuer (as the party entitled to exercise servicing rights) and/or the servicer (as the party exercising those rights in practice) to be authorised for these purposes.

The objective will generally be to ensure that the issuer does not require authorisation, while it will commonly be the case that the servicer does need to be authorised.

As noted in *Residential mortgages and consumer finance*, the relevant asset classes in this context include regulated mortgage contracts and home finance agreements, regulated credit agreements and consumer hire agreements and CBTL agreements. For the sake of simplicity, we consider briefly below only regulated mortgage contracts. Note, however, that broadly similar principles apply also in the case of the other types of agreement referred to above, although the terms of the applicable legislation, and the related analysis, are not identical.

The starting point is that a person will require authorisation under *FSMA* to carry on activities relating to regulated mortgage contracts only if they are regulated activities prescribed by the *RAO* (and other applicable conditions are satisfied; for example, that the relevant activities are carried on by way of business).

Acquiring regulated mortgage contracts

The RAO does not prescribe acquiring regulated mortgage contracts as a regulated activity. Under *article 61(1)* of the RAO, "entering into a regulated mortgage contract as lender" is a regulated activity, but this is understood primarily to refer to the making of an agreement with the borrower; and may also encompass the variation of an existing agreement, in circumstances where the effect of the variation is such as to replace the original agreement, and the making of new advances under an existing agreement. However, the acquisition of a regulated mortgage contract, of itself, is not generally considered to amount to "entering into" the relevant agreement for purposes of article 61(1), and should not fall within any of the other regulated activities prescribed by RAO. The FCA supports this analysis in its guidance in *PERG 4.16.3*.

On this basis, an issuer should not need to be authorised under FSMA in order to acquire regulated mortgage contracts from the originator.

Servicing regulated mortgage contracts

With regard to the servicing of regulated mortgage contracts in the context of a securitisation, the following should be noted in respect of certain key provisions of the RAO:

- *Article 61(2)* prescribes "administering a regulated mortgage contract" as a regulated activity.
- *Article 61(3)(b)* defines "administering" to mean giving the borrower notifications under the contract (for example, notice of a change in interest rate) and/or taking steps to collect or recover payments from the borrower.
- However, *article 62* provides that a person will not be administering a regulated mortgage contract if that person has arranged for a third party to perform such administration and the third party is authorised under FSMA with permission to administer regulated mortgage contracts.
- There are other potentially relevant regulated activities in the context of servicing regulated mortgage contracts, in particular:
    - making arrangements for another person to enter into, or vary, a regulated mortgage contract (*article 25A(1)(a) and (b)*); and

    - advising a borrower as to entering into, or varying, a regulated mortgage contract (*article 53A*).

- However, under *articles 29A* and *54A*, where a person appoints an authorised servicer in accordance with *article 62*, certain actions by the servicer with regard to a regulated mortgage contract (such as, making arrangements with a borrower to vary a contract, or advising a borrower on entering into or varying a contract) will not result in the appointing person (such as, an issuer) carrying on such regulated activities.

Therefore, in the context of a securitisation of regulated mortgage contracts:

- Assuming the servicer's role includes the activities specified in *article 61(3)(b)* (which is likely to be the case), the servicer will need to be authorised under FSMA with permission to administer regulated mortgage contracts. It will also likely require permissions under *articles 25A* and *53A*.
- Assuming the servicer has permission under *article 61(2)*, the issuer should not need to be authorised under FSMA in connection with the servicing of the securitised mortgages or varying the terms of a regulated mortgage contract (provided that the variation does not have the effect of creating a new contract).

The FCA supports this analysis in its guidance in *PERG 4.8.5* and *PERG 4.16.4*.

For further information, see Practice notes:

- *Regulated activities: mortgage-related activities*.
- *Regulated activities: home reversion and home purchase plans*.
- *Regulated activities: sale and rent back activities*.
- *Regulated activities: entering into a regulated credit agreement as lender*.
- *Regulated activities: entering into a regulated consumer hire agreement as owner*.
- *FCA consumer buy-to-let mortgage regime*.

Conduct of business requirements under financial services legislation

If the securitised assets are subject to a specific regulatory regime and the servicer requires authorisation under FSMA in order to perform its servicing functions (see *Requirements for authorisation under financial services legislation*), the servicer will be obliged to comply with all applicable on-going conduct of business requirements under the relevant regime. These include, for example:

- For regulated mortgage contracts, MCOB.
- For regulated credit agreements, CONC.
- For CBTL, the MCD Order.

In each case, the relevant rules typically include (amongst other things) requirements with regard to disclosure and notices, amendments to agreements, arrears management and enforcement.

For further information, see Practice notes:

- *Mortgage conduct of business regulation: MCOB overview*.
- *FCA consumer credit regulation: overview of Consumer Credit sourcebook (CONC)*.
- *FCA consumer buy-to-let mortgage regime*.

Marketing and funding the deal

In some securitisations, the SPV funds its acquisition of the receivables by means of a loan facility, which may be bilateral (with a single lender) or in the form of a club or syndicated facility (with multiple lenders). However, it is much more common for deals to be funded by issuing debt securities (bonds or notes). This section highlights regulatory requirements that may be relevant in relation to the issuance of debt securities funding a securitisation.

For further information on typical transaction structures, see *Practice Note, Types of securitisation*.

Offering, issuing and selling the securities

The key issues relating to the offering, issuing and selling of securities in a securitisation are summarised below. In most respects, the relevant regulatory principles are the same as those that apply to debt securities in other contexts but (as noted under *Retail investors: Suitability test*), there is also an additional restriction imposed specifically by the *UK Securitisation Regulation*.

Accepting deposits

Accepting deposits is a regulated activity under *section 19* of FSMA and any person accepting deposits in the UK must be authorised to do so. In principle, an issuer's receipt of the proceeds of the securities funding a securitisation could constitute the acceptance of a deposit for purposes of *section 19*. However, *article 9(1)* of the RAO establishes an exemption under which (subject to one important qualification (see below)) a sum is not a deposit for these purposes if it is received as consideration for the issuance of debt securities.

Article 9(2) of the RAO provides that the *article 9(1)* exemption does not apply in the case of securities having a maturity of less than one year, unless two conditions are satisfied:

- The redemption value of the securities is no less than £100,000 (or equivalent).
- The securities are issued only to persons whose ordinary activities include acquiring, holding, managing or disposing of investments, either as principal or agent, for the purpose of their business or who may reasonably be expected to undertake those activities with investments for the purpose of their business.

In the context of securitisations, the issuer will not be authorised under FSMA. Therefore, it will need to rely on an exemption under the RAO if its receipt of the proceeds of the relevant securities would otherwise constitute the regulated activity of accepting deposits (which it may not if, for example, the issue proceeds are received outside the UK). In such a case:

- If the securities are scheduled to mature one year or more after closing, the *article 9(1)* exemption will apply.
- If the securities have a scheduled maturity date less than one year after closing, the parties will need to ensure that:
  - the securities are issued with a minimum denomination of at least £100,000 (or equivalent); and
  - provisions are included in the transaction documents (in the form of marketing legends and selling restrictions) with the aim of restricting sales of the securities to persons of the type specified in *article 9(2)*.

For further information, see *Practice note, Accepting deposits: debt securities exemption*.

Financial promotion

Section 21 of FSMA provides that a person must not communicate an invitation or inducement to engage in investment activity (an act known as financial promotion) unless the communication has been made or approved by a person authorised under FSMA or the communication is exempt. In the context of a securitisation, the distribution of the prospectus or other offering document relating to the securities is likely to constitute a financial promotion under *section 21*, as are certain communications made by managers or underwriters to potential investors; and there may be other actions taken by the transaction parties that could also fall within the financial promotion regime.

In cases where the relevant communication is not being made or approved by an authorised person, the parties will seek to rely on one or more of the exemptions under the *Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (SI 2005/1529)* (FPO). In the context of a securitisation, the exemptions most likely to be relevant are those covering communications made to investment professionals (*article 19*) or to high net worth entities (*article 49*).

Typically, the prospectus or other offering document will include a legend aimed at restricting its distribution so that it is communicated only to persons falling within an exemption under the FPO, and the subscription agreement will include a selling restriction under which the managers or underwriters agree not to take any action that would breach *section 21*.

For further information, see *Practice note, Financial promotion: overview*.

Prospectus requirements

In principle, if the relevant securities are to be offered to the public in the UK, it will be necessary to prepare a prospectus, to have it approved by the FCA and to publish it, all in accordance with the requirements prescribed by the *UK Prospectus Regulation* and the FCA's *Prospectus Regulation Rules*. Failure to do so could be an offence under *section 85(1)* of FSMA.

Preparation and approval of a UK Prospectus Regulation-compliant prospectus can be time-consuming and costly, and so transaction parties will commonly seek to apply an exemption from these requirements. The available exemptions include transactions whereby:

- Offers are made only to qualified investors (as defined in the UK Prospectus Regulation).
- Offers are made to fewer than 150 persons (other than qualified investors) in the UK.
- Offers of securities have a minimum denomination of at least €100,000.

Given the relative complexity of securitisations, the parties' intentions, in most cases, will be to market and sell the securities only to institutional investors and other sophisticated buyers. Accordingly, provisions will be included in the offering document and the transaction documents (in the form of marketing legends and selling restrictions) to restrict sales of the securities in such a way that one or more of the exemptions in the UK Prospectus Regulation will apply. On that basis, a UK Prospectus Regulation-compliant prospectus will not need to be prepared and approved, unless that is necessary by reason of the requirements relating to listing of securities (see *Listing the securities*).

For further information, see *Practice note, Prospectus Regulation: DCM: when is a prospectus required?*.

Note that similar considerations may arise under the *EU Prospectus Regulation*, if the securities are to be offered to the public in any EEA member state.

Retail investors: Suitability test

Under *article 3* of the UK Securitisation Regulation, a person is not permitted to sell a securitisation position to a retail investor (as defined in the FCA's *Conduct of Business Sourcebook* (COBS)) unless the seller has conducted a suitability test in accordance with COBS and has determined that the securitisation position is suitable for that client. In certain cases, there are additional conditions with regard to the amount to be invested by the client.

However, given the relative complexity of securitisations, the parties' intentions, in most cases, will be to market and sell the securities only to institutional investors and other sophisticated buyers in any event. In addition, in many cases, measures put in place to take advantage of exemptions relating to the UK Prospectus Regulation, the *UK PRIIPs Regulation* (see below) and the financial promotion regime will effectively preclude any offers or sales to retail investors. Consequently, the impact of the restriction under UK Securitisation Regulation will typically be limited.

Retail investors: Key information document

The UK PRIIPs Regulation requires manufacturers and distributors of certain types of debt securities that are to be sold to retail investors to prepare for investors a pre-contractual disclosure document, called a key information document (KID). These obligations apply where the relevant securities are packaged retail and insurance-based investment products (PRIIPs), which are products in respect of which the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor. Securities funding a securitisation generally would constitute PRIIPs.

Preparation of a KID, and compliance with related rules under the UK PRIIPs Regulation, can be an onerous requirement. Again, therefore (as in the case of the UK Prospectus Regulation), transaction parties are likely to seek to avoid these obligations if they can. Typically, this is achieved by including provisions in the prospectus or other offering document and the transaction documents (in the form of marketing legends and selling restrictions) aimed at precluding any sales of the securities to retail investors (as defined in the UK PRIIPs Regulation). If the securities are not sold to retail investors, the requirement for a KID does not apply.

For further information, see *Practice note, PRIIPs: debt capital markets*.

Note that similar considerations may arise under the *EU PRIIPS Regulation*, if the securities are to be offered in any EEA member state.

Product governance rules

Manufacturers and distributors of financial instruments (including securities issued to fund securitisations) are subject to so-called product governance requirements under the FCA's *Product Intervention and Product Governance Sourcebook*. In summary, these include requirements that:

- A firm that manufactures financial instruments for sale to clients must have in place processes for identifying the target market of end clients, assessing risks to that target market, ensuring that the intended distribution strategy is consistent with the target market and keeping all such matters under review.

- A firm that acts as a distributor for a manufacturer's product must have in place adequate arrangements to obtain information on the product and its approval process, and to understand the characteristics and target market of the relevant financial instrument.

In cases where the arranger and/or any manager or underwriter of securities issued to fund a securitisation are subject to these product governance rules, they will have to ensure that they comply with these obligations in their capacities as manufacturers/distributors of the relevant securities. Typically, that will be a matter for their internal legal and compliance teams. However, there will also be an impact on the prospectus or other offering document and the transaction documents, in that the offering document will need to include appropriate disclosure and disclaimers, the subscription agreement may require specific provisions regarding the respective responsibilities of the managers or underwriters and deal announcements will contain statements as to the target market assessment.

For further information, see *Practice note, FCA product governance and oversight requirements*.

Listing the securities

In certain cases, the parties will wish to arrange for the securities funding the securitisation to be listed and/or admitted to trading on a stock exchange or other market. As in other types of debt capital markets transactions, there is no obligation to do so, but there are various reasons why it may be considered appropriate. For example:

- Certain entities may be unable to invest in the securities unless they are listed/traded on an appropriate market (for example, by virtue of their internal investment policies).
- If the securities are listed and admitted to trading in accordance with the *Income Tax Act 2007*, the issuer may be entitled to take advantage of the "quoted Eurobond exemption", which would mean that interest payments on the securities would not be subject to UK withholding tax.
- More generally, there may be benefits in terms of market profile or as regards pricing or liquidity of the securities.

There are several options in this regard. For example, the parties may:

- Apply for the securities to be listed (that is, admitted to the official list) and to be admitted to trading on the Main Market of the London Stock Exchange (which is a UK regulated market within the meaning of the *UK Markets in Financial Instruments Regulation* (UK MiFIR)).

- Apply to have the securities admitted to trading on the London Stock Exchange's International Securities Market or Professional Securities Market (each of which is a multilateral trading facility and an exchange-regulated market).
- Apply for admission to listing and/or trading outside the UK. For example, it is common for securities funding securitisations to be admitted to trading on the Global Exchange Market in Ireland or the Euro MTF in Luxembourg.

In each case, the issuer (or other parties) will need to follow the prescribed rules and procedures governing the relevant applications, and the issuer will be subject to related and on-going duties and obligations, including as regards reporting and disclosure. The applicable requirements will vary, according to the jurisdiction, the nature of the market (such as, whether a main market or an *MTF*) and the identity of the selected market.

In particular, if the securities are to be admitted to listing and admitted to trading on the Main Market of the London Stock Exchange, it will generally be necessary to prepare a prospectus in accordance with the *UK Prospectus Regulation* (even if that would otherwise not be required because the issuer could rely on a public offer exemption, as described under *Prospectus requirements*). However, this is not the case for securities admitted to trading on an MTF, which have less extensive reporting and disclosure requirements.

Note also that, if the securities funding the securitisation are admitted to trading on a UK regulated market within the meaning of the UK MiFIR, the issuer will be subject to certain on-going requirements under the FCA's *Disclosure Guidance and Transparency Rules*, including as regards the provision of information to investors and to the public. These rules also include certain provisions that go beyond reporting requirements (such as, obligations as to the equal treatment of investors). Certain requirements under these Rules (including as regards the publication of annual and semi-annual financial reports) are disapplied in the case of issuers that have only issued securities in denominations of €100,000 (or equivalent) or more; which is likely to be the case for a securitisation SPV.

In any particular case, as a general matter, the rules and procedures governing an application for admission to listing and/or trading, and the initial and on-going obligations imposed on the relevant issuer, will be the same for securities funding a securitisation as for debt securities issued in other contexts (although, for example, there may be differences in terms of the nature of the information required to be disclosed).

For further information, see:

- *Practice Note, Bond issues: tax*.
- *Practice Note, Listing debt securities in London: FCA and LSE markets*.
- *Practice Note, Listing debt securities in Luxembourg*.
- *Practice note, Prospectus Regulation: DCM: when is a prospectus required?*.
- *Country Q&A, Debt capital markets in Ireland: regulatory overview*.

Investing in the deal

This section highlights requirements applicable to institutional investors (or to certain classes of institutional investor) in connection with their investments in securitisations.

Due diligence

Under *article 5* of the *UK Securitisation Regulation*, institutional investors must comply with a number of due diligence requirements before they invest in a securitisation and must satisfy certain on-going obligations for as long as they continue to hold their investments.

These provisions, although imposed on investors, are intended (amongst other things) as a means of ensuring compliance by originators, original lenders, sponsors and issuers with their obligations under *articles 6*, *7* and *9* of the UK Securitisation Regulation. The due diligence requirements under *article 5* also, in effect, result in elements of *articles 6*, *7* and *9* of the UK Securitisation Regulation having extraterritorial application. This position arises because, in cases where the originator, original lender, sponsor or issuer would not be directly subject to the UK Securitisation Regulation (for example, where it is a US entity), institutional investors must verify compliance with requirements the same as, or very similar to, those specified in *articles 6*, *7* and *9*.

In summary, prior to investing in a securitisation, an institutional investor must verify that:

- The originator or the original lender has granted the credits comprising the receivables on the basis of sound and well-defined criteria and clearly-defined processes.
- The originator or the original lender has systems in place to apply those criteria and processes in accordance with *article 9(1)* of the UK Securitisation Regulation or, where the originator or the original lender is established outside the UK, it has systems in place to apply those criteria and processes to ensure that credit-granting is based on a thorough assessment of each obligor's creditworthiness (which, in effect, is the same as the requirement that would apply if the originator or original lender were established in the UK). See *Requirements as to credit-granting criteria*.
- The originator, the original lender or the sponsor retains an economic interest in accordance with *article 6* of the UK Securitisation Regulation or, where the originator, the original lender or the sponsor is established outside the UK, it retains an economic interest of at least 5% in accordance with *article 6* (which, in effect, is the same as the requirement that would apply if the originator, original lender or sponsor were established in the UK). See *Risk-retention requirements*.
- The originator, sponsor or issuer has, where applicable, made available the information required by *article 7* of the UK Securitisation Regulation or, where the originator, sponsor or issuer is established outside the UK, information

substantially the same as would have been required if the originator, sponsor or issuer were established in the UK. See *Transparency requirements under the UK Securitisation Regulation*.

Prior to investing in a securitisation, an institutional investor must also conduct a due-diligence assessment of the proposed investment, including as to the risk characteristics of the investment and of the receivables, the structural features of the securitisation that could materially impact the performance of the investment and, in the case of STS, its compliance with the STS criteria prescribed by the UK Securitisation Regulation (see *Simple, transparent and standardised securitisations*).

In addition, an institutional investor must comply with a number of related on-going requirements for as long as it holds an investment in a securitisation: see box, *On-going monitoring and reporting* for details.

On-going monitoring and reporting

In summary, an institutional investor must:

- Establish procedures for on-going monitoring of compliance with the conditions relating to credit-granting, risk-retention and transparency.
- Establish procedures for on-going monitoring of the performance of its investment and of the receivables.
- Perform appropriate stress tests on cashflows and on the value of the collateral supporting the receivables.
- Ensure internal reporting to its management body, so that the management body is aware of the materials risks arising from the investment and those risks are adequately managed.

Be able to demonstrate to its competent authority (such as, in the case of a UK-regulated bank, the PRA) that it understands the investment and the receivables and has implemented appropriate procedures and maintains records regarding compliance with the due diligence requirements.

If an institutional investor fails to comply with *article 5* of the UK Securitisation Regulation, it may be subject to an additional regulatory capital charge in respect of its investment in the securitisation (if it is a CRR firm (see *Capital adequacy*) or an insurance or reinsurance undertaking) or other regulatory requirements or sanctions.

Therefore, in a securitisation targeted at institutional investors, the transaction parties will need to consider at the outset how to facilitate compliance by those investors with their obligations under *article 5*. This will be relevant in structuring the transaction (for example, to provide for risk-retention), but will also require the provision of adequate information to relevant investors (for example, as regards the receivables and the credit-granting criteria) and the establishment of systems for providing the disclosure required in accordance with *article 7* of the UK Securitisation Regulation (see *Transparency requirements under the UK Securitisation Regulation*).

Capital adequacy

As noted under *Capital adequacy: significant risk transfer* a CRR firm within the meaning of *UK CRR* (that is, a UK credit institution or investment firm) will be subject to the capital adequacy requirements of the UK CRR (and the related rules of the PRA or FCA). Amongst other things, it will be required to hold a prescribed amount of regulatory capital to protect against the risk of default on its assets.

In this regard, the UK CRR makes specific provision for assets that comprise "securitisation positions", being exposures to (that is, investments in) "securitisations", as that term is defined in the UK Securitisation Regulation. In certain respects, the treatment of a securitisation position may be more favourable to the CRR firm than the treatment that would have been applied if the firm had held an exposure directly to the underlying assets (such as, the loans or other receivables that have been securitised). In other words, the firm may have to hold less regulatory capital than would otherwise have been the case. Conversely, the treatment may be more onerous in certain circumstances. In broad terms, the applicable treatment is achieved through the application of adjusted risk-weights (which are one element of the formula by which the regulatory capital requirement is calculated).

The relevant provisions of the UK CRR distinguish between STS and non-STS securitisations; and lower risk-weights may be applied to STS that satisfy certain prescribed criteria. The rules also distinguish between synthetic and traditional securitisations.

If a CRR firm fails to comply with *article 5* of the *UK Securitisation Regulation* (see *Due diligence*), and its breach is material and occurs by reason of negligence or omission, the PRA or the FCA (as applicable) is required to impose an additional risk-weight in respect of the relevant securitisation exposure, by way of sanction for the breach. That additional risk-weight can be between 250% and 1,250%, thus significantly increasing the firm's regulatory capital requirements (and related costs).

There are other elements of the UK CRR that are relevant in the context of securitisations, including certain rules (for example, as regards the so-called liquidity coverage ratio) that make specific provision with regard to STS and other securitisations.

The relevant provisions of the UK CRR and the related rules are complex (and are subject to on-going review and amendment), and beyond the scope of this note. For a general overview of the UK CRR and links to related resources, see *Practice note, UK Capital Requirements Regulation (UK CRR)*.

Disclosure and reporting

This section considers certain requirements relating to disclosure and reporting in securitisation transactions. These are in addition to the other disclosure obligations described in this note, such as the requirements that apply:

- In connection with the initial marketing and offering of securities funding a securitisation (for example, under *FSMA*, the *UK Prospectus Regulation* and the FCA's *Prospectus Regulation Rules*), as described under *Marketing and funding the deal*.
- When securitisations are used as eligible collateral for purposes of the BoE or ECB funding or liquidity schemes, as described under *Eligible collateral conditions*.

Transparency requirements under the UK Securitisation Regulation

The EU legislation that preceded the *EU Securitisation Regulation* (from which the *UK Securitisation Regulation* is derived) required relevant investors to conduct due diligence in respect of securitisations and (in certain cases) included limited obligations on originators, original lenders and sponsors to make information available to investors for that purpose. However, those disclosure obligations were only briefly stated and limited in scope. There was a perception that extending the disclosure obligations would protect investors (by enabling them to conduct more thorough due diligence, both at the outset and on an on-going basis) and that increased transparency would enhance the securitisation market generally. Therefore, new requirements were imposed on originators, original lenders and sponsors, first through provisions in the *EU Credit Ratings Agency Regulation* (which never came fully into effect) and then through the EU Securitisation Regulation. The relevant requirements now apply in the UK under the UK Securitisation Regulation.

The transparency requirements are prescribed by *article 7* of the UK Securitisation Regulation, as supplemented by binding technical standards (*FCA 2020/80*) in the onshored versions of *Commission Delegated Regulation (EU) 2020/1224* and *Commission Implementing Regulation (EU) 2020/1225* (Article 7 Technical Standards).

The requirements are imposed on the originator, the sponsor and the issuer. However, in each securitisation, the relevant entities must designate one of their number to fulfil the applicable obligations. For example, in a deal that involves an originator (but no sponsor), while both the originator and the issuer may be subject to *article 7*, responsibility for day-to-day compliance must be allocated to one or the other.

In each case, the required information must be made available not only to investors in the securitisation, but also to:

- The competent authorities responsible for supervising the relevant originator, sponsor and issuer (in the case of regulated entities, the FCA, the Pensions Regulator or the PRA, as applicable). However, where the relevant competent authority is the PRA or the FCA, the relevant entities are required to deliver to them only a prescribed notification form and not the documents and information prescribed by *article 7* (unless otherwise requested by the relevant authority) (see *PRA/FCA Direction, Reporting of private securitisations*).

- Potential investors (but only on request).

For certain purposes, *article 7* of the UK Securitisation Regulation distinguishes between securitisations in which a prospectus is required under *FSMA*, the *UK Prospectus Regulation* and the FCA's *Prospectus Regulation Rules* (commonly referred to as public securitisations) and deals in which such a prospectus is not required (private securitisations).

In particular, in the case of a public securitisation, the documents and information prescribed by *article 7* must all be made available through a securitisation repository. A securitisation repository is an entity approved and registered as such by the FCA, which operates a system for collating and publishing the relevant data. If, at any time, no securitisation repository has been registered, the data can be made available through a website meeting prescribed criteria. The parties to a private securitisation need not use a securitisation repository and can implement their own arrangements for making the information available.

The following must be made available at the outset (the requirement under *article 7* is that this information be made available prior to pricing of the securitisation, although, in certain respects, that may not be feasible):

- Documentation that is essential for understanding the transaction (the transaction documents).
- In a private securitisation, a transaction summary.
- In an STS securitisation, the STS notification (see *Simple, transparent and standardised securitisations*).

In addition, the following must be made available on a quarterly basis (or, in the case of ABCP, on a monthly basis):

- Loan-level data (that is, information relating to the receivables).
- Investor reports including information on performance of the underlying exposures, events that have triggered changes in the priority of payments or replacement of counterparties, cashflow data and risk-retention.

For both loan-level data and investor reports, the required information must be made available in accordance with the applicable templates prescribed by the Article 7 Technical Standards. There are different templates to be used, according to the nature of the receivables (for example, residential mortgages, automobile finance or credit cards) and according to whether the deal is an ABCP securitisation or not.

Finally, *article 7* also requires disclosure of any inside information that the originator, sponsor or issuer is required to disclose under the *UK MAR* or, where the UK MAR does not apply, any information relating to significant events such as a material breach, or material amendment, of the transaction documents or a change in structural features or risk characteristics that materially impact the performance of the securitisation. The Article 7 Technical Standards prescribe templates for these disclosures for use in public securitisations, but not for private securitisations.

Accordingly, in a securitisation in which the originator, sponsor or issuer is established in the UK, the transaction parties will need to ensure that all required documents and information are made available in accordance with *article 7* at the outset of the securitisation. They will also need to establish systems and procedures for collating the data required to be made available periodically and for generating reports in accordance with the applicable templates. In addition, if it is a public securitisation, they will need to enter into a contract with a securitisation repository for publication of the prescribed information.

In cases in which the originator, sponsor and issuer are established outside the UK, as noted under *Due diligence*, institutional investors are obliged by *article 5* of the UK Securitisation Regulation to verify only that the originator, sponsor or issuer has, where applicable, made available information "substantially the same" as would have been required if the originator, sponsor or issuer were established in the UK. The scope and effect of this requirement (in respect of which there is no corresponding provision in the EU Securitisation Regulation) are uncertain; and it is not currently clear what information an originator, sponsor or issuer would need to provide in order for an institutional investor to satisfy the relevant obligation under *article 5*.

END OF DOCUMENT